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A European Deposit Guarantee Scheme?

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NOTE

Abstract

Deposit guarantee schemes are an inherent necessity for modern banking systems, because banks cannot survive a run, when all customers simultaneously attempt to withdraw their deposits. Such schemes work because they credibly reassure depositors. This requires immediate access to potentially considerable resources, which only a central bank can provide at crisis times. In the Euro Area, this means that the ECB must lie at the heart of deposit guarantees. This in turn creates the need to adopt clear rules of engagement, including sharing rules to meet potential residual costs or profits. One the other hand, there is no need for a common fund.

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EXECUTIVE SUMMARY

Banks are inherently fragile. Because they operate maturity transformation – borrowing very short in the form of freely withdrawal deposits by their customers – they never have enough cash to pay back all deposits simultaneously. They are open to the "multiple equilibria" phenomenon. When trusted by their customers, they only need very little cahs at hand. However, if customers wrongly fear for their deposits, they collapse as they cannot satisfy massive withdrawals. The purpose of Deposit Guarantee Schemes (DGS) is to make massive panic withdrawals pointless. Credible DGS in effect eliminate the bad equilibrium.

CGS exist in a very large number of countries. To be credible, they must have immediate access to resources large enough to rapidly reimburse all depositors who want to withdraw their monies. What are those resources? In some countries, some funds have been established but they are always too small to match all guaranteed deposits. In the even of a full-fledged banking crisis, the government must instantly mobilize massive amounts that can reach 50% to 100% of GDP in the worst cases. This is why the ultimate guarantor can only be the central bank, which has the possibility of creating unlimited amounts of money on behalf of the government.

In the Euro Area, it is the ECB that can act as lender of last resort. In order to be able to fulfil this function, the ECB needs a number of guarantees. First, it must have real-time and accurate information of the situation of all banks, hence the need for a single supervisor. Second, it must be reassured that the resources that it provides will be used wisely, protecting depositors and not banks with a view of shielding taxpayers. This calls for an independent resolution authority. Third, because its interventions can be costly, an arrangement must worked out to cover possible losses.

On the other hand, a common DGS does not require a common fund. The reason is that a fund of adequate size would reach more, possibly significantly more than 50% of GDP. Anything less would be insufficient in the face of a generalized banking crisis. It is not necessary either once the way is cleared for the ECB to be able to act as lender in last resort.

A common DGS would involve a formal commitment by the ECB to honour the guarantee in the event of a bank failure. This, in and by itself, is enough to stem bank runs. The more complex question is how to deal with a bank failure, an event bound to occasionally occur. As lender of last resort, the ECB will be necessarily involved, through the DSG and possibly the resolution of the bank. This is why DSG and bank resolution are intimately related. While a well-managed resolution does not have to ultimately involve costs, and can even be profitable, the issue of who will bear the losses, or share in the profits, must be dealt with *ex ante*.

1. INTRODUCTION

A "banking union" is essential to the stability – and possibly the survival – of the Euro Area but there is much confusion about what it entails. Most academics agree that the following elements are necessary:
- common regulation of banks
- a single supervision authority for all banks
- a single resolution authority

There is some debate about the need for a common resolution fund.

While we are a long way from all these elements to be agreed upon and implemented, it is natural to ask whether bank deposit guarantee schemes should also be harmonized and commonly funded. The experience during the months that followed the collapse of Lehman Brothers has shown the need for *some* harmonization. Indeed when Ireland faced the premises of its banking crisis, the authorities promptly moved to guarantee all deposits. The measure soon led to a migration of deposits, which prompted some other countries to adopt explicit or implicit full deposit guarantees. The message is clear: the scope for regulatory arbitrage is potentially strong in the area of deposit insurance. This has led the Commission to propose in 2010 that deposits be harmonized, a step that has been only partially taken so far. Within a common regulatory regime, the EU countries have agreed to guarantee bank deposits up to €100,000, but implementation remains incomplete.

In addition, at present, the guarantee is a national undertaking, which implies that it is backed nationally by each government. This is perfectly consistent with the fact that, so far, national authorities have carried out bank supervision and resolution. Indeed, the potential costs of insurance payouts can only be charged to the authorities that set and enforce the scheme. When and if a single supervisory authority emerges, national authorities should not be liable to costs that result from actions (bank supervision) that they no longer undertake.

