


Crisis Management and Guarantees in Europe

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Banking Law Symposium 2011: Crisis Management and the
Use of Guarantees
Paris, October 3-4, 2011



The views expressed in this presentation are those of the author and not necessarily those of the IMF, its Management or its Executive Board

Outline

- Guarantees: A response in a dangerous world in many situations
- Response to banking crisis: deposit guarantees
- Brief history of deposit guarantees
- The emerging European deposit guarantee
- The single European market and the guarantee
- European case studies in the global financial crisis
- Changes to the European guarantees in the crisis
- Unfinished business

Guarantees: A Response to a Dangerous World

- Florida: Increase in flooding and hurricanes
- Co-mingling of events and changed structure
- Response to increase areas where insurance is mandatory
- National Flood Insurance Program: \$764 bn on 4.7 mn policies; state \$400 bn on 1.9 mn policies
- “Workers in Orlando are subsidizing millionaires in beachfront houses” (Sebastian Mallaby)
- “State-based coverage has underwritten coastal development that has been vital to regional growth” (Washington Post)
- Guarantees pre-funded, with debt ceiling, but did not recognize increase in costs or tighter building standards

Guarantees: A Response to Dangers in Banking

- Depositor guarantee
- Mortgage guarantees (Fannie and Freddie in US)
- Banking (SIFI) guarantee
- Depositor guarantee to protect the uninformed individual, and to enhance financial stability (Friedman 1959)
- Less contentious than guarantees on the assets or the institutions: moral hazard, although mitigations

Asian Crisis

- Bank runs pervasive across problem countries
- Thailand blanket guarantee
- Indonesia: initially limited guarantee, did not halt runs; governance issues. Blanket guarantee became credible after depositors received immediate payouts after bank closures
- Progressive wind-down of the blanket guarantees after the crisis

Bank Deposit Guarantee

- Traditional non-crisis: (small) co-payments; limited amounts
- Crisis: blanket guarantee
- Announcement of guarantee can have limited effect:
 - Ability to finance the guarantee (fiscal capacity)
 - Ability to (quickly) deliver on the guarantee (organizational capacity)
 - Lack of credibility (e.g., Bulgaria 1996); failed on both scores

FSB Working Group on Deposit Insurance

- Asian experience showed importance of guarantees, as well as range of existing practices
- FSF working group called for guarantees to be explicit and pre-financed
- Formation of IADI

Deposit Insurance in Europe Pre-global Financial Crisis

- EC 1994 directive, made explicit deposit insurance mandatory, at least 90% coverage, at least Euro 20,000
- Widely varying levels remained, from implicit universal insurance in Germany to very limited insurance in some new members
- IMF Nordic FSAP (2003) illustrated differences in level of coverage, types of deposit covered, pricing mechanism, and institutional governance
- Concerns at possible relocation of banking businesses in light of differing costs of deposit insurance
- Moves towards harmonization

Financial Services in the Single Market

- “European passport” means banks can locate anywhere in the EU if they have a license in a member state
- Supervision remains national; limited powers of national supervisors over foreign banks’ branches
- Risk of regulatory arbitrage across jurisdictions

Impact of the Crisis: Ireland; UK; Icesave

- Ireland: emerging banking problems led to blanket guarantee
- Concern throughout Europe since higher level of protection could lead to depositor flight to Ireland
- Fiscal burden
- UK: Northern Rock, first bank run since 19th century
- Blanket guarantee did not halt runs, as payment delays seemed likely (previously, building societies had implicit total guarantee).
- Icesave: limited payments to UK/Dutch depositors. UK/Dutch actions to ensure UK/Dutch depositors not disadvantaged
- EU: Commission plans for harmonization on maximum level of protection

Deposit Guarantees Only Part of Financial Safety Net

- Strong regulations (EU)
- Strong supervision (national)
- Strong supportive macroeconomic policies (national/EU) and macro safety net (EU/IMF)
- Strong resolution (national)
- Strong depositor protection (EU/national)

