

# Expanded Government Guarantees for Bank Liabilities: Selected Issues

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*Government provision of a safety net for financial institutions has been a key element of the policy response to the current crisis. In the process, existing guarantees have been expanded and new ones introduced, including, in particular, in relation to bank liabilities. Among other things, such guarantees create costs that arise as a result of potential distortions of incentives and competition. To limit such distortions it is important to specify risk-based premiums for additional government-provided guarantees, and to the extent that guarantees are priced appropriately potential distortions also should be limited. The evidence however has been mixed in this regard. The present article discusses pricing and some other selected issues related to the recent expansion of guarantees for bank liabilities.*

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## Executive Summary

This article observes that interest in safety and in guarantee arrangements usually rises in time of financial market stress and, when problems are very severe, so, too, does government provision of the latter. The current episode has not been an exception in that respect. Indeed, the expansion of existing and introduction of new guarantees for financial institutions has been a key element of the policy response to the current crisis, especially following the accelerated “flight-to-safety” in fall 2008. The guarantees include those related to bank assets and liabilities, and the document draws particular attention to the latter:

- First, explicit retail deposit insurance arrangements have been introduced in Committee on Financial Markets (CMF) member jurisdictions where they had not previously existed. Coverage ceilings were lifted in many of the jurisdictions where such arrangements had already been in place, in some cases even to unlimited coverage.
- Second, coverage of guarantee arrangements was also extended to other bank liabilities (and, in some cases, to assets), including to newly issued unsecured debt securities. Such liabilities have not traditionally been backed by guarantees, at least not under normal circumstances.

These and the other actions have avoided a further accelerated loss of confidence on the part of depositors and other market participants, essentially through two channels:

- Guarantees of bank liabilities have reduced the likelihood of bank failures by raising the likelihood that depositors and creditors provide a stable source of funding for banks.
- Guarantees of newly issued bank liabilities have provided the kind of safe investment opportunities much sought after in the flight-to-safety episode.

Among the various policy response measures, the expansion of guarantees has become a key element of the response. It has the benefit of entailing lower upfront fiscal costs relative to other options. Moreover, the chance of such costs arising further down the road was deemed limited given a political commitment to prevent any major institution from failing.

There are nonetheless costs associated with these measures. Even if guarantees do not generate significant upfront fiscal costs, they nonetheless create large contingent fiscal liabilities, as well as other potential costs that may arise as a result of potential distortions of incentives and competition. Perhaps foremost among the distortions of incentives is the risk of moral hazard.

Also, distortions of competition arise between banks that benefit from government guarantees and those banks or other financial institutions that either do not benefit from such guarantees or have to pay higher prices for them. Moreover, distortions in capital markets arise to the extent that other forms of securities do not enjoy such a guarantee, thus an unfair advantage for the bank liabilities enjoying such a guarantee might arise.

The premise of the discussion in the article is that potential distortions should be limited however to the extent that government guarantees are priced appropriately. By contrast, distortions are more likely to arise where guarantees are offered at prices that appear to be substantially lower than market or some form of “fair” prices. In this context, two observations are singled out for special attention:

- First, in the case of retail deposit insurance, several jurisdictions with advance-funding specify risk-adjusted premiums, but others do not. Where guarantees have been expanded

during fall 2008 to unlimited coverage, pricing appears to be extremely difficult and *additional* fees for such extra insurance coverage do not appear to have been collected in many cases. There are some exceptions however.

- Second, the pricing of guarantees of new bank bonds has tended to be close to market rates, with fees typically charged as a function of historical credit default swap (CDS) spreads. Different pricing mechanisms and formulae have been applied across countries however. Differences in these details have implications for the extent of subsidy provided for institutions from different jurisdictions. Even though such effects may have been unintentional, the situation raises issues regarding the level of the playing field of internationally competing banks. Also, the pricing of other securities that do not benefit from such guarantees may be affected.

The issue of pricing is relevant not just with respect to competition but also in the context of the type of exit strategies that the OECD is examining: Financial markets are forward-looking and, therefore, current strategies as regards so-called “emergency measures” are likely to influence the behaviour of market participants going forward. In this sense, there is also a very close link between emergency measures and exit strategies. The Committee on Financial Markets, at its meeting in April 2009, supported the analysis and conclusions provided in the article, and its discussions of the topic included the following results:

- Public authorities have made considerable efforts to charge risk-based premiums for government-provided guarantees for newly issued bank bonds. That is, premiums have generally been a function of some risk measure, even if the specific details of the approaches chosen differ from one country to another. Challenges to the determination of risk-based premiums remain, however, including in particular in situations where market reference prices are not available.
- Where no additional charges have been levied for the expansion of retail deposit insurance coverage to essentially unlimited levels, such coverage should be withdrawn as soon as possible. In most cases, specific termination dates have been scheduled. More generally, where retail deposit insurance coverage levels have been expanded during the recent crisis, once financial conditions stabilise, policy makers need to consider whether to reduce these coverage levels and, if so, to what “normal” level of coverage. In this context, country-specific circumstances need to be taken into account.
- Issues regarding potential competitive distortions exist with respect to the existence (or lack thereof) of a level-playing field for internationally operating banks that either benefit from such guarantees or do not. Perhaps even more importantly, the issuance of bonds backed by guarantees from some highly rated governments has also had profound effects on the demand for and pricing of other securities not benefitting from such guarantees, including in particular relatively close substitutes for those guaranteed bonds, such as bonds issued by some lower-rated sovereign or supra-nationals.
- The issue of exit strategies has different aspects depending on the type of guarantee arrangement. The existence of guaranteed bonds suggests a problem for exit timing issues – the desire is to exit as soon as possible but not too soon. Co-ordination is essential in that respect. For deposit insurance, the issue is not exit, but the notion of what should be the future design of such a scheme. It seems clear that post-crisis it will be necessary to have premiums that not only are higher in level but are also risk-based.

## EXPANDED GOVERNMENT GUARANTEES FOR BANK LIABILITIES: SELECTED ISSUES

### I. Introduction

*As the “search-for-yield” has given way to a “flight-to-quality”, interest in safety and guarantees has risen...*

Investor sentiment in financial markets has changed radically from the higher risk appetite associated with the so-called “search-for-yield” that prevailed in the years preceding the crisis to a “flight-to-quality” since the beginning of the crisis, and especially since fall 2008. This pattern is fairly typical. Interest in safety and in guarantee arrangements usually rises, and when problems are severe, so, too, does government provision of the latter. Indeed, government provision of a financial safety net for financial institutions has long been a key element of the policy response to crises and the current crisis is no exception.

*...and so has the government provision of the latter, although this time to unprecedented levels*

This particular crisis is fairly severe however, so governments have felt obliged to go beyond the usual support measures, moving to expand existing guarantees and to introduce new ones, in some cases quite markedly. The expansion of guarantee arrangements at an unprecedented scale is notable and partly reflects the prominent role that uncertainty has played as trigger of the current crisis, especially uncertainty about financial market valuations. Valuation problems are also complicit in the duration of the problems.

Guarantees can be either explicit or implicit. Either variant can give rise to moral hazard, but an implicit guarantee is arguably more problematic in that respect, as it does not clearly identify its boundaries and what its price is.<sup>1</sup> By contrast, one of the desirable features of explicit guarantee arrangements is that the limits are expressly defined. Because the extent of the guarantee is known, providers of explicit guarantees are able to charge risk-adjusted premiums, which in turn tend to reduce moral hazard.

The present article discusses primarily issues related to *explicit* guarantee schemes in Committee on Financial Markets (CMF) member jurisdictions (including cases where the expansion of the parameters of explicit guarantee arrangements was only *implicit* in policy announcements). In particular, the article places a sharp focus on two types of measures taken since fall 2008:

*Retail deposit insurance coverage was expanded...*

- First, the introduction of explicit retail *deposit insurance arrangements* in CMF member jurisdictions where they had not previously existed, and the lifting of coverage ratios (and abolishment of co-insurance arrangements) in many of the jurisdictions where such arrangements were already in place. It is especially noteworthy that policy makers in some countries made statements suggesting (either explicitly or implicitly) that deposit insurance coverage would be unlimited.

*...and guarantees were extended to include bank bonds*

- Second, the extension of coverage of guarantee arrangements to other bank liabilities including (unsecured) debt securities is also unusual. Such liabilities have not traditionally been backed by guarantees, at least not under normal circumstances. In the current crisis, however, government guarantees have been made available among other things to support the issuance of new bank bonds by qualifying financial institutions, with the government guaranteeing the due payment of principal and interest payable by the issuer to the holders of the liabilities covered by the scheme.

*These actions have bought time*

These and other related actions (such as loss sharing arrangements for assets and capital injections) appeared to have avoided a further loss of confidence on the part of market participants, by raising the likelihood that retail depositors and other creditors would continue to provide a stable source of funding for banks, thus reducing the threat of insolvency of these entities. Thus, these actions have bought time, with limited if any upfront fiscal costs. Actually, just like financial guarantee insurance companies, the government earns a small fee from the debt issuer for lending out its top credit rating.

*There are nonetheless costs associated with these measures, including those potentially arising from distortions of incentives and competition*

There are nonetheless potentially substantial costs associated with these measures. Even if guarantees do not generate significant upfront fiscal costs, they create large contingent fiscal liabilities, as well as other potential costs that may arise as a result of distortions of incentives and competition. In recognition of this situation, the discussions of financial safety net issues at the past CMF meeting concluded that, going forward, policy makers need to consider the issue of “exit strategies” from expanded guarantees. While issues related to exit in the context of the narrow topic of guarantees of bank liabilities are touched upon in the present article, the issue of “exit strategies” more generally is addressed in OECD (2009, forthcoming).

*Appropriate pricing of guarantees limits potential distortions*

Another important issue related to the additional guarantees is their *pricing*. In this respect, the premise of the discussion in the present note is that potential distortions should be limited to the extent that government guarantees are priced appropriately. By contrast, distortions are more likely to arise where guarantees are offered at prices that appear to be substantially lower than market or some form of “fair” prices. In this context, two observations are singled out for special attention:

- First, in the case of retail deposit insurance, some jurisdictions with advance-funding specify risk-adjusted premiums, but others do not. Determining the correct levels of premiums for deposit insurance coverage is notoriously difficult. Where guarantees have been expanded during fall 2008 to unlimited coverage, pricing appears to be extremely difficult and additional fees for such extra insurance coverage do not appear to have been collected in most cases. In those situations, the need for considering “exit strategies” appears to be particularly relevant. The *third section* discusses pricing issues and those related to the transitioning to more limited deposit insurance coverage levels.

- Second, guarantees have been extended to cover liabilities of financial institutions that traditionally have not been covered by such arrangements, such as bank debt issuance. The task of pricing these guarantees is (also) difficult, but may be facilitated by the fact that private markets for similar types of protection exist, specifically those for credit default swaps. While these markets are also not immune to the pricing challenges in the current environment, they nonetheless provide a wealth of current and historical data that provides a good reference for governments. The *fourth section* discusses pricing issues related to government-guaranteed bank bonds.

Before these two sections, the *second section* of this article provides some background information that places the expansion of existing guarantees and introduction of new ones into the context of the current crisis. This section suggests that there has been an exceptional degree of uncertainty surrounding the valuation of the (complex) financial instruments that had been at the core of risk transfers prior to the crisis, and that *recent experiences have created exceptional high demand for simple (guaranteed) products of the highest quality*, which private financial institutions have recently been unable to deliver themselves. The *fifth section* concludes and summarises the results of the discussions of the topic by the Committee on Financial Markets in April 2009.

## II. Some background: The evolving financial crisis

### *Heterogeneous and complex securities at the heart of risk transfers prior to the crisis*

*In the years prior to the crisis, risk transfers occurred via complex, opaque and heterogeneous securities...*

In the years prior to the current crisis, risk transfers in financial markets occurred to a large extent via complex, opaque and heterogeneous financial instruments, but as it turns out valuing these securities is difficult when these markets are stressed. Indeed, one of the things that is different in the current crisis (and there are many things that are similar to previous crises) is the high degree of uncertainty about the valuation of financial instruments that were at the core of financial risk transfers over many years, and this observation may help explain the prominent role that government guarantees have played as part of the policy responses to the crisis.

