

CROSS BORDER BANKING: CHALLENGES FOR DEPOSIT INSURANCE AND FINANCIAL STABILITY IN THE EUROPEAN UNION

By

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Recent Developments

- Negotiations over sale of ABN AMRO
- Growing interest in cross-border mergers in Europe more generally
- Rejection by EU finance ministers and central bankers of ex ante burden sharing in case of financial crisis
- Possibility that EU deposit insurance and bank regulatory structure may be ill-prepared to deal with cross-border banking crisis
 - 46 EU banks have cross-border banking operations

European System Conceptual Design: Sharing of Responsibilities between Home and Host Countries

- Home country primary provider of
 - Consolidated Supervision of holding companies and branches of home country banks
 - Serve as lender of last resort for bank and all branches in home country
 - Deposit insurance for home country banks but not cross-border subsidiaries
- Host country responsible for
 - Its own financial stability
 - Supervision and regulation of domestically chartered subsidiaries
 - Serve as lender of last resort for all **branches in its country and domestic subsidiaries**
 - First responder to local banking crisis
 - Deposit insurance for subsidiaries and topping up insurance for branches

Bright and Dark Sides of EU Regulatory Structure

- In good times, cross-border branching in EU similar to cross-state branching in U.S. (bright side)
 - Regulatory structure that is evolving in EU has come about when banks have been healthy and in non-crisis time
 - Regulatory structure relies upon cooperation, shared responsibility and decentralized deposit insurance structure
- In bad times, cross-border branching in EU will prove to be much different than cross-state branching in U.S. and the structure of regulation and crisis resolution is likely not to work as designed. We argue that this is the dark-side of regulatory design and should be the dominant concern of the EU going forward
- This is the focus of our paper – preparing for the dark side.
- Much of US banking structure and regulation evolved out of crisis as a result
 - U.S. has single deposit insurer that also acts as regulatory and supervisory agency
 - U.S. has separate bank bankruptcy code common to all banks
 - U.S. has PCA and SEIR

Conflicts, Incentive Problems, Agency Problems

- System subjects both domestic and cross-border banks within EU to multiple regulatory schemes which often may involve potentially conflicting goals and loyalties
- Resulting conflicts may confound ability to deal with crisis
- Regulatory design and bankruptcy laws contribute to delays in closing or resolving problem institutions which inevitably implies bailouts of insolvent institutions as the most likely outcome
- This delay potentially increases losses
- May Incent troubled institutions to engage in risk taking to improve their financial condition.
- Problems are acute for deposit insurance systems

Despite Efforts to Harmonize DI Structure Substantial Differences Still Exist

- DI Schemes/Features
 - Funding of the plans (ex ante v ex post; public v private)
 - Pricing of coverage (flat fee v risk based)
 - Operator of plan (the private sector or public sector)
 - Co-insurance
 - Topping up
 - Coverage of foreign deposits
 - Government backing v no backing
- How failing institutions are handled
 - General versus Bank-specific insolvency procedures apply
 - Who declares bankruptcy and when
 - Who has authority to resolve or liquidate a failed institution
 - Whether too-big-to-fail policies in terms of protecting de-jure uninsured claimants might or might not be pursued
 - How conflicts would be resolved where two deposit insurance funds might be affected by failure of an institution with top up coverage
- Settlement of claims
 - Method of notification
 - Filing for claims (responsibility of claimant v notification by fund)
 - Timing of claims payment

Table Differences in Deposit Insurance Agency Authorities and No. of Employees

Country	Authority						
	Terminate Insurance	Examine Institutions	Issue Enforcement Actions	Failure Resolution	Receivership	Liquidation	Number of Employees
Czech Republic	No	No	No	No	No	No	5
Denmark	No	No	No	No	No	No	2
Finland	No	No	No	No	No	No	0 **
France	No	No	No	No	No	No	?
Greece	Yes	No	No	No	No	Yes	11
Hungary	Yes	Yes	No	Yes	No	No	5
Italy	Yes	No	Yes	Yes	Yes	Yes	10
Lithuania	No	No	Yes	No	No	Yes	8
Poland	No	Yes	Yes	No	No	No	97
Portugal	No	No	No	No	No	No	2
Slovenia*	Yes	Yes	Yes	No	No	No	52
Spain	No	No	No	Yes	Yes	Yes	16
Sweden	Yes	No	No	No	No	No	1
UK	No	No	No	No	No	No	113

