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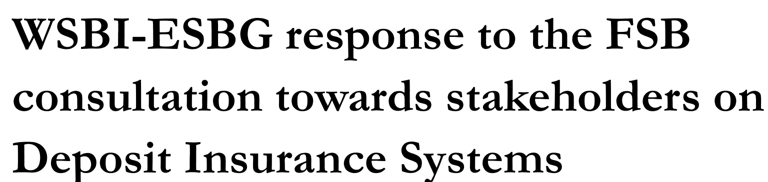

WSBI-ESBG response to the FSB consultation towards stakeholders on Deposit Insurance Systems

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The World Savings Banks Institute (WSBI) and the European Savings Banks Group (ESBG) welcome the opportunity to provide its comments on the Financial Stability Board consultation on Deposit Insurance Systems.

On the questions of the role of deposit insurance in the broader financial system safety net and the lessons from, and the effectiveness of reforms undertaken in response to, the financial crisis:

In the course of the global financial crisis it has become evident that insufficiently or poorly regulated financial systems can lead to instability and high costs for the national economy. In order to get a grip on financial systems and to restore market stability to the greatest possible extent, regulators strived for the establishment of safety nets. Today, these nets basically consist of four individual parts or stabilisers:

1. safeguarding of liquidity by the central banks with the "lender-of-last-resort" function;
2. prudential supervision at the micro and macro levels;
3. the liquidation procedures for insolvent banks; and
4. the deposit insurance schemes (resp.: systems, (=DIS)).

From ESBG and WSBI point of view - with regard to the functioning of deposit insurance within the safety net - two central aspects, which were drastically revealed during the financial crisis, seem worth being explicated:

First, there is significant interdependence between the individual parts of the system, which entails that the weakest of the individual safety elements in the system as a whole always determines the degree of existing financial market stability. For instance, several studies, focusing on the interrelationship between supervision and deposit guarantee, demonstrated that financial crises in countries with a generous DIS and lax supervision were disposed to greater instability and vulnerability to banking crises. Thus, a DIS is the more likely to be successful, the more it is part of a well-designed and implemented financial system safety net, where all elements are consistent with each other. Consistency, in this particular case, refers to the idea that all the individual stabilisers are constructed in a way that allows them to assume their intended function.

The theoretical studies on financial market stability primarily assign DIS the task of ensuring confidence in the banking system and preventing bank runs. In the course of the current financial crisis, one lesson learnt in Europe was that the existence of DIS alone could not prevent a series of bank runs (e.g.: "Northern Rock", UK, 2007; Icelandic banks, IS and abroad, 2008; Fortis/ABN-Amro, IRL, 2010). In the light of these events, academics went even further and concluded that even raising the amount of deposit insurance coverage in all European countries could not stop bank runs in the current crisis. On the contrary, DIS through their various forms in Europe and the unilateral increase of the amounts of coverage by certain governments (e.g., Ireland), presumably contributed to exacerbating the crisis rather than mitigating it.

Altogether, it can be said the crisis has shown quite plainly that DIS, in order to assume their central tasks and to contribute to higher financial market stability, necessarily need to be part of a well-designed safety net, where all the parts have to be matched with each other.

Second, financial system safety nets and each of their individual components are characterised by their double-edged nature in so far as - contrary to their intended function - they can have equally significant destabilising effects on financial markets if they undermine market discipline and create moral hazard problems.

As to DIS in particular, these are likely to diminish market discipline if they are designed in a too generous way, thereby favouring investor protection over market discipline. Thus, every regulator faces a fundamental trade-off between these two principles, when deciding about the final design of its DIS, which is ultimately a question of political choice.

Overly generous DIS diminish market discipline and create a moral hazard problem in two respects, since:

- First, it can reduce the incentive for investors to procure information about the soundness and solvency of a bank and to monitor it on an ongoing basis. The depositors' investment decision is reduced to looking for the bank that promises the highest rates of return, without worrying about the underlying risk.
- Second, the bank's management, when faced with competition for scarce deposits and higher profits, tends to offer higher rates of return on deposits. In order to achieve such higher rates of return, the bank management must pursue a higher-risk business policy, which in turn places higher demands on the relevant financial market supervisory authorities in terms of thorough monitoring.

Consequently, the investors and bank management ultimately rely on the DIS (and thus primarily in others) to cover the costs resulting from their risky behaviour, while they reap the profits, which is thus a perfect example of moral hazard.

Therefore, the ´benefits´ of a DIS (investor protection and prevention of bank runs) should always be weighted against its ´costs´ (weakened market discipline and greater responsibility of supervisors). Moreover, DIS should contain appropriate design features to restrain moral hazard.