*...reflecting a profound change in bank's business models*

That complex and heterogeneous financial instruments have played such an important role in the risk transfer in financial markets reflects the outcome of one of the key developments in financial intermediation that has taken place over the last couple of decades or so, which is the profound change in banks' business models. In particular, these entities have gradually transformed the nature of their activities from their traditional business model, where they grant loans to customers and hold them in their balance-sheet (buy and hold), to a model where loans are originated and then securitised (originate-to-distribute). Traditional banks have increasingly competed in many areas with securities firms and other financial institutions and, in the process, financial innovation has accelerated.

The pros and cons of this transformation have been controversially discussed for some time now. On the one hand, the new model implies that

assets that would have otherwise remained on bank balance sheets up to maturity are sold to a large number of market participants, presumably to those that are best able or at least most willing to include the risk-return tradeoffs associated with these assets in their own portfolios. On the other hand, the new model tends to imply a high level of leverage and reduce the intermediaries' incentives to monitor the quality of their portfolios, thus perhaps raising the total amount of risk created and transferred.

The experiences especially since the beginning of this decade testify to the relevance of the latter view. There has been rapid and almost continuous growth of indebtedness in many parts of the world economy, especially in the household sector, where projections of debt servicing capacity did not properly take into account the possibilities of shocks to income or interest rates in determining the levels of indebtedness and patterns of (re-)payment promises.

In the United States, from the second half of 2005 onwards, lending to riskier customers has intensified, reflecting the interplay of the incentives and actions of a variety of different actors. Unregulated intermediaries, mainly mortgage brokers, sold their mortgages to other intermediaries, and many of them were further used as inputs for the creation of other financial instruments, with a risk/return profile tailored to the specific needs of different types of investors. Rating agencies assigned high ratings to tranches of securities considered as being of high credit quality, especially when financial guarantors that possessed the top credit rating provided additional credit insurance. But when the quality of US subprime mortgages started to deteriorate in an environment of declining US housing prices and increasing interest rates, the securities backed by these loans rapidly lost market value.

The widespread use of leverage in several financial sectors, including in the banking, hedge fund and (parts of) the insurance sectors amplified the downward pressure on these assets' market values, as collateral requirements and market and rating pressures for de-leveraging led to forced selling.

***Problems  
originating in a  
rather small  
segment spread  
rapidly***

Problems initially arose in the subprime segment, which is relatively small compared to the US securitised mortgage market let alone the US financial market. But they have then quickly affected the markets of structured products of all sorts, among the reasons cited above also, because structured financial instruments similar to those that have been used to redistribute sub-prime mortgage credit risk have also been used in other areas of risk transfers in financial markets and created opaque webs of interconnected obligations. Excessive leverage

***Valuation uncertainties spreading to financial firms***

***Uncertainty  
regarding value of  
these assets  
implied uncertainty  
about effective***

Uncertainty regarding the value of these assets (and the liabilities associated to the servicing of them) implied uncertainty about the effective amount and localisation of losses among banks, which led to a collapse of confidence among peers. In the case of many banks, liquidity needs increased as a result of the drawing of credit lines that they had offered to structure financial vehicles.

***amount and localisation of losses, which led to a collapse of confidence among banks***

Moreover, because of such links as well as legal and/or reputational reasons, many banks ultimately took back onto their own balance sheets the structured financial vehicles that initially were conceived to be removed from their balance sheets. This situation entailed a severe impairment of the financial intermediation process, as a result of which there were considerable adverse feedback effects on real economic activity. Consequently, the pool of questionable assets has not remained fixed, but instead has been growing as the initial shock from the sub-prime mortgage market was compounded by more widespread ‘cooling’ of real activity.

***Models to value the complex financial instruments placed a too sharp focus on credit risk aspects, while largely neglecting the role of liquidity***

With hindsight, it is clear that the sophisticated quantitative models that had been developed to value the complex structured financial instruments have placed a too sharp focus on credit risk aspects, while largely neglecting the role of liquidity aspects in valuation. Also, many of the assumptions made regarding the basic parameters underlying the credit risk analytics, such as default correlations between the underlying securities, now appear to have been too optimistic. As a result, available models turned out to be inappropriate during stress periods. Moreover, as the complex structures involved in these securitisations differs considerably one from another, a specific valuation model would have been required for each type of structure. But agreeing on such models was difficult. The heterogeneity of instruments and the lack of a common reference model for valuation made it difficult for market participants to agree on valuation approaches, thus complicating the pricing process.

As financial institutions’ balance sheets have been considerably burdened by these instruments, mainly in relation to their asset side, the uncertainty about the valuation of financial instruments has directly translated to uncertainty about the health of these financial institutions. As a result, many financial institutions were no longer seen as reliable providers of safe investments; rather, these entities were considered being risky investment propositions.

### ***Accelerated “flight-to-quality” in fall 2008***

***In fall 2008, there was an accelerated loss of confidence, reflected in the surge in prices for assets with explicit or implicit insurance***

In fall 2008, following the collapse of the large investment bank Lehman Brothers, there was an accelerated loss of confidence (see *e.g.* Figure 1), which was reflected in the collapse of prices for risky assets and the surge in prices for assets with explicit insurance and/or in demand for those assets perceived to carry an implicit insurance. Private financial institutions (with relatively thin layers of capital such as banks and financial guarantee insurance companies) were no longer able however to provide financial insurance of the (high) quality that was demanded, especially as many of these entities struggled for their own survival being caught in a spiral of effects that were mutually reinforcing downward pressures.

***To interrupt adverse dynamics, comprehensive actions were taken, and guarantees***

To interrupt these unfavourable dynamics as well as to satisfy the demand for safe investments, a number of emergency policy actions were taken that were more comprehensive than the earlier piecemeal interventions during the first phase of the current financial crisis. These measures are discussed in Blundell-Wignall *et al.* (2008), and a recent overview of measures taken until late-



*expanded*

February 2009 is provided in Figure 2. One significant feature of this “new generation” of policy measures taken since fall 2008 was the expansion of existing and introduction of new guarantee arrangements in many countries and at an unprecedented scale. These actions have had at least two different aspects.

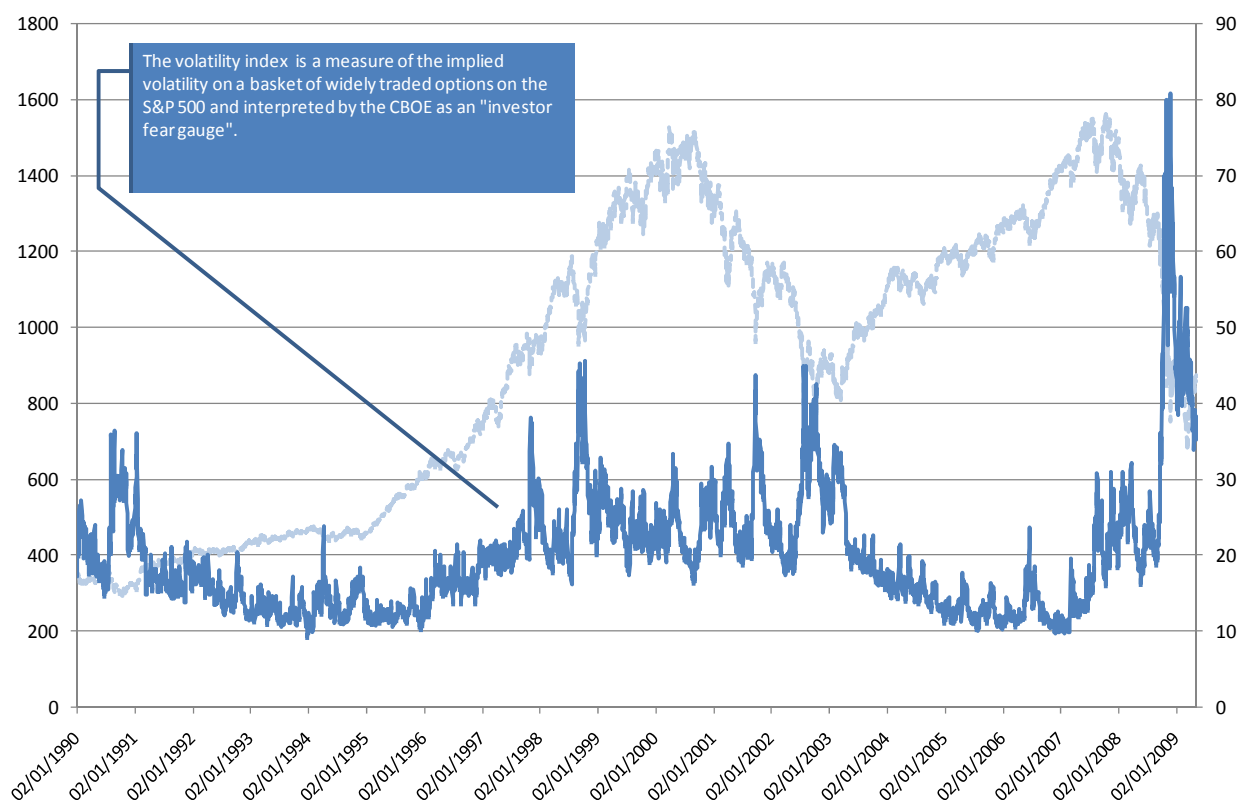
***Guarantees reduced the threat of collapse on the part of banks***

- First, extended guarantees of bank retail deposits and the introduction of bank bond guarantees effectively reduced the threat of collapse on the part of these entities by raising the likelihood that depositors and creditors provide a stable source of financing for them.

***The supposed safety and relative simplicity of government guaranteed investments met with great demand***

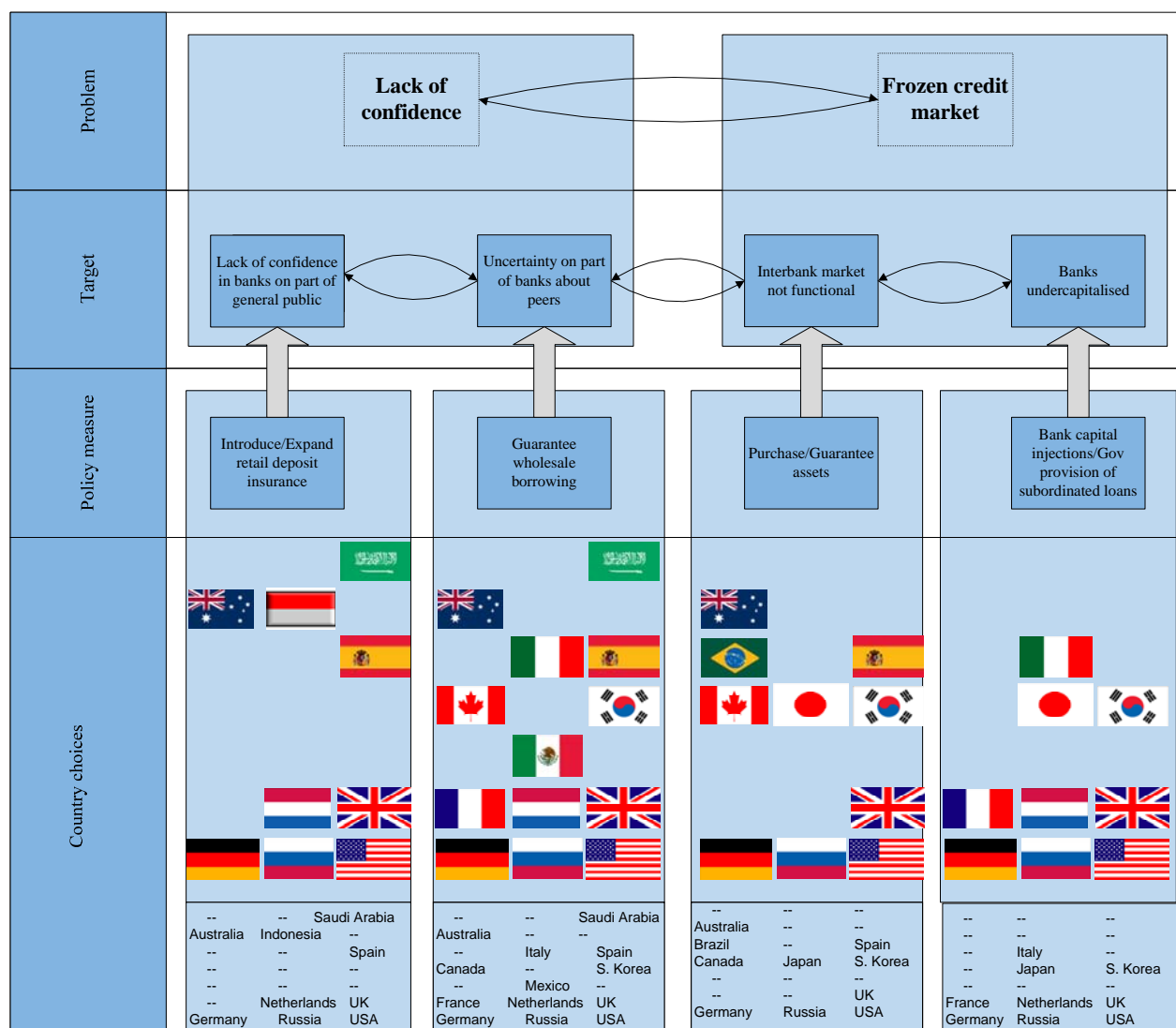
- Secondly, by guaranteeing bank bonds the government - further to facilitating bank refinancing - also essentially substitutes for private financial institutions such as banks and financial guarantors in providing high-credit-quality investments. The supposed safety and relative simplicity of these investments have met with great demand during the current flight-to-quality episode (including on the part of banks themselves).