Thus the Euro Area will have to move to some a common deposit guarantee scheme (DGS). Yet, a number of misconceptions must be cleared and the links with the needed resolution authority clarified. This note starts by recalling the purpose of deposit guarantees. It then argues that the need for harmonization in the Euro Area is mostly predicated upon the much under-discussed role of the ECB as lender in last resort. This observation naturally leads to the poorly understood question of funding.

2. WHY DO WE NEED BANK DEPOSIT GUARANTEES?

DGS fulfil an essential objective: they reduce the odds of bank runs when depositors rightly or wrongly worry about the health of their bank. Panic runs have been ubiquitous in banking history. When they occur, banks invariably fail because fractional reserve banking implies that a bank never has enough cash - or cashable assets – to match deposits. In fact, the economic function of banks is to operate maturity transformation – borrowing very short in the form of freely withdrawal deposits by their customers – while offering loans of variable maturities, some of them extending to 20 years or more. A bank is a bank if it never has access to enough cash to pay back all deposits simultaneously. This is why banks are inherently fragile.

Banks fragility is extreme because banks are subject to the "multiple equilibria" phenomenon. Consider a perfectly healthy bank. As long as its customers rightly believe that their deposits can be paid back, they will not withdraw more than customary cash, which the bank is set to routinely pay back through the holding of reserves, i.e. deposits at the central bank that can be instantly transformed in cash. This is the good equilibrium. The bad equilibrium occurs when customers wrongly fear for their deposits. As the rumour spreads, they all proceed to claim their deposits, which the bank cannot meet. The bank fails and deposits are indeed lost to a self-fulfilling prophecy.

If deposits are fully guaranteed by some authority, depositors have no reason to worry since they know that they will be paid back if the bank fails. As a result, they have no reason to run on their banks and the bad equilibrium does not occur. Even if the bank goes bankrupt for other reasons, depositors need not withdraw their deposits if they have faith in the DGS. Preventing bank runs is the *raison d'être* of DGS.

In practice, however, DGS do not offer a blanket guarantee. The reason is moral hazard. If depositors are completely reassured, they have no reason to monitor their banks and banks are then tempted to take excessive risks in search for higher profits. They can even attract more depositors by using high profits to offer attractive conditions. High profits and generous conditions are justified by the risks being taken, which is acceptable as long as depositors are correctly informed that they may suffer losses, possibly very large losses. Most depositors are unable to monitor their banks, because they are not technically equipped to do so, or they have no access to the relevant information, or they are not able to dedicate the time required to analyze the information. Obviously, most small depositors are in this situation.

This is why monitoring banks is primarily the task of supervisors. When they detect excessive risks, supervisors issue warnings but this action may fail to elicit adequate corrective action from a bank. Closing down the bank, or withdrawing its licence, is an extreme action that supervisors only take if they are sure that the bank is unsafe, but full certainty is rarely reachable. This is why it is a good idea to combine supervision with incentives for large depositors to be constantly careful. A warning by the supervisor will lead large depositors to withdraw part of their monies and thus exercise adequate pressure on a bank reluctant to heed the supervisor's suggestions. The small depositors, whose deposits are fully guaranteed, need not be concerned, nor even aware of the situation. Partial DGS, e.g. the €100,000 guarantee agreed upon in the EU, thus represent an acceptable trade-off between stabilizing banks and providing them with incentives to act prudently.

3. WHAT IS SPECIAL IN THE EURO AREA?

In order to be credible, a DGS must have access to sufficient resources to effectively pay back all guaranteed deposits, and to do it fast. Indeed, the scheme loses its effectiveness if depositors are not fully convinced that they will be able to cash in whatever they wish without delay. In most developed countries, bank deposits amount to about 100% of GDP and guaranteed deposits range from 50% to 100% OF GDP (IMF, *Deposit Guarantee; Technical Note*, March 2013). Full credibility is achieved if depositors are reassured that all of their guaranteed deposits are effectively protected. Banking crises erupt abruptly and are often contagious. They are abrupt because it is inherent to bank runs; they are contagious because of the self-fulfilling prophecy nature of bank runs. This means that, to be credible and therefore effective, a DGS must have immediate access to amounts of this order of magnitude. How can this be achieved?

