EUROPEAN SAFETY NETS

Texte prononcé par Jacques de Larosière lors d'un colloque organisé à Paris par l'American University le mardi 15 juin 2004

We know the classical problem raised by "safety nets" organized for the benefit of depositors in cases of bank failures.

The justifications for such "safety nets" are twofold :

- to protect depositors unaware of growing financial difficulties of their bank ;
- to give a sense of confidence to the general public in order to avoid irrational panics and bank runs.

But, safety net schemes also entail basic problems :

- if they are too generous -and even more so if they are financed by public funds- they can create "moral hazard" and encourage irresponsible behaviors by depositors ;
- as "safety nets" lower the risk premium on bank liabilities, they can encourage banks to operate with higher risk portfolios and lower capital. As Chairman Greenspan stated[1] : "The result is a distortion in real resource allocation… In the absence of the safety net, these higher lending risks would have to be reflected in some combination of higher deposit costs, more liquid asset holdings, or a larger capital base… With the safety net, lower interest rates and higher credit availability are accorded riskier borrowers, benefiting speculative and riskier ventures at the expense of sounder ones".

Therefore, the policy objectives of a sensible system of "safety net" is to minimize those risks, while providing depositors -especially the smaller and less informed ones- with a reasonable degree of confidence.

Of course, "safety nets" are only the emerged part of the iceberg. One of the basic tasks of monetary authorities is to ensure that, through adequate regulation and supervision, the banking industry (and more generally the financial institutions) of a country are transparent, well managed, soundly capitalized and under constant scrutiny. We all know the decisive importance of regulation and supervision to prevent the emergence of bank failures. Early detection of liquidity or solvency problems -through proper disclosure- can often avoid disastrous liquidations under stress conditions.

Furthermore, we also know that under certain circumstances of systemic risk (if a major financial institution is in danger and can spread out a crisis through a "domino effect"), there may be some scope for the Central Bank -as a lender of last resort- to ensure the availability of liquidity.

[1] A. Greenspan : "The financial Safety Net", speech on May 10, 2001.

The question I would like to address is the following : now that the euro is -since its creation in 1999- the common currency of the Euro zone, with a single monetary policy conducted by the European Central Bank, how have "safety net" issues been addressed ? Have the European members unified their former individual schemes ?

And what is the role of the ECB as a lender of last resort ?

o0o

I. The European banking "safety nets" :

After the creation of the euro, the responsibility for the soundness of the banking system continues to be of the competence of national authorities. This was, at the time of the negotiation of the Maastricht Treaty, a matter for discussion. But, in the event, it was decided that each member country would keep the responsibility of monitoring its financial institutions within the framework, of course, of a strongly harmonized set of financial regulations. This harmonization results from legislation : European directives -in accordance with the Basle Committee principles- set up a common framework for all EU countries. But, harmonization also consists of an ongoing collaboration of banking regulators and supervisors between the different Member States. Thus, it has been decided -within the Lamfalussy framework- to set up a "Banking Committee" (featuring the national authorities in charge of banking regulation) besides a "Committee of European Banking Supervisors" (CEBS). Both committees will see to it that regulations and their implementation are, in effect, carried out harmoniously within the EU.

But the final responsibility for banking supervision, as I already said, still lies in the competence of national authorities (these authorities already collaborate closely in the case of "cross border" European financial institutions).

So, one can understand that in such a setting, bank "safety nets" were to remain "national". However, even before the creation of the euro, it had been understood that it would be useful - in a single market where competition should be free- to eliminate strong disparities between different national systems. Indeed, each European country had its own "safety net". These systems were influenced by different historical backgrounds and practices. Eventually, after several years of efforts, the European Union has adopted in 1994 a directive that governs the basic features of a "minimal" system of "safety nets" (Directive 94/19) CE-May 30, 1994).