**Figure 1: Measure of uncertainty**



Source: Thomson Financial Datastream. Notes: Volatility index shown by the bold line. For reference, the thin line shows the actual S&P 500 index.

Figure 2 : Overview of policy measures taken by G-20 plus Netherlands and Spain



Notes: The figure shows information for the G-20 countries and the Netherlands and Spain. The information on ‘Country choices’ is organised in alphabetical order in three columns as shown. A flag or country name indicates that the measure has been taken in that country.

Source: IMF (March 2009) and communications from CMF delegates.

### III Retail deposit insurance arrangements

#### *Expansions of deposit insurance coverage undertaken in fall 2008*

***Policy makers wanted to avoid deposit insurance from turning out to be the weak element of the safety net***

Government provision of a financial safety has been a key element of the policy response to the crisis. In this context, it is widely recognised that, like any safety net, the strength of the financial safety net is determined by the strength of its weakest element. According to many observers, the episode involving Northern Rock in the United Kingdom highlighted that the deposit insurance mechanism can turn out to be a weak element in a country’s financial safety net. Many of the issues related to deposit insurance that were highlighted by this

episode were not specific to the United Kingdom however, but they were relevant for the systems in place in other countries as well. This suggestion has been underscored by the large number of policy measures taken across CMF member jurisdictions in the Fall 2008, many of which were changes to the parameters of deposit insurance arrangements.

***Low levels of coverage are not effective in preventing bank runs***

Earlier discussions with that Committee concluded that an emerging consensus among policy makers was that one of the lessons from the run on mortgage lender Northern Rock in the United Kingdom is that “deposit insurance systems with low levels of coverage and partial insurance, together with likely delays in repayment, may not be effective in preventing bank runs” (Schich, 2008a).

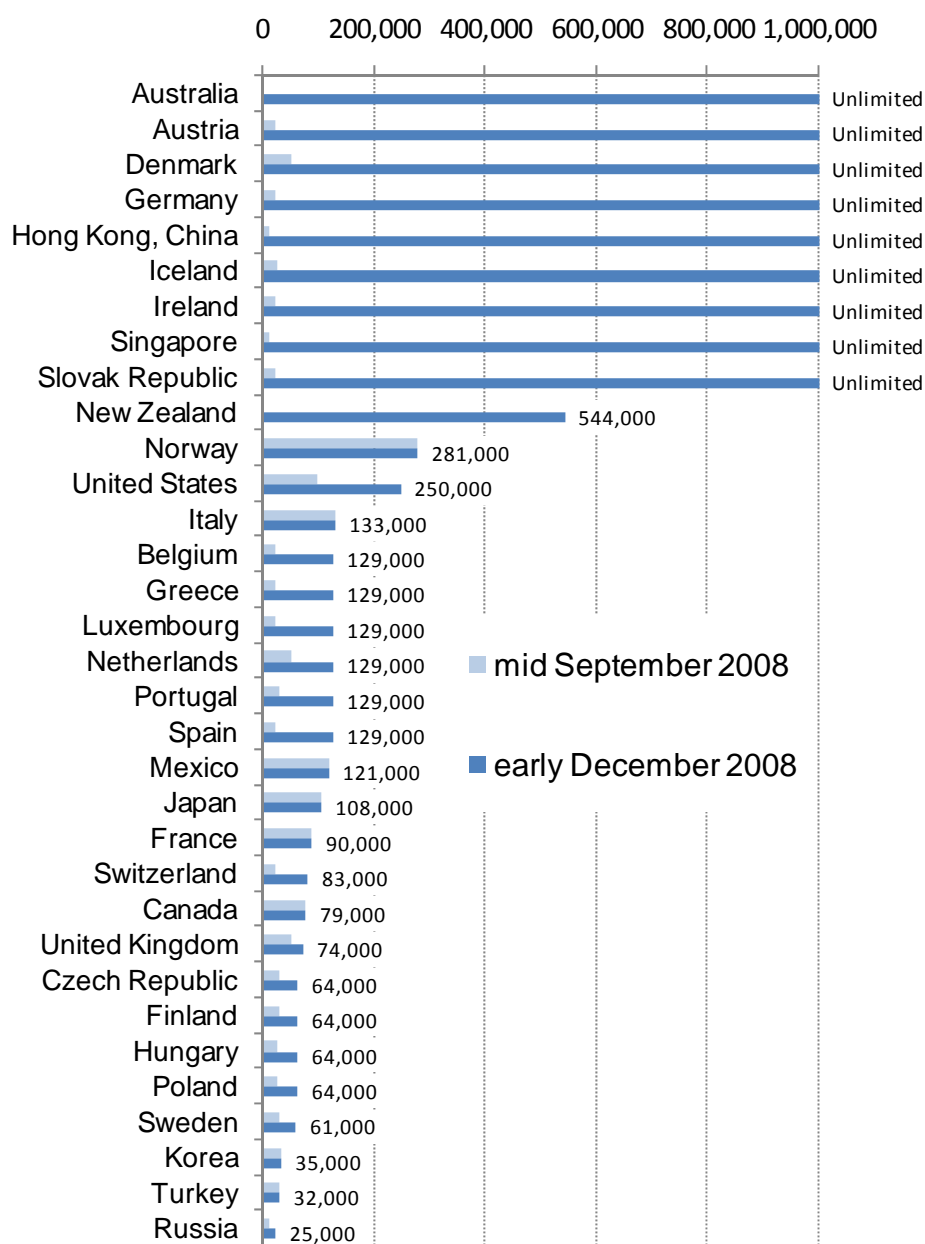
The policy actions taken in the fall 2008 reflected this understanding. Having said that, at least some of the changes may have gone beyond levels that, at that time, might have been considered adequate. An overview is provided in see Figure 3.

***A remarkable feature of changes in fall 2008 was the introduction of unlimited retail deposit coverage in nine CMF jurisdictions***

Most (but not all) CMF members have changed their deposit insurance ceilings and all changes have been upwards adjustments of coverage ceilings per person and per bank. Changes have taken place in 25 out of the 33 jurisdictions covered here, while there were no changes in just eight jurisdictions. A remarkable feature of these changes was the introduction of unlimited retail deposit coverage in nine jurisdictions. Announcements to that effect were either made explicitly or implicitly, in the form of statements by policymakers suggesting that all retail deposits were covered by a government guarantee.

Finally, where explicit deposit insurance schemes had not existed, depositor protection was raised through the introduction of such schemes. Australia, which had established an early access facility in June 2008, extended in October 2008 a three-year guarantee on all deposits in the country’s banks, building societies and credit unions (which was replaced a modified guarantee arrangement in November). At the same time, the finance minister of New Zealand announced that the government had introduced an opt-in deposit guarantee scheme.

Figure 3. Deposit insurance coverage limits



Notes: The figure shows the USD equivalent of the maximum deposit insurance coverage as of December, compared to the situation in mid-September 2008 (using bilateral exchange rates as of early December in the case of both dates to eliminate changes induced by exchange rate movements). Where policy statements suggested or were interpreted as suggesting unlimited deposit insurance coverage, the figure contains a value of USD 1 million (which is being chosen for presentational purposes only). It is worth noting that the reduction in dimensionality implied by the current graph may be misleading in the case of some countries. For example, in Australia, coverage in excess of AUD 1 million is not automatic and requires the payment of a fee by the deposit-taking institution; hence the chart may give a somewhat exaggerated view of the scope of the guarantee in that country.

Source: Schich (2008b).

***Levying risk-adjusted premiums for deposit insurance coverage during “normal times”******Risk-adjusting premiums helps reducing moral hazard, but involves significant practical challenges***

As regards pricing of deposit insurance coverage, there are very significant differences across CMF member country jurisdictions. Adjusting for risk the premiums that financial institutions pay helps reducing moral hazard, but involves significant practical challenges. Solving these problems is likely to be reflected in the choice of country-specific responses (Garcia, 2000).

- First, accurately forecasting the degree of risk that a bank places on the deposit insurance fund has been notoriously difficult. The formulae to accurately assess risk can easily get very complex. Complexity (as the recent crisis reminds us) can however stand in the way of achieving transparency and accountability, which are desirable features of the premium setting process.
- Second, even where premiums are risk-adjusted, there is always a degree of subsidy inherent in deposit insurance: If there was no subsidy and the premiums were to precisely represent a bank’s risk to the deposit insurance fund, the premiums would be prohibitively expensive for already weak institutions and insurance arrangements may not be feasible.

***An element of risk-adjustment is present in many systems***

Reflecting these challenges, premium setting arrangements have differed considerably across CMF member jurisdictions, although an element of risk-adjustment is present in many of the systems with advance-funding features. The details of the determination of the risk-adjustment are however different from one country to another (see for comprehensive reviews Garcia, 2000 and European Commission, 2008).

Where explicit deposit insurance systems were introduced during the fall 2008, risk-adjusted premiums were specified. For example, in New Zealand’s *Crown Retail Deposit Guarantee Scheme* insured deposits will be capped at NZD 1 million, though depositors may hold insured amounts at different institutions. All financial institutions with liabilities of up to NZD 5 billion will pay a fee for the insurance, though this fee will apply only to growth in liabilities since 12 October 2008. The fee is tied to an institution’s credit rating and set at 10 basis points per year for those rated AA or better, 20 basis points for A-rated entities, 50 basis points for B rated entities and 100 basis points for BB rated entities. Institutions rated BBB or less, or that are unrated, will pay a fee of 300 bps, though still only on liabilities in excess of the level at the cut-off date. Financial institutions with liabilities in excess of NZD5 billion will pay these fees on the excess growth and not on the total growth in liabilities. In Australia, a fee applies to retail deposits exceeding AUD 1 million, with the fee being determined as a function of the credit rating of the deposit-taking institution.

***Was there a levy charged for the extra deposit insurance provided during the crisis?******Little if any additional charges***

It appears that the extra deposit insurance coverage provided by governments in fall 2008 was in many cases not accompanied by higher fees or

***were levied on the institutions that benefitted most from the extra insurance coverage, at least not directly***

premiums, even if in some cases governments made commitments of public funds to backstop such arrangements. In particular, little if any additional charges were levied on the institutions that benefitted most from the extra insurance coverage, at least not directly *as a function* of or with explicit reference to that extra coverage. (Questions concerning the actuarial soundness of deposit insurance premiums may be distinguished from situations in which practical circumstances have given rise to a need to replenish deposit insurance funds, such as is the case in jurisdictions where advance-funding arrangements require specific targets for the ratio of funds to deposits; see also Box 1).