One solution is for the DGS to accumulate adequate reserves. Obviously, a fund of 50% of GDP, or more, is beyond reach (this is of the same of magnitude as current public debts). Smaller funds can handle occasional failures of small banks or isolated shortages of large banks. More serious events, however, will never be dealt with pre-accumulated funds. This is why a credible DGS, of the kind required to deal with a systemic banking crisis, must have access to emergency central bank financing. Indeed a central bank is the only source of large emergency funding. This is the meaning of lending in last resort, a function of any central banks.

The fact that the central bank is an essential component of a DGS immediately alerts us to the fact that the Euro Area is special. The fundamental need for a DGS means that the ECB is the lender of last resort for each and every Euro Area member country. This simple observation carries far-reaching implications.

3.1. The ECB must have real time and complete information

In order to commit potentially large resources, the ECB must be able to evaluate the situation of the bank(s) in crisis. In particular, it needs to assess the viability of the bank and the amounts that need to be injected and in what form. Obviously, banks are complex undertakings and such judgements require intimate knowledge of the banks in question. On the other side, bank crises need to be dealt within a matter of days, possibly even hours (e.g. before the end of the next weekend). This can only be done if the parties involved, including the ECB, have already analyzed the situation of every single bank. In effect, a bank crisis should never catch the central bank by surprise. This is the key reason why the ECB must be the single supervisor, and the supervisor of all banks in contrast with the currently agreed-upon arrangement.[1]

3.2. The ECB must be protected

Emergency injection of resources does not necessarily imply that there will be losses, but losses are a possibility. Such losses are properly understood as a transfer from taxpayers to either the banks or their creditors, including the depositors. In a democracy, such transfers can only be decided and arranged by elected officials who are accountable to their taxpayers. This means that the eventual losses must not be borne by the ECB, nor should the decision on how to structure the emergency assistance be left to the ECB alone. The ECB must be protected from the unavoidable political fallout of its actions.

Outside the Euro Area, the implementation of the DGS is governed by an agreement between the central bank and the Treasury. The central bank is the arm that provides resources but it is understood – and often formally agreed – that any loss will be borne by the Treasury. Within the Euro Area, the Treaties also stipulate that any cost of a bank rescue will be borne by the country of origin of the bank. The situation is doubly complicated.

First, the issue of who is responsible for the bank failure immediately emerges. Obviously, the supervisor’s responsibility cannot be ignored. The fact that the ECB will be the single supervisor, fully justified as argued above, creates a serious difficulty. The bank’s government, which will always be able to claim that the crisis is a failure of the supranational ECB, will naturally objects to bearing the costs. Unless it is fully reassured that it is protected from such a situation, the ECB will be reluctant to undertake the lender in last resort function and the DGS will lose all credibility. Bank runs will not be eliminated.

Second, overtime the situation will become more complicated as more banks operate in many countries. Although a bank is incorporated in one country, its losses may emerge in a subsidiary or a branch located in another country. This will create further ambiguity and it stands to undermine the DGS.

In the end, any residual cost must be borne not by the ECB but by some political authority. How to structure the corresponding payments, and how do apportion possible profits, is a

[1] This point was made clear during the crisis of Northern Rock in the UK. Even though the Bank of England the FSA were supposed to share information, the Bank of England was caught off guard and its initial réaction not to intervene was a clear mistake. One can argue that a well-informed Bank of England would have reacted differently. The lesson has been learned and the Bank is now the key supervisor.

complicated issue. It must rest on commonly agreed sharing rules based on transparent criteria. It can be a common undertaking of all Euro Area member countries or it can be devolved to specially created bank resolution authority or to a dedicated fund.

3.3. The ECB must be reassured

As noted above, an emergency intervention may result in losses. This does not need to be the case. Much experience has been gained in recent years on how to structure these interventions in a way that protects the taxpayers. For example, in both the US and Switzerland, the interventions have turned to be profitable. The principle is to inflict the first losses on the bank, meaning its shareholders and unsecured creditors but excluding insured deposits, and to make sure that the first profits accrue to the taxpayers. The outcome will depend on how the bank recovers, which is the reason why the DGS authority and the central bank must have real-time, complete and accurate knowledge of the bank situation. In some cases, it will turn out that the bank is irremediably bankrupt and it will have be closed down, or resolved as it is called. Here again, there are many ways of resolving a failed bank, some of which may entail large losses to the taxpayer while others may protect the taxpayer. As before, there are deep issues of income redistribution, with serious political implications.

