Rethinking Europe's deposit guarantee scheme

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Remark for the reader:
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Text:
Today's debate on a European deposit guarantee scheme one-sidedly emphasizes the dangers of further mutualization of risks. Wisely designed, however, a European deposit insurance can help containing the costs associated with risk mutualization, potentially even reducing risk.

Today, all EU countries are obliged to create a scheme that is capable of safeguarding bank deposits up to an amount of 100,000 euros per customer and bank. Hitherto, deposit insurance has been organized on a national basis: If there is a financial crisis in one country, the domestic deposit guarantee will intervene. If the funding requirements exceed fund liquidity, the respective country's government may be forced to provide further funds.

Creating a European deposit guarantee has been on the European policy agenda for several years. Already in 2015, the five Presidents of the European Commission, Eurogroup, Euro Summit, European Parliament and European Central Bank (ECB), in their first joint report, called for a Europe-wide deposit guarantee scheme as an important step towards completing the Economic and Monetary Union.

In Germany, this claim largely met resistance, or was rejected outright. Critics have emphasized in particular that a European deposit guarantee scheme would contribute to the mutualization of bank liabilities in the euro area. The criticism is that southern European countries could, for example, access the guarantee funds set up in Germany to protect savers.

However, although the ultimate liability for a deposit insurance promise *de-jure* currently lies with institutions within the country of domicile, there is an *implicit* risk-sharing effective between individual countries in the Monetary Union. This problem became apparent, for example, during the Greek financial crisis in 2011. At that time, Eurozone governments provided Greece with financial assistance. This happened despite the explicit no-bailout clause in the EU treaty. The rescue was motivated by substantial amounts of Greek government debt on the balance sheet of some major banks domiciled in "donor" countries. A default, so it was believed, would jeopardize the solvency of these banks and may have turned out to be even more expensive than a direct rescue of the borrower country, Greece.

Theses events have shown in an exemplary way that, at the national level, stability of public finances and of banks are linked with the potential to aggravate a financial crisis. In the case of major dislocations, state funds will be needed in order to stabilize banks, and/or the deposit scheme. Since this requires the mobilization of significant resources in the short term, market participants may consequently have doubts about the sustainability of the state's fiscal policy. As a consequence, prices of government bonds issued by this country will drop, causing losses in bank trading books and increasing the pressure on financial institutions. This self-reinforcing, vicious cycle can also have a destabilizing effect on countries with seemingly sound fiscal policies so that financial assistance is needed.

Meanwhile, the European Stability Mechanism (ESM) has come into existence, which is a special intergovernmental mutual fund providing liquidity with conditions to states in the event of a crisis. This is an improvement compared to the situation in 2011, as today an intervention can be based on clear rules and conditions. However, this fund is backed by the member countries jointly, such that the risk-sharing continues through the ESM. Moreover, in the event of a crisis, it may also be questioned whether the available funds do really suffice.

Note that risks are transferred among countries not only through financial assistance by the ESM but also through interventions by the ECB. While a direct risk-sharing among countries within the European System of Central Banks (ESCB) via Emergency Liquidity Assistance (ELA) credit lines has been ruled out in principle, the programs relying on buying government bonds and other securities do, in fact, share the risk of sovereign defaults.

Thus, despite national responsibility for deposit insurance, there is an implicit sharing of risk in the current system, leading to a redistribution of losses among participating countries in a financial crisis. This is particularly problematic from a regulatory point of view. To the extent that investors, national financial regulators, and governments can assume that existing risks will be redistributed to the disadvantage of other countries in a crisis, the willingness to effectively prevent and reduce those very risks decreases. Thus, implicit risk sharing will ultimately undermine the efficiency and performance of the European financial system.