A notable exception from this general trend includes Australia, which has introduced an additional fee for (at least part of) the additional deposit insurance coverage provided. To understand the context of this element of the current Australian deposit insurance scheme, it is useful to take a step back and review recent changes in deposit insurance arrangements in that country. Australia had been until quite recently one of the two CMF member countries with no explicit deposit insurance.<sup>2</sup> As Figure 3 shows, the country has now actually jumped from being among the CMF jurisdictions having the lowest amounts of coverage to one of those with the highest within only a couple of months, with the announcement on 12 October of a guarantee on deposits under the Financial Claims Scheme. Under these new arrangements, all deposits at Australian authorised deposit takers are automatically guaranteed up to AUD 1 million (around €500,000) and larger deposits can be guaranteed on payment of a fee, which is the same as that which applies to the guarantee covering wholesale funding (see also discussion in section IV of this article). Although there is no upper limit to such deposit insurance coverage in the case of Australia, Figure 3 perhaps gives a somewhat exaggerated view of the scope of the guarantee in that country, since there is an explicit fee for guarantees on deposits above AUD 1 million (and in most cases, Authorised Deposit-taking Institutions – ADIs – recover the fee from depositors).<sup>3</sup>

***In some cases, the expansion of deposit insurance coverage to restore confidence was chosen for its minimal upfront fiscal costs***

Elsewhere, however, no extra deposit insurance fee has been levied in most of the cases where additional deposit insurance coverage was provided. At least in some cases, it appears that the expansion of deposit insurance coverage to restore confidence was chosen more for its minimal upfront fiscal costs relative to other options, while the chance of such costs arising further down the road was deemed limited given a political commitment to prevent any major institution from failing. In the case of some of the announcements introducing blanket guarantees,<sup>4</sup> such actions were justified as efforts to undo competitive disadvantages arising from the introduction of similar guarantees elsewhere. More generally, there has indeed been a feeling that many governments did not want to stand behind others, as there was a perception that the provision of such guarantees might provide some financial institutions or sectors with unfair competitive advantages as compared to their peers that operate in the same or similar market segments but with more limited, if any, deposit insurance guarantees. Under these circumstances, the need for determining appropriate prices may have been perceived as secondary.

**Box 1. Selected deposit insurance funding issues**

Sound funding arrangements are critical to the effectiveness and credibility of the deposit insurance system. Such systems can be either funded or unfunded or consist of a combination of both elements. Ex ante funding involving a stand-alone deposit insurance fund ensures that funds will be available for depositor compensation when needed, provided premiums charged reflect appropriate assumptions regarding potential losses and other deposit insurance costs. Under such circumstances, the provision of timely access by depositors to their insured deposits is facilitated, as no additional government action or decision is required. Whatever the specific arrangements, the aim is that the deposit insurance system can ensure the prompt reimbursement of depositors' claims (see also BCBS and IADI, 2009). In the case of ex ante funding, it is important to maintain an appropriate ratio between the size of the fund and the amount of total insured deposits, although the "adequacy" of such a ratio depends on the goals of the deposit insurance system, in particular the specific mix of consumer protection and financial stability objectives, as well as the outlook for the latter.

Funding levels can turn out to be inadequate however once bank failures accumulate. In such situations, the difficult issue arises as to how funds should be collected, and (to the extent that failures are not idiosyncratic events) efforts to raise additional funds would be confronted with the risk of reinforcing downward cyclical developments.

For example, in the United States, as a result of the losses resulting from several failures, the Federal Deposit Insurance Corporations' (FDIC) reserve fund had been reduced significantly, even if there is uncertainty about the ultimate losses associated with these interventions (*i.e.* much of that cost should be recovered in the future as the FDIC liquidates the assets held by those institutions). The FDIC, which did not collect insurance premiums from most banks from 1996 to 2006, recently announced an increase in the fees it charges to its insured banks, which has met with criticism on the part of many banks, especially smaller ones. The agency's authority to borrow from the Treasury to meet deposit insurance system funding needs has been already increased.

Where funding levels of deposit insurance funds turn out to be inadequate, the spotlight is almost inevitably put on the taxpayer. A country's fiscal capacity may not always be sufficient, however, to meet demands for compensation by depositors insured under a domestic scheme. For example, the Icelandic deposit insurance fund was funded to the tune of EUR 100 million, while deposits at Icelandic branches in Germany (which were covered to some extent by that scheme) alone amounted to more than EUR 300 million. There were also large branches of Icelandic banks in the United Kingdom and the Netherlands. Issues related to the compensation of depositors of branches of Icelandic banks in these three countries complicated negotiations related to international help for the country. A stand-by arrangement with the International Monetary Fund was concluded as well as bilateral arrangements, as a result of which funding was made available to compensate depositors up to the limit specified under (previous) EU rules (that is up to a maximum of EUR 20,000 per depositor). This example has illustrated that international co-ordinated efforts may be necessary to allow for successful bank rescue operations in such situations, although clear frameworks for such operations do not exist. When international policy actions need to be decided during a crisis situation in a largely ad hoc fashion, additional costs could arise however. By contrast, the mere existence of international policy arrangements set up in advance, perhaps in the form of some kind of mutual insurance arrangements, may even prevent a crisis of confidence from occurring.

***Transitioning to what level of guarantee?***

***As financial stability returns, policy makers need to consider whether the extended coverage will be maintained or not***

As financial stability returns, policy makers need to consider whether the extended coverage will be maintained or not. One of the key questions that policy makers need to answer in that context is what level to transition to, in other words, what a suitable normal level of deposit insurance coverage is. Where the additional guarantee has been conceived as temporary and a specific timeline set (*e.g.* in New Zealand the guarantee is scheduled to be in place until October 2010), the question naturally arises as to what will replace that temporary arrangement.

Unfortunately, there is no rule of thumb to set the limits of "normal" deposit insurance coverage and countries have followed different approaches to fit domestic circumstances. These include the public policy objectives that the deposit insurance arrangements are supposed to meet, with the balance between

financial stability and consumer protection and other objectives varying from one country to another. Whatever the specific amount is, the level of coverage needs to be sufficiently high to ensure that the deposit insurance system is credible and that it instils confidence on the part of the public.

Specifying a too low coverage amount tends to be less effective in instilling confidence on the part of (retail) depositors, and it runs the risk of undermining the credibility of the deposit insurance scheme, thus increasing the likelihood of bank runs when problems occur. By contrast, the higher the extent of the guarantee the greater is the risk of moral hazard.

With most deposit insurance schemes, the response to the above described trade-off historically under normal circumstance has been to establish coverage limits that gravitate towards covering the vast majority of small depositor's balances while ensuring that large, especially corporate and interbank, deposits are exposed to market discipline. Additional considerations need to be taken into account however when transitioning to more limited guarantees in the context of a crisis situation (see also discussion in the next sub-section).

*Despite similarity in the basic approach, there has been no agreement on a specific value of maximum coverage across different CMF jurisdictions*

In any case, despite this similarity in the approach, there typically has been no agreement on a specific value of maximum coverage across different CMF jurisdictions (Figure 3). At the end of last year, some 18 out of 33 CMF member jurisdictions have specified ceilings per person and per bank that range between the equivalent of USD 60.000 to USD 135.000. The median value of such ceiling was the equivalent of about USD 130.000 at the end of last year.<sup>5</sup>

Looking ahead, recent decisions regarding EU Directives imply that convergence of deposit insurance ceilings should occur within many European CMF member jurisdictions (specifically, among those that are members of the European Economic Area). In a report on deposit guarantee schemes due at the end of 2009, the European Commission will have to assess the appropriateness of a harmonisation of coverage levels, possibly at EUR 100.000. Under current circumstances, by 31 December 2010 EU Member States (and other EEA jurisdictions implementing EU Directives) have to ensure that the coverage for the aggregate deposits of each depositor be set at 100.000 euros in the event of deposits being unavailable. Incidentally, this suggested level is close to the current median of the sample of CMF member jurisdictions, which is much higher than it was in September 2008, that is before insurance coverage levels were expanded.

*Country-specific circumstances may make any common fixed amount of coverage either "too high" or "too low"*

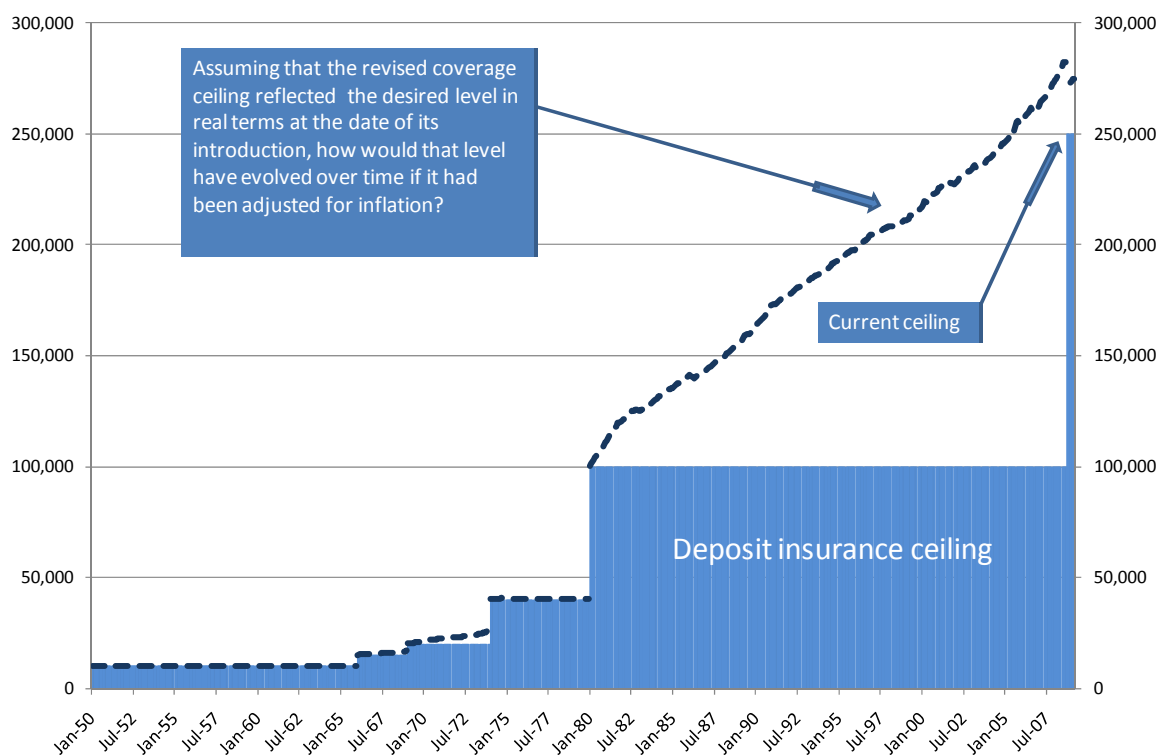
Such an amount might not be the most appropriate in the case of every CMF member, however. Generally, country-specific circumstances may make any common fixed amount of coverage either "too high" or "too low", depending on the specifics of individual jurisdictions. For example, in Norway, the choice of the deposit protection ceiling of 2 million crowns was intended to cover even a once-in-a-lifetime situation for a normal family, which would be a situation in which a family receives the proceeds from the sale of their house, without yet having reinvested the proceeds. Public authorities considered that in such situations, which could extend to a few weeks, households should not have to worry about which bank to use for depositing these proceeds. At the time, more than 75 per cent of house sales involved payments below 2 million crowns.



Even though house prices are now considerably higher than they were when the new ceiling was introduced, a discussion on a potential upward revision has actually not taken place. Looking forward, it is not so clear whether this level of protection can even be maintained. Were the proposal by the European Commission to be passed as is, Norway would be forced to modify its tested deposit insurance system and reduce the protection limit. Actually, the recent European proposal would necessitate a reduction of about 50 per cent from the level established in Norway (see also Figure 3).

In the United States, where the increase in insurance coverage was initially conceived as temporary, discussions have set in as to whether to extend the duration of expanded coverage beyond the initially specified date of 31 December 2009, perhaps even making the change permanent.<sup>6</sup> In May, the coverage limit of USD 250,000 was extended to December 31, 2013. Note that, as a general rule, deposit insurance coverage ceilings are in practice sometimes subjected to change as a result of developments in GDP growth or inflation rates, and not necessarily as a result of immediate stability concerns. In this context, it is interesting to note that the current ceiling of USD 250,000 is similar to the level of the ceiling that would be obtained by adjusting the previous ceiling by a measure of inflation since the date of its introduction in January 1980 (see Figure 4). That level would appear to be high compared to the statutory ceilings in place in many other countries, including European ones, although this observation had been true also before the crisis.