Interestingly, in the most recent debate about the proposal for a directive approximating European DIS, the role of moral hazard did apparently not merit a lot of attention. This was not least because of the Commission, who - contrary to empirical findings - basically argued that investors could not be expected to assess the creditworthiness of banks.

As a result, the current directive, most notably by raising the amount of coverage from EUR 20,000 to EUR 100,000 and by excluding only the deposits of banks, insurance companies, investment firms, pension funds and government agencies from the deposit guarantee, will make European DIS significantly more generous.

The tendency to greater investor protection and thus less market discipline will be somewhat mitigated by the risk-based contributions that are provided for by the directive. These contribution payments, however, concern only the incentive structure of the bank management and do not find any equivalence on the investor level.

In ESBG and WSBI view, this should be considered as a ´potential gap in the design of DIS', which is why the introduction of a co-insurance in European schemes is discussed in the following.

On potential gaps in the design of deposit insurance systems:

The issue of 'coverage':

In the light of the mentioned deficiency and well aware that co-insurance has been abandoned by Directive 2009/14/EC, the European Savings Banks Association believes that co-insurance can be a suitable design feature to promote market discipline.

The argument goes that a portion of losses to be borne by depositors raises depositors' awareness of the fact that every bank ultimately has a certain risk of insolvency. As a consequence, they would take a greater interest in the bank's business policy. This would contribute substantially to market discipline, promote safe business models in banking and thereby raise financial market stability.

Nowadays, even small investors would have many ways of obtaining information about banks through a variety of media. Introducing co-insurance would also make consumer protection associations become more involved in informing their customers of the creditworthiness of various banks. And not least, the bank's managers themselves would have a stronger incentive than before to prepare relevant reports and provide information to the general public. All this would make an important contribution to financial literacy and to more market discipline.

As to the concrete design of co-insurance models, several forms are conceivable, depending on the ultimate purpose of such a feature: for instance, if the objective is to achieve broadest possible participation in exercising market discipline, then a fixed percentage of coverage (e.g. 10%) would be advisable. If the aim is to provide a certain degree of investor protection despite the exercise of market discipline, then one could rather consider a model, which stipulates no co-insurance for the base deposit, whereas beyond that, a fixed percentage up to the limit of coverage applies (*e.g.*, 10% of EUR 20,001 to 100,000).

The issue of 'funding':

A measure that could merit further consideration in the debate about the design of DIS on a European level refers to the issue of funding and was recently implemented in Spain on a national level. Facing increased pressure from international rating agencies due to high sovereign debt, the Spanish government introduced an additional charge on high-interest deposits. This surcharge will be paid to the deposit insurance fund and thus remains in the financial sector. All financial institutes offering interest rates that are unusually high compared to market average, are called to notify the stock of such rates every four months and to pay the respective surcharge to the fund.

The rationale for this measure is the attempt to restrain the ´fight for deposits´ among banks by surpassing each other in offering higher interest rates since this competition reduces banks' return and makes credits dearer. With regard to the political justification for such legislation, it should be noted that neither the weakening of banks' balance, nor more expensive credits are desirable from an economic point of view. Moreover, given that the ´fight for deposits´ undoubtedly leads to an erosion of banks' profit, which in the following increases the likelihood of their collapse, it appears not unreasonable to prevent this ´fight´ by contributing higher premiums to the fund.

In the light of the innovative character of the Spanish charge as well as the appropriateness of the measure to obviate unwanted developments on financial markets, it could be considered in essence for a possible introduction on European level.

At the same time, an amendment or further development of this provision should be contemplated: The purpose of use of an additional charge on high-interest deposits, as any other contribution paid to the fund, should not only be spent exclusively on measures of crisis management and liquidation in case of insolvency but rather on actions of ´early intervention´, such as recapitalisation or restructuring. Such a use could have the advantage of anticipating an impending liquidation and have a lasting effect on the institute's resilience.

About WSBI-ESBG (World Savings Banks Institute – European Savings Banks Group)

WSBI-ESBG – The Global Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries of the world (Asia-Pacific, the Americas, Africa and Europe – via ESBG, the European Savings Banks Group). WSBI works closely with international financial institutions and donor agencies and facilitates the provision of access to financial sectors worldwide – be it in developing or developed regions. At the start of 2009, assets of member banks amounted to almost € 9,000 billion, non-bank loans to € 4,300 billion and non-bank deposits to 4,600 billion. Together the member banks conducted operations through 160,000 outlets.

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of over € 6.000 billion, non-bank deposits of € 3.100 billion and non-bank loans of € 3.300 billion (all figures on 1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI and ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI and ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

WSBI-ESBG – Association internationale sans but lucratif/Internationale vereniging zonder winstoogmerk/International not-for-profit association

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