I shall briefly indicate the main principles of this harmonized system of "safety nets" :

1. All financial institutions habilitated to receive deposits are covered by the system ;
2. The system is compulsory : no bank can opt out ;
3. Banking systems of a "mutualist" or "cooperative" nature are responsible for their branches (an individual branch of such a network is covered by the "solidarity" of its parent institution) ;
4. European branches of foreign banks (non EU) can choose not to participate in the system as long as they offer -though their parent- a guarantee equivalent to that provided by the European system ;

5. Deposits received in different european countries by a EU bank are covered by the scheme of the "country of origin" of the interested bank ;
6. The minimum amount of the guarantee is 20.000 euros per depositor. This amount is in the range of previous national systems, some of which (France, Italy,…) being significantly more "generous" than others ;
7. The system allows a mechanism of "co-insurance" whereby a depositor is not totally indemnified, and has to bear the cost of a minimum charge ("franchise") on his guaranteed deposit (this minimum cost should not be higher than 10 % of the guaranteed amount) ;
8. The guarantee is enforced as soon as the default ("constat d'indisponiblité") has been declared by the competent authority. The guarantee must be paid not later than three months after the declaration of default ;
9. Banks are obliged to inform their depositors about the risks they run and the characteristics of the available "safety net".

o0o

I will not give you a detailed analysis of how the 1994 Directive has been applied in each EU country.

Let me just say that, although the main principles of the directive are common to all, there are still some differences between national systems -especially as far as guaranteed amounts are concerned- as is shown in the following table[2] :

	Insurance limit Per person/ per capita GDP	Insurance limit per account/ per capita GDP	Funded by
Belgium	0,9	0,9	Banks
Denmark	1,4	1,4	"
France	3,3	3,3	"
Germany	0,8	0,8	"
Greece	2,1	-	"
Netherlands	0,8	-	"
Portugal	2,8	-	"
Spain	1,3	-	"
United Kingdom	1,3	-	"
USA	-	*3,3*	*"*

As an illustration, I shall give you the main characteristics of the French safety net as it has been established by the law dated June 25, 1999.

The former French mechanism has been completely overhauled and has now been transformed into a coherent system that goes beyond the minimum obligations of the directive and features preventive ways of intervening.

[2] Commission Bancaire, February 2000.

1. The system is compulsory for all banks (credit institutions and asset management companies) ;
2. It is managed by the banking industry. One single private institution (the "Fund for the depositors guarantee") manages the insurance system. It is under the surveillance of the French public auditing system ;
3. Contrary to the past mechanism (where funds were called as and when needed), the scheme is an "ex ante" fund, which means that member banks provide contributions in the form of a line of equity (500 million euros) and annual contributions : the annual contributions are to produce overtime a global cumulative amount of 950 millions euros ;
4. Contributions are calculated on the basis of the size of the interested institutions (deposits + 1/3 of credits). But besides these quantitative criteria, four risk-based indicators can change the basic contribution by +/- 25 %. This is to ensure that contributions are proportionate to the risks of the whole system and then that "heavy risk takers" do not take advantage of the scheme at the detriment of more conservative institutions ;
5. Newcomers to the scheme pay additional contributions in order to catch up and participate in the building up of the fund ;
6. The maximum indemnification per depositor is 70 000 euros (slightly higher than under the previous system) ;
7. Another scheme also covers assets held by investors in the form of securities.

By way of comparison, the UK compensation scheme (FSCS) -which provides finance as and when required ("ex-post" scheme)- includes co-insurance risk sharing arrangements when losses exceed prescribed modest thresholds.

In Germany, the private sector banks are covered by a mandatory scheme and, in addition, operate a voluntary mechanism which insures each depositor for up to 30 % of a bank's capital. The savings banks, Landesbanken, and cooperative banks belong to schemes that protect the institutions themselves (rather than just depositors).

