

# **Financing deposit guarantee schemes after the current financial crisis**

*Christos Vl. Gortsos*

*Associate Professor of International Economic Law*

*Secretary General of Hellenic Bank Association*

EFDI Seminar: October 2009

# A. The bank safety net

Public authorities are heavily concerned with the vulnerability of the banking system to economic and financial shocks, and the preservation of its stability and soundness. In order to prevent the evolution of negative externalities in the form of contagious bank failures, they command a wide set of instruments which comprise the so called “bank safety net”. According to **Guttentag and Herring**, the components of the bank safety net can be viewed as:

*“a series of circuit breakers designed to prevent a shock to one part of the financial system from surging through the financial network to damage the rest of the system.”*

Even though the various components of this “crisis prevention, resolution and management system” are somewhat complementary, each has a specific contribution to the preservation of stability in the banking and more generally in the financial market.

# A. The bank safety net

## Bank safety net components

- Authorisation of credit institutions
- Micro-prudential and macro-prudential supervision of credit institutions
- Reorganisation and winding-up of credit institutions
- **Operation of deposit guarantee schemes**
- Last resort lending
- Neutralisation by the monetary authority of any shift in the public's excessive demand for cash in periods of crisis

## B. Objectives of deposit guarantee schemes

The failure of coordination among depositors under adverse market conditions, leading to runs and panics, can be solved either by suspending the convertibility of deposits into cash or by deposit guarantees. A deposit guarantee scheme is an arrangement between banks, with or without the participation of the government and/or the central bank, which guarantees the default-free character of deposits in the presence of bank failure. The existence of a scheme assuming the obligation to compensate depositors if their bank is closed down, has a dual function:

- First, it assures small and unsophisticated depositors that the guarantee fund will compensate them if their bank is unable to convert their deposits into cash
- Secondly, it protects the banking system from the massive withdrawal of funds by panic-stricken depositors. Deposit guarantee schemes alleviate some of the inherent problems leading to runs and panics.

# C. Attributes of deposit guarantee schemes

Deposit guarantee schemes, either public or private, are characterised by **five (5) main attributes**:

- the scheme assumes **an explicit obligation**; when a bank fails, the scheme is required to reimburse its depositors to the extent that their financial claims are covered,
- the guarantee provided by the scheme is **non-discretionary**; once the operation of the bank has been terminated, depositors have a direct claim for reimbursement against the deposit guarantee scheme, no matter why the bank has failed,
- deposit guarantee is an ***ex-ante* safe instrument for depositors**; it makes them certain of reimbursement, dampening hence the incentives for banking runs and panics,
- **the level of protection** offered by the scheme is **usually limited**; the value of the intervention has a ceiling depending on the amount of covered deposits and the percentage guaranteed,
- in principle, the cost of bank failures is charged to the banking system (**no taxpayers' money solution**), which is funding the scheme either through annual contributions of its members or *ex post* with the amounts required for reimbursement when a bank has been closed down

# D. Negative effects of deposit guarantee schemes

However, there are three main negative effects of deposit guarantee schemes:

- Moral hazard: participation in a deposit guarantee scheme enables bank managers to finance risky assets with partially insured liabilities. Excessive risk-taking is also made possible by the fact that insured depositors lack the incentive to monitor and control their bank. For these reasons it is claimed that the existence of deposit guarantee undermines the safety of banks and creates *per se* the need for enhanced prudential supervision.
- The *ex post* treatment of small and large banks participating in a deposit guarantee scheme can under circumstances be unequal. Governments may feel urged to bail-out depositors of large failing banks, if these are considered “too-big-to-fail”, or, more accurately “too-big-to-be-left-to-fail” (and in some cases “too-interconnected-to-be-left-to-fail”), due to the extent of the losses they would cause to their creditors. Hence, depositors in large banks may be covered *ex post* more comprehensively than those of other banks.
- The position of uninsured depositors is also ambiguous. Those at large banks are implicitly insured, while those at smaller institutions have to incur the losses from the failure. As a result of this discriminatory policy, small depository institutions operate at a disadvantage when competing with large ones, and market discipline is less effective throughout the system.