**Figure 4: Evolving deposit insurance ceiling in the United States**



Source: Author's calculations based on data from Federal Deposit Insurance Corporation and United States Bureau of Labor Statistics.

*Issues to be considered when transitioning from blanket to limited guarantees*

***Delaying the withdrawal increases the risk of moral hazard, while a too rapid withdrawal may threaten financial stability***

Should policy makers decide to reduce existing coverage levels, they need to implement effective strategies to transition to more limited guarantees. The transition from very extensive or even unlimited to limited coverage involves trade-offs, however, the extent of which is influenced by country-specific factors such as the social and economic environment, as well as the structure and development of the financial system. A key trade-off is that delaying the withdrawal increases the risk of moral hazard, while a too rapid withdrawal may complicate the return to financial stability.

***While universally applicable rules as to how and when the transition from blanket guarantees to more limited guarantees are unavailable...***

The experiences with the transitioning from blanket to more limited deposit insurance guarantees have differed across countries, as has the duration of periods during which blanket guarantees were in place (see Appendix 1), reflecting both specific institutional and historical conditions as well as the extent of progress made regarding the resilience of the banking system. Reviewing past experiences (in a comprehensive survey undertaken by the IMF to identify good practices regarding deposit insurance arrangements), a study concluded that it is difficult to identify specific universally applicable rules as to how and when the transition from blanket guarantees to more limited guarantees should be made (Garcia, 2000).

***..., withdrawal should be as rapid as possible***

Having said that, there has nevertheless been widespread agreement that unlimited retail deposit coverage, once implemented, should be withdrawn as rapid as a country's circumstances permit (FSF, 2001). Otherwise, additional costs could arise (Box 2). The experience of Japan with deposit insurance illustrates the difficulties in withdrawing extended guarantees.<sup>7</sup>

*How credible are specific timelines for withdrawal of blanket guarantees?*

***Withdrawing blanket guarantees is difficult....***

Practices that are relevant to the possible timing of withdrawal of blanket guarantees have differed across the jurisdictions concerned. Some governments have set specific deadlines for the extra deposit insurance to be withdrawn (see Appendix 2 for an overview), such as end-2009, although it cannot be excluded that such deadlines be prolonged. In some cases, no specific deadlines have been set so far, although the announcement regarding statutory limits may provide an indication regarding envisaged timelines in at least one case. Two considerations are singled out for attention here in this context:

***... when policy measures to address the root causes of the crisis are not ambitious enough***

- First, one risk is that even the “new-generation” policy measures to restore confidence and support financial intermediation to address the crisis are not ambitious enough, not credible or ill-focused (see e.g. Blundell-Wignall et al., 2008). This situation may lead banks and other entities covered by the guarantees to believe that the extended guarantees will stay in place for longer than the government may have initially planned or announced. To the extent that the measures are perceived as insufficient to insulate troubled bank assets, banks may lose motivation however to contribute to these efforts while deposits

remain fully protected, thus creating additional moral hazard. As a consequence, the guarantees put in place in fall 2008 would actually worsen the problem they were supposed to cure.

### Box 2. BCBS and IADI (2009) guidance on exit from blanket guarantees

The basic trade-off involved in transitioning from a blanket guarantee is summarised in a FSF study as follows: “After a country has suffered a financial crisis, it is best to ensure that most of the major problems relating to the financial crisis have been adequately addressed before transitioning to limited-coverage deposit insurance. However, if governments wait for all deficiencies in an economy or financial system to be addressed or the system to be reformed, blanket guarantees could become entrenched” (FSF Working Group on Deposit Insurance, 2000, p.12). The relevance of these considerations, developed before the year 2000, has been confirmed in recent joint work: As foreshadowed in the discussions of the issue of deposit insurance at past CMF meetings, the BCBS&IADI draft guidelines have now been finalised and issued as a Consultative Document. The explanations and supporting guidance in relationship to the transitioning from blanket guarantees specify the following (BCBS and IADI, 2009, p. 13f):

*The first issue arises from the fact that protection for depositors and possibly other creditors is being reduced. This may present a concern to the public. Therefore, policymakers should pay particular attention to public attitudes and expectations. Countries with a high level of capital mobility, and/or a regional integration policy, should consider the effects of different countries’ protection levels and other related policies.*

*Second, policymakers should consider the capacity of the banking system to fund a new deposit insurance system. The transition to limited coverage usually involves the imposition of new or revised premiums or levies on banks. If those funds are insufficient to pay for the cost of the blanket guarantee – especially if it stems from a systemic crisis – the cost usually is shared between banks and the government. The latter can resort to budgetary resources (i.e. higher taxes), asset sales, or debt issues. In any case, it is important to have a clear mechanism in place to ensure that the deposit insurance system will have access to adequate funding during and after the transition.*

*The final issue concerns how fast the transition should proceed. In general, the transition should be as rapid as a country’s circumstances permit. Some countries have implemented so-called fast-track transitions successfully soon after the crisis has passed. These are countries that have restored the banking system to financial health rapidly; and where strong prudential regulation and supervision, effective legal frameworks, and sound accounting and disclosure regimes were already in place. In other countries, the implementation of a blanket guarantee has been associated with a comprehensive post-crisis bank restructuring strategy and measures to improve prudential regulation and supervision, the legal framework, and the accounting and disclosure regimes. This has implications both for the length of time that the blanket guarantee needs to stay in place and for the speed of the transition. The gradual removal of a blanket guarantee allows banks time to adjust to necessary institutional changes which could include legal and supervisory reforms. In addition, a gradual transition permits bank managers to be trained in a risk-management culture and gives depositors time to become accustomed to the new arrangements. A major disadvantage, however, is that the transition period might be perceived as being too long, raising doubts among depositors and creditors about the government’s commitment to withdraw the blanket guarantee. In addition, the longer the blanket guarantee remains in place, the more likely it is to give rise to additional moral hazard.*

***Also, it is a question whether a government guarantee can effectively be withdrawn under all circumstances***

- Second, an interesting question is to what extent government guarantees can effectively be completely withdrawn under all circumstances. To be sure, government guarantees can be withdrawn once times get better, that is once the crisis abates. However, once a government has entered such territory, there may be a general perception that a government guarantee will always be made available during a crisis situation. Indeed, the policy actions taken today in response to the crisis are likely to be imprinted in the memories of

market participants, including depositors and bank managers. There may be a general perception that, once a guarantee is extended in any given crisis, the specific type of government guarantee – such as a blanket retail deposit insurance coverage -- will always be made available during crisis situations, that is when large parts of the banking system are coming under stress. If true, it might be necessary to strengthen other elements of the financial safety net, including the prudential and supervisory framework, so as to limit moral hazard.

#### IV Introduction of guarantees for bank bonds

##### *An emerging new asset class*

##### ***Governments have extended guarantees to bank bonds***

Several governments have also extended guarantees to bank liabilities not traditionally covered by guarantee arrangements (for some other examples see Box 3), including newly issued senior unsecured bank debt. Since the first issuance of a guaranteed bond on 22 October 2008 by Barclays Bank in the United Kingdom, the market for guaranteed bonds has grown quickly in several countries, including in the United States, the United Kingdom, and France. From an investors' perspective, governments are now substituting in for such private financial institutions such as *e.g.* financial guarantee insurance companies, which used to be able to provide investments highest (credit rating) quality.<sup>8</sup>

##### ***The market for bank bonds is growing rapidly and projected to continue to grow***

Government-guaranteed bonds (GGB) have met with vigorous demand. Issuance activity of GGB slowed somewhat in February 2009 (Figure 5), but has picked up again subsequently and is projected by market participants to continue being strong throughout the remainder of the year. According to one estimate, (cumulative) gross government-guaranteed bond issuance could reach USD 1 trillion by the end of the year.<sup>9</sup> In terms of gross issuance, the largest regional markets are the United States, the United Kingdom, France, and Germany (Figure 6).<sup>10</sup> For sure, the potential market dynamics are limited by the fact that all programmes have a finite lifespan, even though initial end-dates have already been postponed.

##### ***Underwriting GGB has become an important source of banking income***

As a result of growing issuance activity, banks have been reported to already have earned close to USD 1 billion in fees in less than four months in selling GGB to investors. This new source of income has been compensating at least partly for the lower revenues earned from fixed income and mergers and acquisitions activities. For a typical European government-guaranteed bank bond, a bank syndicate can reportedly charge EUR 1.5 million for a EUR 1 billion bond with a three-year maturity, while the fees in the US may be even double that level. Banks appear to be very keen to be involved in this type of activity and, ironically, there were instances where a bank participated in (and shared in the fees for) underwriting its own bond issues.<sup>11</sup>

**Box 3. Other types of government guarantees**

The United States has proposed a new programme to address the problem of bad assets on banks' balance sheets that would expedite the process of separating out the problem "legacy" loans and securities. It involves enabling final purchasers of the legacy loans to buy them using debt guaranteed by the FDIC. The FDIC guaranteed debt would be collateralised by the purchased assets and the FDIC would receive a fee in return for its guarantee. As regards the investors, the Treasury explains that a broad array of investors is expected to participate and that the participation by individual investors, pension funds, insurance companies and other long-term investors is particularly encouraged. To the extent that banks are among the buyers (of other banks' legacy loans) then the liabilities incurred in the context of these purchasers would potentially benefit from this type of guarantee.

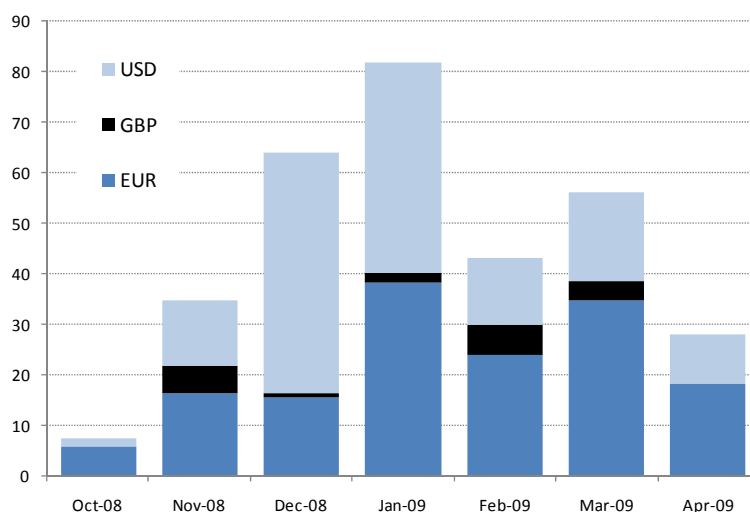
Several governments have also extended guarantees to interbank deposits, although only on a temporary basis. For example, already on 30 September 2008, the Irish government guaranteed all deposits held in the six biggest banks. The scheme guarantees was estimated to cover EUR 400 billion of liabilities, including retail, commercial and interbank deposits. The scheme took effect immediately and was scheduled to expire in September 2010. On 10 October 2009, Ireland extended its blanket guarantee on bank deposits to five foreign-owned banks with substantial operations in Ireland. The Temporary Liquidity Guarantee Program in the United States also provides for guarantees of interbank deposits on a temporary basis. Inclusion of interbank deposit in guarantee schemes is unusual, however, and such guarantees are unusual under normal circumstances (and typically not part of permanent features of deposit insurance arrangements). For example, in a worldwide survey conducted by the IMF of such schemes, 54 out of 76 guarantee schemes surveyed explicitly excluded inter-bank deposits from coverage. The incidence of coverage of such types of deposits was mostly concentrated in emerging markets, although it was not restricted to them. The ECB explicitly recommended on 20 October that government guarantees on interbank deposits should not be provided.

Some governments also provide protection to qualifying institutions against credit losses on qualifying portfolios of assets that exceed a "first loss" amount to be borne by the participating institution. For example, in the United Kingdom, the Asset Protection Scheme was introduced in January 2009 to protect larger deposit-taking institutions from certain future exceptional losses on a pool of eligible assets, which have been investigated and approved for coverage. There is a "first loss retention" by the participating bank, which means no protection payments are made in relation to losses up to the first 10 per cent of the agreed value of the asset pool. In return for participation in the scheme the bank will have to pay a fee, which can be paid in cash or securities. In the case of Royal Bank of Scotland, the agreement reached at end-February 2009 foresaw the payment by the bank to the government a fee in the form of non-voting but dividend-paying shares equivalent to about 2 per cent of total assets insured, which in turn amounted to about 15 per cent of total assets. A key feature of such schemes is that the participating financial institution is subjected to a number of additional restrictions and conditions, compared to those regarding government guarantees for bonds. For example, the German "Finanzmarktstabilisierungsfonds" (Financial Market Stabilisation Fund) assumes risk positions (shares in losses on specific assets) when a number of conditions are fulfilled. They include not only the pursuit of "solid business policy" (already applying in the case of government provision of bond guarantees), but also provisions on remuneration and restrictions regarding dividend payments, as well as requirements to extend loans to small and medium-sized enterprises.