This is why the central bank must be reassured that resolution will be conducted in a way that does not tilt the stakes in favour of bank shareholders and/or unsecured depositors. The experience is that the political authorities are occasionally partial to the bank interests. This is one reason why the Euro Area needs a single resolution authority independent of the ECB and of unquestioned integrity, which means an arm’s length relationship with national (and other European) authorities.

4. THE FUNDING ISSUE

Current plans seek to establish a fund that would be used for financing the DGS under discussion. The reasoning is that the fund would solve several of the requirements listed above:
- It would match the collective nature of the SSM and of the contemplated DGS.
- It would avoid the delicate issue of assigning eventual costs according to the nationality of the rescued bank.
- It would create an access to funding.
- Charging the banks for insurance premia would reduce moral hazard.

Unfortunately, the essential requirement, that the DGS has access to resources sufficient to match any contingency is not met. Currently, some countries have established such a fund, others not, as the following table shows. Some funds are being financed by the government, others through a levy of all banks, in some case weighing individual bank assessed riskiness.

The Commission has proposed that a fund be gradually built up from bank contributions to reach 1.5% of guaranteed deposits within 10 years. This means that the fund would not have a significant size for years to come and that, after 10 years, it could only deal with occasional individual bank runs. Meanwhile and for systemic banks crises, the funding problem would remain unsolved. Implicitly, therefore, the ECB would have to be involved in many plausible situations. Because this role remains implicit, the proposed DGS will lack credibility and the ECB will not have any of the guarantees listed in Section 3.

Table 1. EU: Characteristics of EU Deposit Guarantee Schemes, 2012

	Austria	Belgium	Cyprus	Estonia	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg	Malta	Netherlands	Portugal	Slovakia	Slovenia	Spain	Bulgaria	Czech Republic	Denmark	Hungary	Latvia	Lithuania	Poland	Romania	Sweden	UK
Type of Deposit Insurance Scheme																											
explicit	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
legally separate	x	x	x	x	x	x	x	x		x	x	x		x	x		x	x	x	x	x		x	x	x		x
within central bank									x				x			x											
within banking supervision agency																						x					
within Ministry of Finance																										x 1/	
Participation and Coverage																											
domestic banks	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
local subsidiaries of foreign banks	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
local branches of foreign banks	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
foreign currency deposits	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
interbank deposits																				x							
Payouts to Depositors																											
per depositor per institution	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
Funding																											
ex-ante fund		x	x	x	x	x	x	x	x			x		x	x		x	x	x	x	x	x	x	x	x	x	
ex-post scheme	x									x	x		x 2/			x											x
funded by government																											
funded privately	x	x	x	x	x	x	x	x	x	x	x	x	x 3/		x	x 4/	x	x	x	x	x		x	x	x	x	x
funded jointly														x 5/								x					
guarantee from government in case of a shortfall of funds 6/	x		x	x										x	x	x		x		x	x	x			x		
Contributions and Assessment Base																											
risk-adjusted premiums					x	x		x		x				x							x				x	x	
assessment base																											
covered deposits	x				x					x						x				x						x	
eligible deposits		x	x	x		x	x	x			x	x		x	x		x	x	x		x	x	x		x		x
total deposits									x																		

Notes: Table excludes voluntary and contractual schemes other than the national statutory scheme.

1/ Swedish National Debt Office.

2/ In 2011, the Netherlands adopted a regulation to transform its ex-post DGS into an ex-ante funded scheme with risk-based contributions, to come into effect on July 1, 2013.

3/ The Dutch Central Bank administers the scheme and pays out the depositors. The costs of the scheme are transferred (including the administrative costs) ex post to the members of the DGS, subject to an annual cap of 5% of own funds of each member.

4/ In case of a bank failure, the Bank of Slovenia temporarily assumes the obligation to pay the guaranteed deposits and then calls on other banks to contribute funds needed for the paying out of insured deposits. To ensure banks have sufficient liquid assets to contribute such funds, all banks are required to invest a minimum of 2.5% of insured deposits in debt securities that are eligible for the collateralization of Eurosystem receivables as defined by Bank of Slovenia.

5/ Initial contribution to the DGS fund provided by Banco de Portugal.

6/ In the case of a shortfall of funds, the DGS can issue bonds/receive loans guaranteed by the goverment.

Sources: European Commission, International Association for Deposit Insurers, Financial Stability Board, and national deposit insurance agencies.

