

# **EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE**

**Statement No. 5**

**Milan, 18 October 1999**

## **A NEW ROLE FOR DEPOSIT INSURANCE IN EUROPE**

Deposit insurance has traditionally served two purposes, namely consumer protection and prevention of bank runs. In this statement the European Shadow Financial Regulatory Committee (ESFRC) takes the view that deposit insurance can and should play a key role primarily in facilitating the liquidation of insolvent banks without the need for bail-outs. We propose that the EU's 1994 Deposit Guarantee Directive (DGD) be amended to introduce risk-related insurance premiums, establish immediate pay-outs when deposits become unavailable, and make transparent precisely what liabilities are protected.

The DGD, based on the principle of home country control, made deposit guarantee schemes mandatory in all EU member states and established a minimum level of insurance coverage of 20,000 euros per depositor. To date, however, deposit insurance in the EU has been largely redundant because there have been relatively few bank liquidations and national authorities have tended to favour a policy of protecting entire banks rather than depositors. The practice of bailing out institutions creates expectations of official support beyond deposit insurance limits, thereby distorting market incentives and undermining financial discipline (the so-called moral hazard problem).

In the evolving European financial system deposit insurance is likely to play a much more important role than previously. Intensifying cross-border and domestic competitive pressures and related financial restructuring are likely to be accompanied in the years ahead by a higher incidence of bank insolvencies. Furthermore, the recent experience with deposit insurance in the USA and other countries highlights the fact that deposit insurance that is poorly designed or not supported by a robust supervisory framework can become an independent source of financial instability.

It is the strongly held view of the Committee that deposit insurance should be designed and operated in a way that allows, and indeed requires, national authorities to liquidate insolvent banks, thereby exposing uninsured depositors and other creditors to default risk. Such an approach ensures that high-risk institutions pay a market penalty in terms of higher funding costs. In this way excessive risk-taking can be discouraged.

## **Proposal**

### ***Transparency***

To achieve the above objective, the level of insurance coverage (which may differ among EU member states) must be clearly specified so that bank depositors and other creditors can be in no doubt about the insured or uninsured status of their claims. In this context, restrictions on the use of deposit insurance information in advertisements (as contained in the DGD) are unhelpful and should be removed.

### ***Immediacy Pay-out***

In contrast to current requirements for compensation to be paid within three months of deposits becoming unavailable, we advocate immediate pay-outs in order to sustain depositor confidence in the guarantee scheme.

### ***Limiting protection***

It is a central part of our proposal that uninsured deposits and other liabilities should be “credibly uninsured”, meaning that holders of such claims have no expectation of official support in the event of a bank insolvency. Beyond the need for robust payment and settlement systems, and the availability of effective emergency liquidity assistance, the following conditions should be met:

1. A programme of prompt corrective action for banks with deteriorating financial conditions, and orderly liquidation and winding-up procedures for insolvent banks are necessary (see ESFRC Statement No. 1 of 22 June 1998). The Committee is deeply concerned that the proposed EU directive on the reorganisation and winding-up of credit institutions has been stalled for many years.
2. Deposit insurance must be set at a level that enables national authorities to accept the political consequences of bank liquidations. We emphasise that it is the responsibility of each member state to set its insurance coverage at a level that allows the authorities to liquidate insolvent institutions. It is also desirable to introduce a uniform maximum coverage so that wholesale depositors and other creditors are not protected.

## **Funding the scheme**

The insurance premium should be risk-related. We believe that for this purpose bank risks should be assessed on the basis of market indicators rather than on the basis of regulatory judgement. In order to capture the full default risk to which a bank is exposed, we recommend that the risk premium on credibly uninsured subordinated debt should be used as one such indicator (see the Joint Statement by the Shadow Financial Regulatory Committees of Europe, Japan and the USA of 14 June 1999). If risk is properly priced, the difficulties surrounding home country control and

optional topping-up (of home country to host country insurance level) would be largely eliminated.

The insurance scheme should always be funded ex-ante rather than ex-post, with a fund target measured as a percentage of insured deposits.

The Committee also believes that banks should continue to make contributions to the deposit insurance fund during periods of high bank profitability and few insolvencies in order to avoid a situation in which the level of insurance premiums becomes pro-cyclical, i.e. fluctuating in parallel with the fortunes of the banking industry.

## **Investor compensation**

Deposit insurance has become linked to investor protection in the 1997 Investor Compensation Directive (ICD). In particular, the compensation levels provided for in the DGD are replicated in the ICD. The policy issues involved in these two types of schemes are different, however, and should be treated separately.

## **Implementation**

Most of our proposals can be implemented in a decentralised manner by national authorities. However, we believe it would be preferable to reinforce this approach by amending the DGD along the lines proposed above, using the opportunity of the required review in 1999.