*Using market prices as reference for setting government guarantee fees****The need for charging an appropriate price is recognised as being important***

The need for charging an appropriate price for government guarantees of bank bonds has been widely recognised by policy makers as being of paramount importance. In practise, the fees charged for guarantees on wholesale funding have been typically risk-based, relying on credit ratings<sup>12</sup> or credit default swap premiums or reflecting the term of the instrument. In a number of countries, the fee structures have been adjusted over time.

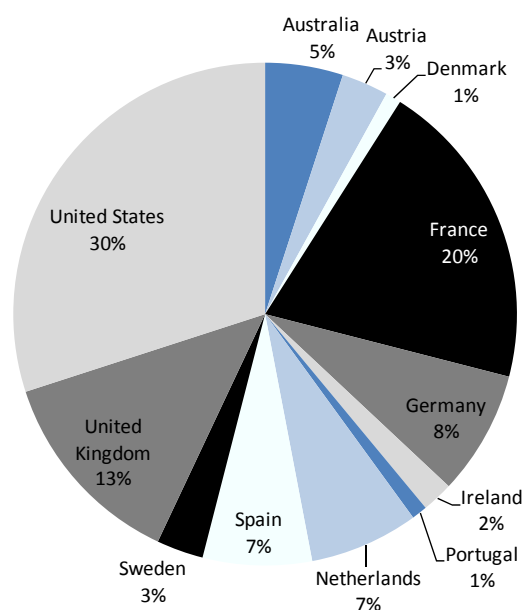
The task of specifying risk-adjusted premiums for government guarantees of bank bonds should be facilitated, as compared to the case of retail deposit insurance coverage, because there already exist markets for similar types of protection, specifically those for credit default swaps (CDS), which could provide a reference for premium setting.

**Figure 5: Gross issuance volumes of GGB (in EUR billion)**

Source: Barclays Capital Research, "The AAA Investor", 30 April 2009.

**Figure 6: Regional structure of GGB issuance**

Per cent of total gross issuance, as of February 2009



Source: Barclays Capital Research, "The AAA Investor", 30 April 2009.

*CDS are, in principle, a helpful reference for fee-setting...*

Many policy makers concur that, in principle, the premium for government provision of bank bond guarantees should be determined on the basis of market-oriented valuation and be as close as possible to market premiums, to the extent that such reference prices are actually available.<sup>13</sup> There are however at least two problems in this regard.

*...although there are problems in practice*

- First, questions have been raised regarding the appropriate functioning of the pricing mechanism in financial markets. In such a situation, the question arises how one could explicitly calculate an appropriate premium for a public guarantee at a time when market prices in illiquid markets are highly volatile and may no longer exhibit close correlations with changes in underlying fundamentals.

The issue of lack of liquidity is currently particularly relevant in the case of contracts over long horizons exceeding five years, while movements at the shorter end tend to suffer less from that issue. Having said that, the very short end of one year or so appears to be driven by short-term hedging considerations, and is thus considered by many market participants as being less reliable as an indicator of market perception of default probabilities. The benchmark and the rate least affected by these issues appears to be the 5-year rate.

One approach to addressing the issue of a liquidity premium in observed data has been the charging of premiums using a function of historical CDS prices according to which more distant observations are valued more heavily as compared to most recent observations. To the extent that prices have indeed become ever more unreliable over time, this practice thus corrects for some “price anomalies”. Statistical theory does not provide clear guidance as to what particular weighting scheme should be chosen, and approaches have differed across countries. The ECB Council has provided guidance in this respect.<sup>14</sup>

- Second, while premiums for credit default swaps reflect market expectations of the riskiness associated with the debtor, such guarantees are provided by *private* counterparties, and not the government. Guarantees by the government from the same constituency than the former should (under rather general conditions) be more valuable given that sovereigns tend to be characterised by a more limited counterparty credit risk than private entities. All issues guaranteed by governments are rated AAA/Aaa/AAA by Fitch, Moody’s and S&P, respectively.

*The practical problems are addressed differently in the various programmes...*

This issue could be addressed by charging an extra fee in addition to the debtor-specific risk-based premium, although it is not so clear how the level of that extra fee should be determined. Conceptually, one approach could consist of charging the difference between the borrowing rates of an AA-rated institution and the Treasury in the same country, so as to account for the quality of the credit rating of the Treasury that provides the guarantee. In practice, a flat extra premium is generally charged in addition to the risk-based debtor-specific premium, with guidance from the ECB Council suggesting a value of 50 basis points.

Guarantees are made available by governments with the aim of initiating and supporting the financial intermediation process and in some cases the guarantees are provided conditional on specific actions taken by the beneficiary financial institution. Such conditions and restrictions regarding bank behavior in principle tend to lower the value of the guarantee for the bank and thus the premium that governments should charge. By how much is not so clear, however, and there will necessarily be some scope for interpretation that may vary from country to country.

*..., so that the details of guarantee programmes differ, despite co-ordination*

The rescue packages including their guarantee elements are co-ordinated to some extent across countries, although the specific design and implementation remains a national responsibility. As a result, even though a growing number of countries has now implemented or announced bank debt guarantee programmes that have a similar focus, the details of these programmes differ. For example, in the case of the United States, institutions not wishing to participate had to opt out of the programme, while elsewhere prospective borrowers have to apply to the government for a guarantee on that particular issue. Also, the types of specific instruments covered and the envisaged duration of the validity of the guarantees differ (some of which have already been extended).

*Fee levels can differ noticeably from one programme to another as a result of the specific design of the fee-setting mechanism*

The determination of fees levied by the government also differs from one programme to another and, as a result, fee levels can differ across countries. The following simple example illustrates this point. For a guarantee on a two-year bond, for example, Citigroup would be charged 100 basis points on an annual basis under the United States Temporary Liquidity Guarantee Programme for debt issued before 1 April 2009 (for recent revisions to fee structure see Table 2). An institution that has exactly the same history of CDS spreads as Citigroup would however have to pay 130 basis points (50 basis points fixed plus median spread from 2 July 2007 to 1 July 2008) and 107 basis points (50 basis points fixed plus median spread from 1 January 2007 to 31 August 2008) for a similar two-year government guarantee in the United Kingdom and Germany, respectively.<sup>15</sup> The difference between the latter two premium estimates reflects the choice of reference period, which is different between the schemes used in Germany and the United Kingdom. This choice influences the premium level; for example, the CDS premium for Citigroup remained below 20 basis points for most of the first half of 2007. The reference period suggested by the Governing Council of the ECB is from 1 January 2007 to 31 August 2008. The example given here is not chosen to imply that some specific premium setting regime is more or less appropriate than another, but just to highlight how differences in details of government guarantee programmes can matter for the charges levied.

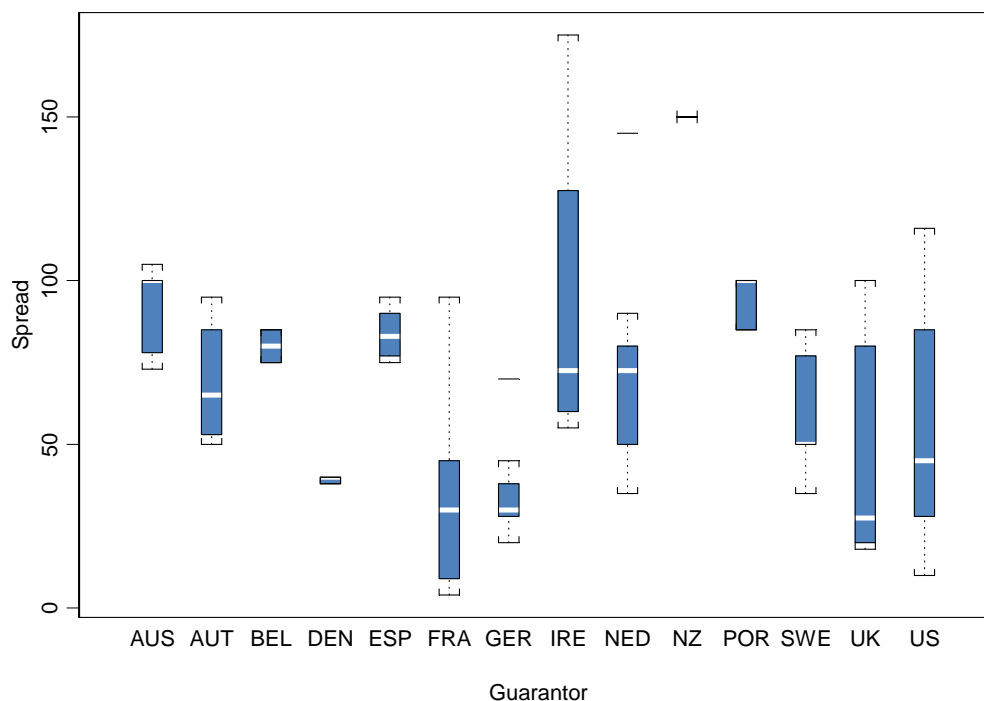
*(Primary) market data suggest that the value of a guarantee reflects the identity of the sovereign*

An interesting observation is that (primary) markets appear to distinguish between guaranteed issues according to currency (e.g. spreads are higher in USD issues than in EUR issues), maturity, etc. as well as the type of sovereign guarantor (see e.g. Figure 7).<sup>16</sup> This observation implies that market participants suggest that the value of a government guarantee differs depending on which sovereign extends it.



**Figure 7: Ranges of primary issuance spreads of GGB**

(data from October 2008 to April 2009)



*Notes:* Boxplot (showing minimum, maximum, upper and lower quartiles, median and outlier) representation of the spread at issue of selected government guaranteed bonds denominated in either USD or EUR with principal amount exceeding USD 1 million (between four and nine issues per country, with maturities ranging from 2 to 5 years, but being concentrated between 2 and 3 years), compared to the mid-swap rate in the respective currency (here either US dollar, British Pound or Euro). The mid-swap rate is an important reference value for refinancing on the capital market; it describes the fixed rate side of an interest rate swap between AA-rated banks.

*Source:* Author's calculations based on information from public authorities' websites, Thomson One Banker, Barclays Capital, and informal communications from CMF delegates.

**Table 2: Charges levied for government guarantees of bank debt**

	United States	United Kingdom	France	Germany
Name of scheme	<i>Temporary Liquidity Guarantee Programme</i>	<i>Credit Guarantee Scheme</i>	<i>Société de financement de l'économie française</i>	<i>Sonderfonds Finanzmarktstabilisierung</i>
What is guaranteed?	New senior unsecured debt, including promissory notes, commercial paper, unsecured sections of secured debt.	New senior unsecured debt instruments of varying terms of up to 36 months, in any of sterling, US dollars or Euros. Some flexibility was added in December 2008 to allow rolling over debt as agreed with the Treasury (beyond the initial term).	New debt issued by a special purpose vehicle which will then grant repo credit lines to participating French banks up to 5 years of maturity.	New debt up to 5 years of maturity.
Fee setting	Sliding fee based on term of maturity. Maturity up to 180 days: 50 basis points. Maturity from 181 to 364 days: 75 basis points. Maturity up from 365 days: 100 basis points.	50 basis points plus 100 per cent of the median 5-year CDS spread calculated over the reference period, which is from 2 July 2007 to 1 July 2008.	20 basis points plus the refinancing costs of the SFEF plus an institution-specific premium calculated as a function of its CDS spread.	Maturity from 3 to 12 months: 10 basis point fee to issue government guaranteed bonds plus a fee of 50 basis points.  Maturity from one to five years: 50 basis points plus median 5-year CDS spread over the reference period, which is from 1 January 2007 to 31 August 2008.
Surcharges in addition to fees	In March 2009, the FDIC imposed a surcharge (in addition to current fees) on debt issued with a maturity of one-year or more beginning in the second quarter to gradually phase-out the program. For guaranteed debt that is issued by June 30, 2009, and matures by June 30, 2012, the surcharge is 10 basis points (on an annualised basis) for an insured depository institution and 20 basis points (on an annualised basis) for all others. For all other guaranteed debt that utilises the extension (either through a maturity after June 30, 2012, or through issuance after June 30, 2009), the surcharge is 25 basis points (annualised) for an insured depository institution and 50 basis points (annualised) for all others.			