Source: IMF, *Deposit Guarantee; Technical Note*, March 2013

One answer is that the Basel 3 agreements stipulate larger capital requirements. A higher absorbing capacity, so goes the argument, would allow a bank to face significant losses and thus remain solvent. The argument misses the fact that the main purpose of a DGS is *not* to protect a bank from insolvency but to make bank runs impossible, even in the case is solvent. Repeating the point made in Section 2 above, a bank run destroys a bank independently of whether it is solvent not. A bank run does not relate to bank solvency but to fears that may well be unjustified. There is no amount of capital large enough to stem a bank run.

It follows that the Euro Area does not need a common fund to establish a DGS. A fund stand to make matters worse by not foreseeing the crucial role of the ECB in the event of a generalized bank crisis. A fitting example is the Irish crisis that saw the government inject more than 30% of its GDP. This intervention – certainly badly designed, largely under pressure from other countries – pushed Ireland into a public debt crisis even though its governments had been remarkably fiscally disciplined before the crisis. Adding this amount and the €40 billion support to Spanish banks, the total amount reaches 1.2% of Euro Area GDP. Further adding €80 billion injected in 2008 by Germany and €10 billion by France, the amount mobilized during the crisis reaches 2.1% of GDP. In none of these cases a bank run occurred because national DGSs were in place, some of which offered a blanket guarantee. As a result no expense was incurred. Somehow, national DGSs were credible and, yet, there was no commensurate fund available. Had a run happened, it is unclear whether the governments would have had the means to disburse the promised funds.[2]

Finally, one argument against the setting up of a fund must be dispelled. It is sometimes claimed that a bank-financed fund would harm the industry's competitiveness if some countries, like the UK, refuse to join and do not build up their own fund. This is either a misunderstanding of the role of insurance or an admission that the fund is useless. For those who believe that the fund is needed to provide an effective guarantee, its cost should be seen as an insurance premium. One way or another, these costs are bound to be borne by bank depositors, hence the fear of a loss of competitiveness. But depositors benefit from the guarantee. Some may prefer unguaranteed deposits and migrate their banking business to other countries. This is not a loss of competitiveness, it is the provision of a particular service. Of course, if the fund is useless, the service is not worth the cost, but the argument is not competitiveness. Finally, if the costs are supported by all taxpayers, as is currently the case in some countries, we face a case of state aid.

5. CONCLUSION: COMMON OR HARMONIZED?

The adoption of a Euro Area wide DGS is the logical implication of the single supervision mechanism agreed upon (but this mechanism must be applied to all banks). Along with a single resolution authority, it is a mandatory component of a banking union.

In the wake of the crisis of 2008-9, the EU countries have agreed to adopt the same guarantee level, €100,000 per deposit. In principle, this form of harmonization should be adequate. Unfortunately, a DGS cannot operate without central bank acting as lender of last resort. This means that the Euro Area must

[2] Still, the question of why national DGS were credible remains. Was it belief that the ECB was ready to act as lender in last resort? Was it the lack of experience with bank crises?

adopt a common DGS. Given that the ultimate provision of the guarantee is collective, the guarantee must be the same and run by a Euro Area wide agency.

This greatly complicates matter, of course. The lender of last resort, which alone can provide credibility to the DGS, must be protected against a number of risks inherent to any insurance scheme. The ECB must have real-time and accurate information of the situation of all banks: the SSM is a necessary bedfellow of the common DGS. The ECB must be protected against bad uses of its resources, which makes a common resolution authority necessary as well. While the execution of the guarantee and the occasional resolution of failed banks must be structured in a way such that taxpayers face no residual costs, losses are bound to occur now and then. In that case, the DGS needs a sharing rule that wold apply to both residual losses and residual profits.

On the other hand, a common DGS does not require a common fund. The reason is not that it would unduly undermine Euro Area bank competitiveness, but that it is not useful. The power of a DGS is that it is credible: depositors must be reassured that under no circumstance they will lose access to their guaranteed deposits for more than a very short period of time, to be measured in days.[3] A fund of adequate size could be in excess of 50% of GDP, or more. Anything less is useless. It is not necessary either once the way is cleared for the ECB to be able to act as lender in last resort.

[3] This is why the first rescue plan of Cypriot banks, which included haircuts on guaranteed deposits, was a massive mistake. It is essential that the DGS provides iron-clad reassurance that there will never be any such haircut.