Supervisors and Deposit Insurers:

Conflict of interest or workable cooperation?

Discours prononcé par M. Jacques de Larosière lors de la conférence internationale organisée conjointement par l'EFDI (European Forum of Deposit Insurers) et la FDIC (Federal Deposit Insurance Corporation) sur le thème :

"*DEPOSIT INSURANCE SYSTEMS DURING AND AFTER A SYSTEMIC CRISIS*".

à Paris, les 29 et 30 juin 2009

This topic raises the classical "moral hazard" dilemma: if deposit guarantee schemes are too generous, this may - unwillingly - provide an incentive for banks and their supervisors to be less vigilant in their credit management and credit assessment duties.

Therefore, it is necessary to find the right balance: while maintaining the confidence of depositors in the banking system - which can be considered as a public good - one must also ensure that bank managers and financial supervisors keep a close watch on risk developments.

The importance of the link between supervision and deposit insurance cannot be overstated: weak supervision leads to bank failures which, in turn, unsettle deposit guarantee schemes.

The two fields - supervision and insurance schemes - must therefore be identical. There should be no guarantee for unregulated and non (or lightly) supervised firms.

I will address the subject in two sections:

- The European framework ;
- The more general lesson to be drawn from the crisis.

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I. <u>**The European framework**</u>

1. <u>The European deposit guarantee schemes (D.G.S.) are very diverse and are a source of weakness</u>.

As noted in the "Report on financial supervision in the European Union" [1], the schemes are very different from one country to another :

[1] The high level group on financial supervision in the E.U. – Brussels, 25 February 2009

- *In terms of the amounts insured*: the amounts go from unlimited (Germany) to 20.000 euros depending on the national schemes ;
- *In terms of the funding mechanisms*: certain countries have adopted pre-funded systems (Spain, France, Germany, Belgium …) while others (Italy, UK) rely on ex-post funding ;
- *In terms of mandates and scope of action*: some countries have only "pay-box" functions, other schemes can play a large, preventive role (France, Belgium, Germany, Italy, Poland, Portugal and UK).

This diversity in the current organisation of deposit guarantee schemes has proved to be a serious weakness in the E.U. banking regulatory framework. The differences in minimum coverage levels are a source of distortions: "in a situation where a national banking system is perceived as becoming fragile, there is a risk that deposits would be moved to the countries with the most protective regime (thus weakening banks in the first country even further); second it would mean that in the same member state the customers of a local bank and those using the services of a third country branch could enjoy different coverage levels" [1].

This situation is not consistent with a well functioning Single Market.

2. The European deposit guarantee schemes must be reorganized

One of the major flaws in the European setting - i.e. the different levels of guarantees per country - has been addressed in a recent Commission directive (published in March 2009) which will raise the level of protection, for all depositors, to a single level of 100.000 euros.

This is an important step forward and should be seen as the prelude to a more extensive harmonization of European D.G.S.s. Indeed, there are other, unresolved, issues that have to be tackled: sustainable funding, scope of action of D.G.S.s, preventive role to avoid crisis, relationship with financial authorities ….

The European Commission will have to report to the Council of Ministers on these issues before the end of 2009.

If Europe wants to avoid the repetition of the failures of the recent events (lcelandic case) and the systemic dangers stemming from the current lack of robust risk-sensitive pre-funded arrangements, much more than the alignment of guaranted amounts is called for.

3. Banking supervision domain, deposit insurance domain

There is a close link between the banking supervision domain and the deposit insurance domain. It is a natural link that is easily understandable and that advocates working together because deposit insurance and more generally depositor trust in the safety of the banking sector is a collective good for which both share the responsibility and needs a fair cooperation.

[1] The high level group on financial supervision in the E.U. – Brussels, 25 February 2009

As you know, the high-level group on financial supervision in the E.U. which I chaired, suggested last February putting in place a macro-prudential level of supervision which would be close to the ECB. This development seems to us to be the best way for systemic supervision in Europe ; supervision that has become indispensable. Its ultimate consequence would be, if politics allow it, the setting up of a European mechanism that would be responsible for deposit insurance in case of systemic crisis.

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II. The more general lessons to be drawn from the crisis

1. The financial crisis has rocked the deposit insurance systems

Given the massive losses incurred over the last two years by a large number of banks, Governments and Central Banks had no other option than to provide massive bailouts to those institutions (in the form of liquidity, capital injections, guarantees …).

In some circumstances (Northern Rock is one of the most striking and appalling examples), Governments have gone as far as stating that they would provide a blanket guarantee for all deposits in all banks whatever their size, in order to reassure the public.

The problem now is to return to more sustainable and reasonable arrangements and to avoid the “extreme moral hazard” that would stem from such events and statements. The danger is that, no matter the details of deposit guarantee schemes, governments would always be expected to top up their funding in an unlimited fashion. That is why it is essential to build a robust and credible system of deposit insurance.

2. What could be the main features of a reasonable set of deposit insurance arrangements for the future?

a) The first feature (leaving aside the agreed uniform level of guarantees mentioned above) would be to generalize pre-funded systems.

The report of the panel I chaired stated: “preference should be given to the schemes that are pre-funded by the financial sector. Such schemes are better to foster confidence and help avoiding pro-cyclical effects resulting from banks having to pay into schemes at a time where they are already in difficulty”.

b) Furthermore, D.G.S.s should provide wider functions than strict compensation for deposits in failed banks.

Indemnification of failed deposits is the “ultima ratio”. But, I believe that it would better to focus on preventing these ultimate situations. Of course the efficiency of surveillance is here of the essence. What we proposed, in our Report, is to improve the macro-oversight of systemic risks by creating a specific “Systemic Risk Council” under the aegis of the European

Central Bank. We also propose to strengthen the cooperation between supervisors and to give to the relevant European “Authorities” more powers.

But deposit guarantee schemes should also powerfully contribute, in my view, to this reinforced surveillance. The French model of D.G.S.s shows, for example, that such schemes can help to restructure vulnerable financial institutions, thus avoiding disastrous runs that are harmful to the whole banking system. Such restructuring actions (that are in the scope of the “Fonds de Garantie des Dépôts”) are a way of safeguarding, the value of banking assets. Organizing - under the leadership of the D.G.S. and in close collaboration with the supervisor (Commission Bancaire) -, the transfer of deposits of a weakening bank to a strong institution can, of course, entail for the scheme significant costs. Indeed, the resulting losses that will be supported by the scheme may well go beyond what would have resulted from the mere indemnification of deposits, in case of liquidation. But the systemic advantages of such a “resolution” mechanism are significant.

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In conclusion, it seems clear that the reinforcement of regulation and supervision in Europe and in the world at large - as the Report has recommended - would go a long way towards preventing the return of the series of events that have led to such a deep financial and economic crisis.

This progress - if enacted - should be intimately linked to the improvement of European (and global) deposit guarantee schemes. These national schemes should, in my view, play a crucial role in the “resolution” mechanisms, as the FDIC leadership has shown in its own field of action over the recent period.

We should, in such an international Conference, share our experience, our ideas and try to think in global terms because the financial system will continue to function in a global framework.