*(continued on next page)*

**Table 2 (continued): Charges levied for government guarantees of bank debt**

	United States	United Kingdom	France	Germany
Initial cut-off date for issuance of new debt	Debt issued from 14 October 2008 to 30 June 2009.	New debt issued before April 2009.	New debt issued before 31 December 2009.	New debt issued before 31 December 2009.
Revised cut-off date for issuance of new debt	On 17 March, the Board of Directors of the FDIC voted to extend the debt guarantee portion from June 30, 2009 through October 31, 2009.	New debt issued before December 2009.	(unchanged)	(unchanged)
End of validity of guarantee, as initially suggested	Guarantee not to extend beyond 30 June 2012.	Guarantee not to extend beyond April 2012.	Guarantee not to extend beyond 31 December 2014.	Guarantee not to extend beyond 31 December 2012.
(Revised) End of validity of guarantee	For entities that are eligible to issue FDIC guaranteed debt after June 30, 2009, the guarantee on debt issued on or after April 1, 2009, will expire no later than December 31, 2012. The guarantee on debt issued before April 1, 2009, will expire no later than June 30, 2012.	Guarantee not to extend beyond April 2014. In December 2008, the duration of the scheme was lengthened from 3 to 5 years. In this context, the 3 year maximum term of individual instruments was retained, although some flexibility was added to roll over debt as agreed with the Treasury to enable institutions to better manage the transition from guaranteed to wholly unsupported funding.	(unchanged)	Guarantee not to extend beyond December 2014 (as maximum maturity was raised to five instead of three years).

*Notes:* The Federal Deposit Insurance Corporation (FDIC) officials reportedly advised the largest banks in the United States on 9 March 2009 that they may be charged more for the agency's debt guarantees. On 17 March, the Board of Directors of the FDIC voted (to extend the debt guarantee portion from June 30, 2009 through October 31, 2009, and) to impose a surcharge on debt issued with a maturity of one-year or more beginning in the second quarter to gradually phase-out the program. For guaranteed debt that is issued by June 30, 2009, and matures by June 30, 2012, the surcharge will be 10 basis points (on an annualised basis) for an insured depository institution and 20 basis points (on an annualised basis) for all others. For all other guaranteed debt that utilises the extension (either through a maturity after June 30, 2012, or through issuance after June 30, 2009), the surcharge will be 25 basis points (annualised) for an insured depository institution and 50 basis points (annualised) for all others. Surcharges will be in addition to current fees for guaranteed debt.

*Source:* OECD estimates based on information available from the public websites of public authorities and informal communication with Treasury or central bank staff.

### *Eligibility among financial institutions*

***Another issue that might have implications for competitive conditions is the design of eligibility criteria***

Another issue that might have implications for competitive conditions is the design of the criteria defining which financial institutions are eligible for issuing debt under government-provided guarantee schemes. For example, to avoid distortions, benefits have been typically made available both to domestic financial institutions as well as to subsidiaries of foreign institutions in several programmes, although there have also been discussions as to whether access to programmes should not be restricted to domestically owned institutions. Where eligibility and the terms and conditions of benefits are determined, at least to some extent, as a function of various criteria such as the role of the financial institution for domestic financial stability, the payment system, and for confidence in the financial markets, there is some scope for discretion. In the European Union, the European Commission has published guidance on how Member States can support financial institutions whilst respecting EU state aid rules.

### *Distortions vis-à-vis other debt securities*

***Issues may arise as other forms of securities do not enjoy a guarantee***

A related issue is that other forms of securities do not enjoy a guarantee; hence, an unfair advantage for the bank liabilities enjoying such a guarantee might arise or perceived to exist, as a result of which there could be shifts of funds from other securities, such as (not-government-guaranteed) bank liabilities or covered bonds. For example, in Germany, issuers of Pfandbriefe have opposed an extension of the term of government guarantees from three to five years on the grounds that demand for the former would be reduced and issuance costs increased. More generally, the appetite for non-guaranteed debt issued by financial institutions has been reported as being very limited and the pricing of issues by lower-rated sovereigns and supra-nationals has reportedly been affected.

To reduce the possibility of such developments and the potential adverse implications associated with them, at the level of national markets, one approach has been to widen the guarantees to other forms of liabilities. In those situations, the difficult issue arises however as to where to draw the line. Clearly, issues are further complicated to the extent that the competitive distortions involve cross-border effects.

## **V Concluding remarks**

### ***Moral hazard risk can be limited by setting risk-based premiums***

***While the immediate task is to restore confidence...***

Perhaps foremost among the challenges associated with guarantees for bank liabilities is that, like any insurance, they give rise to moral hazard. Moral hazard is an important issue and should not be ignored, even if in the midst of a crisis the immediate task is to restore confidence and guarantees can be beneficial in that respect.

***...authorities should aim at limiting moral hazard***

Having said that, it is worth noting that the (immediate) policy response to a crisis can have an important influence on the functioning of financial markets over the medium to long-term as the crisis itself. Thus, even in the midst of a

financial crisis, authorities should not lose sight of the fundamental policy goal of supporting efficiently operating financial markets. The manner in which policy makers manage and resolve the current crisis will affect market participants' expectations regarding future policies and, perhaps, the likelihood and depth of future crises, through the impact it is likely to have on market discipline (which arguably has not worked properly in this crisis).

Financial markets are forward-looking and, therefore, current strategies as regards so-called "emergency measures" are likely to influence the behaviour of market participants going forward. In this sense, there is also a very close link between emergency measures and the sort of exit strategies that the OECD is examining, which makes it very difficult if not impossible to separate these issues. For example, providing guarantees for extensive periods, especially to institutions that are technically insolvent, subsidises "gambling-for-redemption" strategies, thus undermining market discipline and possibly raising the final costs of resolving a crisis for the deposit insurer, the government, and the public at large (Lumpkin, 2002, 2008).

Where extra deposit insurance has been put in place and new guarantees on bank bonds have been provided, government insurance potentially covers a large part of total bank liabilities, and thus becomes a key parameter in banks' refinancing. As banks that are actual or potential beneficiaries of such guarantees adapt to this situation, they might develop business strategies that rely heavily on the availability of such forms of government support, which makes it likely that the extension issue arises even where governments have specified termination dates for the additional bank liability guarantee coverage.

***Specifying risk-based premiums for government-supported guarantees is helpful in that respect***

To limit moral hazard it is important to specify risk-based premiums for government-provided guarantees. The evidence in this regard has been mixed, however. While government-provided guarantees for wholesale liabilities have typically involved the charging of risk-based fees, some governments have not even attempted to levy fees for the additional retail deposit insurance coverage that was provided. These cases include some cases where a blanket retail deposit guarantee was announced.

### ***Blanket retail deposit insurance guarantees should be withdrawn as soon as possible***

***Specifying a credible timeline for withdrawal of guarantees is complicated by the considerable uncertainty about the crisis duration***

Where no charges are levied for blanket guarantees, the issue of a proper "exit strategy" becomes particularly relevant. It is important to specify when the extra deposit insurance will end (as some governments have done), and this timeline needs to be credible. Absent a credible "exit strategy", government guarantees once implemented can be difficult to withdraw. The difficulty with specifying timetables for the phasing-out of extended guarantees is, however, that in the midst of a crisis there is considerable uncertainty about the duration of the crisis (which may explain why some governments have not provided specific guidance as to when exactly the blanket guarantee that is in place will be withdrawn).

***No strong conclusions exist as to how to phase out***

Unfortunately, there does not exist *specific* guidance as to how and when the transition from blanket guarantees to more limited coverage should be made. The experiences of countries having withdrawn unlimited guarantees do not

***unlimited guarantees that would apply under all circumstances***

allow us to draw general strong conclusions that would apply under general circumstances and in the current situation. Rather, country-specific circumstances need to be taken into account, and the role of and possible interactions with protections given to other types of liabilities, such as those on bank bonds, also need to be considered. In any event, experience shows that unlimited guarantees tend not to be withdrawn within a couple of years after introduction.

***Once the crisis abates, policy makers need to decide what a “normal” level of coverage is***

***One of the key questions is what level of coverage to transition to?***

More generally, where policy makers have decided that the extended coverage will not be maintained once the crisis abates, one of the key questions is at what level of coverage to target? In other words, what is a suitable “normal” level of deposit insurance coverage? Specifying a too low coverage amount tends to be less effective in instilling confidence on the part of (retail) depositors, and it runs the risk of undermining the credibility of the deposit insurance scheme, thus increasing the likelihood of bank runs when problems occur. By contrast, the higher the extent of the guarantee the greater is the risk of moral hazard.

***The response to that question is likely to depend on country-specific factors***

With most deposit insurance schemes, the response to this trade-off historically has been under normal circumstances to establish coverage limits that gravitate towards covering the vast majority of small depositor’s balances while ensuring that large, especially corporate and interbank, deposits are exposed to market discipline. Despite this similarity in approach, there typically has been no agreement on a specific value of maximum coverage across different CMF jurisdictions. Generally, country-specific circumstances may make any common fixed amount of coverage either “too high” or “too low”, depending on the specifics of individual jurisdictions.

***More (comparative) work on pricing frameworks for bond guarantees needed***

***Bank bond guarantee fees have been risk-based, but details differ across jurisdictions***

In the response to the current crisis, the pricing of guarantees of bank bonds has tended to be risk-based and often close to market rates (although those prevailing before the worsening of the crisis in fall 2008), with fees typically charged as a function of historical credit default swap (CDS) spreads.

Different pricing mechanisms and formulae have been applied across countries, however. Differences in these details have implications for the extent of subsidy provided for institutions from different jurisdictions, which raises issues regarding competition.

***There appears to be a need for closer co-ordination***

To level the playing field among internationally competing banks, there may be a need for governments to co-ordinate more closely regarding the details of the design, implementation, and exit from their programmes to avoid introducing competitive distortions.

This issue has been recognised and initiatives to address it have been taken. For example, the Governing Council of the European Central Bank has provided some recommendations for a framework that governments might want to follow.

The role of such frameworks is potentially very important as government-guaranteed bonds appear to be becoming an established asset class on their own. While it is never too early to consider the issue of exit strategies, another conclusion of the present article is that further work on frameworks for the pricing of guarantees is also needed, especially as markets for government-guaranteed bonds are projected to further increase.

### *Selected results of the discussions of the topic by the Committee on Financial Markets*

The Committee supported the analysis and conclusions provided in the paper, suggesting some specific qualifications and corrections. These changes will be taken into account before publication. Several results of the discussions are singled out here for special attention:

#### *Challenges to the setting of risk-based premiums remain*

Public authorities have made considerable efforts to charge risk-based premiums for government-provided guarantees for newly issued bank bonds. That is, premiums have generally been a function of some risk measure, even if the specific details of the approaches chosen differ from one country to another. Challenges to the setting of risk-based premiums remain, however, including in particular in situations where market reference prices are not available.

#### *The “normal” level of deposit insurance coverage likely depends on country-specific factors*

Where no additional charges have been levied for the expansion of retail deposit insurance coverage to essentially unlimited levels, such coverage should be withdrawn as soon as possible. In most cases, specific termination dates have been scheduled. More generally, where retail deposit insurance coverage levels have been expanded during the recent crisis, once financial conditions stabilise, policy makers need to consider whether to reduce these coverage levels and, if so, to what “normal” level of coverage. In this context, country-specific circumstances need to be taken into account.

#### *The issue of competitive distortions introduced by bank liability guarantees is relevant*

Issues regarding potential competitive distortions exist with respect to the existence (or lack thereof) of a level-playing field for internationally operating banks that either benefit from such guarantees or do not. Perhaps even more importantly, the issuance of bonds backed by guarantees from some highly rated governments has also had profound effects on the demand for and pricing of other securities not benefitting from such guarantees, including in particular relatively close substitutes for those guaranteed bonds, such as bonds issued by some lower-rated sovereign or supra-nationals.