All elements are necessary for financial stability

The New EU Financial Stability Infrastructure

- Attempting to create a framework to maintain stability while still having to address ongoing crisis
- Establishment of the ESA: EBA; EIOPA; ESMA
- Establishment of the ESRB
- Duality of the roles, of maintaining stability in normal times, while seeking achievement of stability in present times
- Dual timeframe: crisis response has to be immediate; creating infrastructure for normal times can be more measured: EC envisages review in 2014

Regulation

- Basel III developed in response to the crisis and a center point of enhanced regulation
- CRD IV put forward as the mandatory legal framework for EU member states
- Largely follows Basel III, which is welcome, but
 - Definition of capital weaker: Accepts some forms of non-common equity as tier one capital; allows some additional deductions

“Maximum harmonization” may prevent countries raising capital requirements to the levels they think appropriate

Supervision

- Single European passport leaves national authorities with limited powers over foreign branches
- Cross border: Colleges of supervisors provide partial answer, but effectiveness is unproven
- Much emphasis on offsite supervision but argument that problems emerged from defects in onsite. Risk of deterioration in onsite supervision, since it is costly and enhanced offsite is resources intensive

Macro

- Guarantee that the authorities would have appropriate macro polices to support financial stability
- Rapid cuts in interest rates to zero at start of crisis
- Major initial fiscal stimulus
- Less ability now to maintain the guarantee: increasing ineffectiveness of QE in US; inflation fears in Europe; concern at rising fiscal burden; also at policy near-paralysis
- Focus on macroprudential policies as key elements of toolkit but limited experience with them and politically contentious

Resolution

- National responsibility, particularly awkward in cases of cross border institutions
- Fortis bank
- Single EU agency would make handling much easier but insufficient political support at the moment
- Ex ante rules important to enable smooth resolution of cross border institution
- Credibility would only be established if tested

2010 Revision of Directive on Depositor Guarantee Schemes

- Made higher limits (Euro 100,000) permanent
- Co-insurance abandoned
- Harmonized coverage (excludes deposits of financial institutions, public authorities, structured investment products)
- Speedier payout (7 days, not several months)
- Better consumer information
- All currencies covered
- Cross border banks pay out locally

2010 Directive: Some Issues

- Technical issues
- Credibility issues
- Deposit insurance within the overall safety net
- Deposit insurance within the European project

2010 Directive: Technical Issues

- Many good points, but some technical issues remain:
 - Enhanced governance: how are the funds managed?
 - Ex ante funding
 - Risk-related premia
 - Scope for “Least cost solution” option, to work with resolution funds
 - “Depositor Preference” to limit cost to taxpayer

2010 Directive: Credibility Issues

- Need to demonstrate that deposit insurance will operate in line with its commitments, in particular will pay out within 7 days, including for cross-border institutions
- Need to demonstrate that deposit insurance will not exceed its commitments, in particular that deposits above 100,000 Euro, or ineligible deposits, will not be covered. Recent crisis has harmed credibility on this score

2010 Directive within the Overall Financial Stability Framework

- Much progress achieved in Europe in enhancing financial stability and the safety net, but gaps remain:
 - Basel III modifications in CRDIV
 - Supervisory enhancement not demonstrated
 - Recapitalization of European banks not complete
 - Bank resolution framework not yet in place: without resolution framework, not clear that European authorities will be able to close a bank and bring deposit guarantee mechanism into play

2010 Directive within the Overall European Project Framework

- Too much “Europe”—maximum harmonization on coverage levels (?)
- Too little “Europe”—deposit insurance remains at a national level, in the face of large pan-European banks: present system harmonizes certain key elements, but national discretion means variety of practices likely to remain; alternative could be a European deposit insurance system, either as a complement to the national systems for pan-European banks, or as a replacement, possibly over time: could complement a European resolution system



Thank you