*Performed by the Central Bank

** Run by Banker's Association

Source: Bank of Canada Deposit Insurance Survey

Dark Side of DI Conflicts

When a Crisis Occurs

- Bankruptcy statutes force delay and increases failure costs
- Loss typically controlled and determined by regulators/supervisors not DI system
- Topping off provisions mean that losses to host country are determined by policies in home country
- Information sharing cross country and between DI and supervisors breaks down in crisis
 - Problem of subsidiaries
- Taxpayers may not want to pay for losses to citizens of other countries
- Coverage differences exist
- Depositors unsure of status due to differences in treatment

Public Policy Objectives in Resolving a Banking Crisis

- Minimize adverse externalities (societal costs) of bank failures – minimize business disruption, credit and liquidity losses.
 - Under PCA and SEIR depositors would have immediate (next business day or so) full access to
 - Par value of their insured claims or to
 - Estimated recovery value of their *de jure* uninsured claims.
 - Qualified borrowers would be able to utilize their existing credit lines immediately
- Maximize efficiency – reduce costs and permit free entry and exit of inefficient or unlucky banks at minimal societal cost
- **Efficient resolution occurs when the sum of aggregate credit losses and aggregate liquidity losses are at or close to zero.**

Four Point Program to Achieve Public Policy Objectives

- Structured regulatory actions to turn troubled banks around before failure and, if unsuccessful, mandatory prompt “legal” closure at positive capital (SEIR) – minimize credit losses
- Prompt assignment of estimated losses in failures to uninsured claimants (loss sharing) – minimize loss to insurer and enhance market discipline
- Prompt transfer of par value of insured deposits and estimated asset recovery value of uninsured deposits to other/bridge bank for seamless access – no “physical” closure and minimize liquidity losses (separate legal from physical closure)
- Prompt reprivatization of bridge banks at sustainable capital.
- Publicize rules widely for credibility and accountability

Mandatory Prompt Legal Closure at Positive Capital

- Combine with PCA to turn troubled banks around before failure.
- If unsuccessful...
 - Legal closure – revoke charter and place in receivership
- If successful at positive capital
 - Losses only to stockholders.
 - No credit losses, deposit insurance redundant.
 - Minimize contagion
- PCA buys time so legal closure not surprise or hasty.

Prompt Allocation of Losses

- PCA provides advance time to estimate recovery values and prompt legal closure rule minimizes credit losses
- Minimize losses to insurer through loss sharing with uninsured, at-risk claimants
- Reduce moral hazard, enhance market discipline
- Avoid TBTF/SRE, but always safety-valve

Prompt Transfer of Activities and Access to Other Banks

- Liquidity losses often as or more important than credit losses (frozen accounts).
- Minimize liquidity losses by no physical closure. Near immediate (next day) customer access to appropriate value of deposits and credit lines. Minimize contagion
- Transfer to other private or new bridge bank major activities
 - Par value of insured deposits
 - Estimated recovery value of uninsured deposits (advance dividend)
 - Performing credit lines
- Requires insurer to have pool of funds or borrowing authority
- Reduces pressure to keep insolvent banks open. Minimizes TBTF/SRE and minimize loss of private information

Prompt Recapitalization

- Enhance efficiency
- At sustainable capital
- Bridge bank provides additional, but not infinite, time

Proposed Solution to EU Cross-Border Branching Insurance and Resolution Problems Is to Use Financial Incentives

- Offer cross-border banks or their subsidiaries effective DI discount on premium if voluntarily accept a system of (PCA) and (SEIR)
 - Included would be legal closure of institution at positive level of capital
 - Agree to “put” their charter back to the chartering authority
 - Administered by home country
 - The exact implementation might depend upon the structure of how insurance charges are levied.
 - In cases of ex ante premiums PCA banks either be granted a discount on their charges or alternatively, non-PCA banks could be levied a
 - In cases of ex post charges, PCA-banks would be charged less than non-PCA banks.
- Lower relative premiums for PCA banks are justified because of the lower expected losses that would accrue.

Benefits/Conclusions

- Deals with credit, business disruption and liquidity costs of failure by ensuring customer access to deposits and to borrowing lines.
- Virtually eliminates need or concern for cross-country burden sharing since institutions should be resolved before economic insolvency occurs.
 - Better than DI because losses are minimized and not shifted.
- No taking of private property since institution is voluntarily “put” to the chartering authority.
- Ex ante process knowledge eliminates destructive uncertainty that leads to panic behavior
 - Avoids all negative aspects of so-called “constructive ambiguity.”
- Eliminates potential spillover effects to other banks since they too are certain about the status of their claims
- Gives time to work out counterparty issues with derivatives
- Provides incentives to smaller countries and smaller deposit insurance schemes to be especially vigilant (Is a reason for them to have monitoring and supervisory responsibilities).
- Can be viewed as an interim step towards an EU-wide system that doesn’t need further changes in law except to the extent that differential premiums need to be established.