# E. Financing alternatives

1. Ex-ante vs. ex-post vs. mixed systems: criteria of decision-taking:
  - availability of funds
  - banks' outflows
  - moral hazard
2. Considerations for ex-ante systems:
  - what is the optimal size of the fund in the presence of large banks, especially if these are “too-big-to-fail” ?
  - what is the optimal size of the fund in order to provide compensation in the case of a generalised crisis ?
  - entry and exit costs
3. Borrowing arrangements in mixed systems

# E. Financing alternatives

4. A less evident but mostly important dimension: the “post crisis” size of deposit guarantee schemes
  - the role of DGSs in the resolution of distressed banks in order to minimise its own losses
  - forbearance (recognition – reaction lags) vs. prompt corrective action
  - when should a DGS intervene: when deposits “become unavailable” or before ?
  - how should a DGS co-exist with supervisory authorities ?
5. The European framework:
  - (a) should all these aspects be harmonised ?
    - one size fits for all ?
    - the role of *ex post* state financing
  - (b) can all these aspects be harmonised ?



## **TABLE 1: EUROPEAN BANKING LAW**

### **Provisions for Community credit institutions within the single financial area**

#### **A. Provisions on the rules according to which regulatory intervention is exercised**

<b>Financial policy instruments</b>	<b>Extent and level of harmonisation</b>
Authorisation of credit institutions	<ul style="list-style-type: none"><li>• full-extent harmonisation</li><li>• minimum harmonisation</li></ul>
Micro-prudential supervision of credit institutions	<ul style="list-style-type: none"><li>• limited-extent harmonization</li><li>• minimum harmonization</li></ul> smoothed by “level 3” legal acts adopted by CEBS
Reorganisation and winding-up of credit institutions	no harmonisation
Operation of deposit guarantee schemes	<ul style="list-style-type: none"><li>• limited-extent harmonisation</li><li>• minimum harmonization</li></ul>

## **TABLE 2: EUROPEAN BANKING LAW**

### **Provisions for Community credit institutions within the single financial area**

#### **B. Provisions on the authorities and schemes competent for the exercise of regulatory intervention**

<b>Financial policy instruments</b>	<b>National vs. supranational competent authorities and schemes</b>	<b>Competent authorities and schemes for foreign establishments of Community credit institutions in other member states</b>	
		<b>for foreign branches</b>	<b>for foreign subsidiaries</b>
Authorisation of credit institutions	National supervisory authorities	home member state supervisory authorities	<ul style="list-style-type: none"><li>• supervisory authorities of subsidiary's home member state</li><li>• consultation and exchange of information between supervisory authorities of parent and subsidiary credit institutions</li></ul>

## TABLE 2: EUROPEAN BANKING LAW

### Provisions for Community credit institutions within the single financial area

#### B. Provisions on the authorities and schemes competent for the exercise of regulatory intervention

Financial policy instruments	National vs. supranational competent authorities and schemes	Competent authorities and schemes for foreign establishments of Community credit institutions in other member states	
		for foreign branches	for foreign subsidiaries
Micro-prudential supervision of credit institutions	National supervisory authorities	<ul style="list-style-type: none"> <li>• home member state supervisory authorities (for solvency)</li> <li>• host member state supervisory authorities (for liquidity)</li> </ul>	<ul style="list-style-type: none"> <li>• on a solo basis: supervisory authorities of subsidiary's home member state</li> <li>• on a consolidated basis: supervisory authorities of parent credit institution</li> </ul>

## **TABLE 2: EUROPEAN BANKING LAW**

### **Provisions for Community credit institutions within the single financial area**

#### **B. Provisions on the authorities and schemes competent for the exercise of regulatory intervention**

<b>Financial policy instruments</b>	<b>National vs. supranational competent authorities and schemes</b>	<b>Competent authorities and schemes for foreign establishments of Community credit institutions in other member states</b>	
		<b>for foreign branches</b>	<b>for foreign subsidiaries</b>
Reorganisation and winding-up of credit institutions	National supervisory and/or judicial authorities	home member state competent authorities	competent authorities of the subsidiary's home member state

## TABLE 2: EUROPEAN BANKING LAW

### Provisions for Community credit institutions within the single financial area

#### B. Provisions on the authorities and schemes competent for the exercise of regulatory intervention

Financial policy instruments	National vs. supranational competent authorities and schemes	Competent authorities and schemes for foreign establishments of Community credit institutions in other member states	
		for foreign branches	for foreign subsidiaries
Operation of deposit guarantee schemes	National deposit guarantee schemes	<ul style="list-style-type: none"> <li>• home member state scheme</li> <li>• host member state scheme (in case of “topping-up”)</li> <li>• cooperation between home and host member state schemes (in case of “topping-up”)</li> </ul>	scheme of the subsidiary’s home member state