#### *Exit strategy issues differ depending on the specific type of guarantee provided*

The issue of exit strategies has different aspects depending on the type of guarantee arrangement. The existence of guaranteed bonds suggests a problem for exit timing issues – the desire is to exit as soon as possible but not too soon. Co-ordination is essential in that respect. For deposit insurance, the issue is not exit, but the notion of what should be the future design of such a scheme. It seems clear that post-crisis it will be necessary to have premiums that not only are higher in level but are also risk-based.

### APPENDIX 1. SELECTIVE OVERVIEW OF (OTHER) PERIODS OF UNLIMITED DEPOSIT INSURANCE REGIMES SINCE 1990

Country	Date announced or placed	Date of removal	Comments
Finland	February 1993	December 1998	The existing system of deposit insurance, in place before the full guarantee, was revised in 1998.
Honduras	September 1999	September 2002	Government bonds can be issued to provide for the guarantee.
Jamaica	January 1997	August 1998	The full guarantee was removed at the time when limited explicit deposit insurance went into operation.
Japan	June 1995	Largely removed in April 2005	The unlimited guarantee was announced in June 1995, enacted into law in June 1996, and withdrawn for time deposits in April 2002 and for ordinary deposits in April 2005. One type of payment and settlement deposits continues to be fully covered (see also Table A.2).
Korea	November 1997	January 2001	Limited explicit deposit insurance, first introduced in 1996 (and then overridden by the unlimited guarantee) was reintroduced in 2001.
Kuwait	1992	No date has been set for cessation	The guarantee has been announced as a political commitment by the government, but it is not written in law. Kuwait does not have explicit deposit insurance.
Malaysia	January 1998	September 2005	An explicit deposit insurance system was put in place effective as of September 2005, specifying a coverage limit of RM 60,000. In October 2008, the limited guarantee was replaced again by an unlimited one, to be withdrawn by December 2010.
Mexico	1990	January 2005	Starting around 1990, government-owned banks were privatised. The Banking Savings Protection Fund was put in place, and there was an understanding that the government would effectively provide unlimited coverage for deposits. Since January 2005, the coverage limit has been set to 400,000 UDIs.
Norway	1961	December 1996	Deposit guarantee schemes had existed since 1961 (banking laws). Deposit insurance with an explicit limit, <i>i.e.</i> up to Norwegian kroner 2 million was introduced in 1996 to replace an explicit (savings banks) or assumed (commercial banks) unlimited deposit insurance guarantee.
Sweden	December 1992	July 1996	Explicit deposit insurance was introduced for the first time in 1996 to replace the unlimited guarantee.
Thailand	August 1997	Between August 2009 and August 2012?	An explicit guarantee system has been introduced on August 2008 with the formation of the Deposit Protection Agency. It is envisaged that the unlimited guarantee be phased out gradually between August 2009 and August 2012.
Turkey	May 1994	June 2000	Phased out gradually since June 2000 (100.000 TL from June 2000 to December 2000; thereafter 50.000 TL), although another blanket guarantee was provided between July 2003 and July 2004. Since then, coverage remained limited at TL 50.000.

Source: Garcia (2000) and OECD Secretariat updates, based in parts on communications from CMF delegates.



## APPENDIX 2: SELECTED INFORMATION RELATED TO UNLIMITED RETAIL DEPOSIT INSURANCE GUARANTEES: TIMING AND OTHER ISSUES

Australia	The unlimited guarantee of deposits that was announced in October 2008 was to expire after three years time and be replaced by a deposit insurance scheme capped at about AUD 20,000. On 12 October 2008, Australian Prime Minister Kevin Rudd explained that under the country's plan, all deposits in the country's banks, building societies and credit unions, would be guaranteed by the Australian government for the next three years. Subsequently, from 28 November 2008, the following modifications were specified: All deposits at Australian authorised deposit takers are automatically guaranteed up to AUD 1 million (around €500,000) and larger deposits can be guaranteed on payment of a fee which is the same as that which applies to the guarantee covering wholesale funding. The scheduled termination date is 12 October 2011.
Austria	Unlimited deposit insurance planned to be in place until end-2009, and thereafter, from 2010, insurance on deposit would have a limit of 100,000 euros. The scheduled termination date is 31 December 2009.
Denmark	With effect from 1 October 2010, ordinary deposits will be covered up to DKK 750,000, although a three-year transition scheme will be introduced to ensure a gradual phase-out of the existing unlimited government guarantee until it expires on 30 September 2010.
Germany	The announcement regarding deposit insurance coverage was a political commitment. A change of legislation was not implemented and is not planned to be implemented. While there are no specific press releases available related to the new (unlimited) deposit insurance coverage, the websites of the German Finance Ministry and the Deutsche Bundesbank refer to that guarantee. The latter specifies that "the Federal Government recently stated that no saver in Germany would lose a single euro as a result of the financial crisis. The Federal Government is to act as guarantor for the deposit guarantee schemes' ability to pay in full." ( <a href="http://www.bundesbank.de/presse/presse_aktuell_einlagensicherung.en.php#aenderung">http://www.bundesbank.de/presse/presse_aktuell_einlagensicherung.en.php#aenderung</a> ; consulted on 21 April 2009.) Also, it is announced that the statutory deposit guarantee which currently covers 90% of deposits up to a maximum value of EUR 20,000 will be increased to EUR 50,000 by 30 June 2009 at the latest. The current 10% depositor retention will be abolished. With effect from 31 December 2010, it is planned to further increase the amount covered to EUR 100,000.
Hong Kong, China	On 14 October 2008, the Hong Kong SAR Government announced the use of the Exchange Fund to guarantee the repayment of all customer deposits held with all authorised institutions in Hong Kong, with that guarantee to remain in force until the end of 2010. The scheduled termination date is 31 December 2010.
Iceland	A specific deadline for transition to more limited deposit insurance has not been officially announced. Having said that, the assessment that an unlimited deposit insurance coverage has been introduced is also difficult to base on official announcements. The information available regarding current coverage limit in Iceland is EUR 20,887, according to the official website <a href="http://www.tryggingarsjodur.is/Payments/">http://www.tryggingarsjodur.is/Payments/</a> . There is a view however that <i>de facto</i> a blanket guarantee has been introduced (see e.g. Laeven and Valencia, 2008).
Ireland	On 30 September 2008, the Irish government guaranteed all deposits held in the six biggest banks, including retail deposits. The scheme was scheduled to expire on 30 September 2010, although a review clause exists.
Singapore	The unlimited guarantee announced in October 2008 was announced to remain in place until 31 December 2010.
Slovak Republic	On 24 October, Slovak lawmakers approved a government proposal to expand insurance to the full amount of bank deposits, without specifying a specific deadline for transition to a more limited guarantee.

Source: OECD assessment based on publicly available information from website of central banks or finance ministries.

## NOTES

- <sup>1</sup> One prominent specific example is afforded by financial institutions that are considered the government-sponsored housing agencies, which were set up in the United States to provide a backstop of liquidity for the home lending sector in times of crisis. While that goal has remained, in the meantime, the agencies had been privatised and the guarantee that the US government had provided them with explicitly became implicit. There has been a long-standing debate on the issue of pricing that guarantee and the possible unintended consequences a mispriced guarantee can have. In deed, many observers consider that this situation has contributed to the engagement in risky activities, which ultimately resulted in the need for direct government support. More generally, some financial institutions may simply be “too big to fail”.
- <sup>2</sup> Australia was noted in previous discussions by the Committee on Financial Markets as one of the few industrial countries that did not have any form of deposit insurance for retail deposits (see *e.g.* Schich, 2008a). Then, in mid 2008, the Australian Government announced the introduction of an ‘Early Access Scheme’, designed to ensure timely access to depositors with claims on a failing bank (which was officially not defined as an explicit deposit insurance system however).
- <sup>3</sup> Australian-owned ADIs and Australian-incorporated ADIs that are subsidiaries of foreign-owned banks are automatically guaranteed by the Australian Government without charge. The Financial Claims Scheme is estimated to cover the entire deposit balance of over 99 per cent of depositors (by number) with eligible ADIs, as most depositors have relatively small balances. For large deposits, institutions typically offer the guarantee on an ‘opt in’ basis to customers, although there has been relatively little demand for this guarantee, with the guarantee fee being paid on around AUD 19 billion of deposits in February 2009, a relatively small amount compared to the coverage of the guarantees on wholesale funding.
- <sup>4</sup> According to BCBS and IADI (2009), a “blanket guarantee” is a declaration by authorities that in addition to the protection provided by limited coverage deposit insurance or other arrangements, certain deposits and perhaps other financial instruments will be protected. For the purpose of the present discussion, this definition is modified to say that “certain deposits and perhaps other financial instruments will be protected without specific limits”.
- <sup>5</sup> The median is chosen here a simple summary statistics, as weighted averages are not very useful to calculate given the existence of unlimited guarantees. Between December 2008 and the time of writing, actual ceiling in local currencies have not been changed, so that any variation in that statistics would just reflect exchange rate movements.
- <sup>6</sup> In the United States Congress, Representative Barney Frank introduced on 9 January 2009 a bill to amend the Troubled Assets Relief Program (TARP) so as to make the USD 250,000 deposit insurance limit permanent, and to adjust this amount by inflation starting on 2015. The bill was referred to the Senate Finance Committee on 22 January 2009 and no further action has been reported. A second bill, introduced on 2 February 2009, proposes to amend the Federal Deposit Insurance Act to increase the bank deposit insurance limit from USD 100,000 to USD 250,000. The bill was sent to the House Financial Services Committee on February 4, 2009, and referred to the Senate Committee on Banking, Housing, and Urban Affairs on 11 March 2009 (see Gonzales and Getter, 2009). In May 2009, the United States Senate passed the bill S.896 to prevent mortgage foreclosures and enhance mortgage credit availability. One of the provisions of this bill is the extension of the FDIC's USD 250,000 deposit insurance limit to December 31, 2013 (from December 31, 2009).
- <sup>7</sup> In Japan, after Japanese banks started to suffer from the non-performing loans crisis in the 1990s, the Deposit Insurance Act was revised in 1996 to temporarily lift the deposit insurance coverage limit of JPY 10

million per person per bank, so as to insure all deposits without limit. The original limit was intended to be reinstated in April 2001, but its reinsertion was then postponed to April 2002, and even then it was only gradually lifted; first for time deposits on that date, and subsequently for ordinary deposits, except for deposits that bear no interest, are redeemable on demand, and provide payment and settlement services.

<sup>8</sup> These companies have now lost their triple-A ratings, which was at the heart of their business model, which was to “rent out” their top credit rating to borrowers with a lower rating against a fee. As a result, they have not attracted any new business, although at least one new competitor without a legacy burden has entered this market. On the experience of financial guarantee insurance companies in the recent crisis see also Schich (2008c).

<sup>9</sup> BNP Paribas estimates, as reported in “Banks dive into government-backed bonds”, *The Wall Street Journal*, 24 March 2009.

<sup>10</sup> The size of these programmes could be very significant in terms of a country’s gross domestic product. Related estimates and a discussion of fiscal aspects is provided in Cotarelli (2009).

<sup>11</sup> See “Banks earn USD 900 million with state-backed debt”, *Financial Times*, 1 March 2009.

<sup>12</sup> In Australia, the Government opted for a rather simple fee structure based on the issuer’s credit rating, where the fee levied per annum increases with the relative riskiness of the debtor implied by its credit rating (AAA to AA– 70 basis points; A+ to A– 100 basis points; and BBB+ and below and unrated 150 basis points).

<sup>13</sup> For some banks credit default swaps are not available, however. Also, proposals regarding pricing in the European context are typical referring to double-A rated banks, but in the case of some countries all banks are rated lower than that.

<sup>14</sup> Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt, 20 October 2008.

<sup>15</sup> OECD Secretariat estimates based on the information in Table 2 and data for 5-year CDS premiums for Citigroup obtained from *Thomson Financial Datastream*.

<sup>16</sup> In France, a central agency (*Société de Financement de l’Économie Française* – SFEF) owned by participating banks and the government, issues government-guaranteed debt and passes on the proceeds to participating banks, which has implied that bonds issued by SFEF being relatively closely priced to French government debt.

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