A European deposit guarantee scheme can replace the existing implicit risk-sharing with an explicit contractual commitment. Properly designed, it would reduce the risk tolerance of banks and national guarantee institutions before a loss occurs. Moreover, the liability promise of a deposit re-insurance scheme could be formulated as a conditional promise, depending upon some restrictions pertaining to a bank's exposures. Also, the premium that an insured bank would pay, can be sensitive to those risk characteristics. In fact, it can be made fair, i.e. risk-adequate, by actuarial standards. A European deposit guarantee could then influence the banks' risk behavior and reduce actual loss expectation.

Against the background of significant variation in the composition of bank portfolios across countries, e.g. the share of own national government bonds in total bank debt, or the volume of non-performing loans, the importance of charging risk-adequate premiums is evident. Modern methods of risk measurement allow premiums to be set according to an individual, case-specific risk profile. As a result, a high default risk translates into an equally high deposit insurance premium.

Just like life insurers who cover people with different mortality probabilities without necessarily causing a redistributional side-effect, a proper European deposit insurance would be based on the expected default risk and the associated loss given default, thus averting redistribution effects.

Of course, determinants of bank default risk are to some extent under the control of policy makers. Examples include national insolvency laws or a country`s fiscal stance. For that reason, the risk-adequate premiums will need to be country-specific, depending on loan portfolio composition, and on government holdings on bank balance sheets.

Nevertheless, based on past experience, it will be difficult to assess country-specific risks beyond doubt. Especially in economically difficult times, the danger of a political intervention affecting premium setting for deposit insurance has to be taken seriously. A European deposit guarantee, therefore, has to hard-wire risk-adequate premium setting in their statutes. This also

includes a monitoring role vis-à-vis national deposit insurers, and a harmonization of their risk models.

So what should such a European scheme ideally look like? Given the institutional structure of the European Union, it should follow a subsidiarity principle in line with established regulatory policy ideas and align liability and decision-making. That is why we are proposing a European deposit *re*-insurance, rather than a plain-vanilla, all-encompassing deposit insurance. It would complement rather than replace the existing national guarantee schemes. The national systems continue to secure deposits in domestic banks only.

The European deposit reinsurance would be a second stage of protection at the European level, based on the insurance principle, analogous to reinsurance in property insurance. It covers the claims of individual national deposit insurance schemes from a defined amount of damage up to a defined maximum amount, say from 50.000 to 100.000 Euro – which is the maximum statutorily guaranteed deposit. Importantly, the European reinsurance should perform a monitoring function vis-à-vis national deposit insurers, encompassing the necessary information and intervention rights.

The proposed two layered deposit insurance scheme allows to compensate for differences in the risk levels between national deposit insurers (layer one) by an adequate pricing of the reinsurance services on layer two. Deposit reinsurance, through its premium scheme, provides clear incentives for risk reduction on the part of the national deposit insurers. The European deposit reinsurance will be more effective, if a strong role as supervisor is assigned to her from the beginning. This will allow the reinsurance entity to oversee risk management practice, including risk measurement and premium setting at the national level. It will be relevant here, like in other parts of the European supervisory regime, to minimize the possibility of national politicians to intervene in the process, once its rules are properly laid out.

Ultimately, within the framework of European deposit reinsurance, each banking institution could decide for itself whether it wants to participate in the reinsurance system despite possibly high premiums or whether it wants to reduce positions with a higher risk and only enter the system at a later date. To be effective, the choices made by banks have to be disclosed to bank clients, allowing them to transfer accounts from banks with lower insurance standards to competing institutions offering higher standards.

A properly designed European deposit reinsurance system is therefore by no means another step towards increased mutualization of risks. On the contrary, it can serve to even reduce the existing implicit risk-sharing. From an economic perspective, this weighs more heavily than the fact of a legally agreed liability within the framework of reinsurance. By actively limiting risks, an appropriately structured European deposit reinsurance system can increase the stability and efficiency of the European financial system in a way that is redistribution-neutral. Evidently, our re-insurance scheme proposal presupposes the willingness of European governments to allow for a reflection of country-specific risks in deposit insurance premiums – and thus to deviate from the existing regulatory practice of classifying government bonds as being risk-free by definition.

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