There is in all European countries a close link between the management of the compensation scheme and the supervisory authorities who are best placed to assess the risks incurred by the banking industry.

o0o

II. Is there a European lender of last resort ?

I shall be very brief of that question, for two reasons :

Firstly, because Central Banks (and, for that matter, former Central Bankers) have no inclination to be explicit on the subject. The risk of moral hazard is such that Central Banks carefully entertain on this topic a high degree of "constructive ambiguity".

The second reason is that the European Central Bank has formulated a concise view on the subject.

The Maastricht Treaty (art. 105(5)) provides that Euro system is to "contribute to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". To this effect, the "Banking Supervision Committee" (BSC), a group of high-ranking representatives of Central Banks and banking supervisory authorities, is the main body which assists the European System of Central Banks in the fulfillment of these tasks.

Within the Eurosystem, an emergency liquidity assistance (ELA) has been instituted which embraces the support given by Central Banks in exceptional circumstances and on an case by case basis to temporarily illiquid institutions and markets.

Of course, the ECB stresses, in its policy statements, that one should not overemphasize the importance of ELA. Indeed, what is more important is to enforce effective prudential regulation and supervision in order to prevent crises. The ECB also underlines that the provision of ELA has been a very rare event in industrial countries over the past decades.

"However, if and when appropriate, the necessary mechanisms to tackle a financial crisis are in place. The main guiding principle is that the competent national Central Bank (member of the Eurosystem) takes the decision concerning the provision of ELA to an institution operating in its jurisdiction. This would take place under the responsibility and at the cost of the national Central Bank in question. Mechanisms ensuring an adequate flow of information are in place in order that any potential liquidity impact can be managed in a manner consistent with the maintenance of the appropriate single monetary policy stance. The agreement on ELA is internal to the Euro system and therefore does not affect the existing arrangements between Central Banks and supervisors at the national level or bilateral and multilateral cooperation among supervisors and between the latter and the Eurosystem. However, their smooth functioning assumes an ability to implement, swiftly and efficiently, coordination mechanism aimed at dealing with the cross-border implications of financial crises and at preventing contagion".[3]

The ECB has given a press release on March 10, 2003 stating the existence of a "Memorandum of Understanding" (MoU) that contains basic principles and procedures for cross-border co-operation between banking supervisors and Central Banks in crises situations (see Annex). In the course of 2003, a crisis management simulation was organized aimed at understanding how the provisions of the MoU would assist the organization of cooperation and information sharing between authorities in practice (see Annual Report 2003, ECB).

But the problem is more complex. The more a financial market -like the Eurozone for example- is deregulated and integrated, the more "national" financial failures can have spill over effects. If the problem is of a liquidity nature, the arrangements mentioned above seem adequate. However, in some exceptional cases, the collapse of a large financial institution -whose deposits could be widely spread out geographically in the Union- may have to involve some form of fiscal support, as has been observed in past "rescue" experience. Hence, the need for some fiscal coordination -in the event of a "cross-border solvency crisis"- may become more relevant as transborder integration develops.

o0o

[3] ECB Annual Repart, 1999, pp. 98-99.

To conclude, one can stress from the above analysis the following main ideas :

a) bank regulation and supervision are coordinated at the European level (but more has to be done on the implementation side through the Lamfalussy procedure) ;
b) depositors "safety nets" are still different from country to country but are governed by common basic principles ; in this regard, one should underline the European effort to better link the architecture and funding of insurance "safety nets" to risk assessments concerning the participant banks ;
c) the ECB has made clear that it has worked on a mechanism of coordination with the Central Banks of the Eurosystem in order that sufficient liquidity may be provided under severe crisis circumstances.

Annex

ECB PRESS RELEASE

Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations

10 March 2003

1. The banking supervisory authorities and the central banks of the European Union (EU) have agreed on a Memorandum of Understanding (hereafter referred to as "the MoU") on high-level principles of co-operation in crisis management situations. The authorities that have endorsed the MoU are listed in the Annex to this Press Release. The banking supervisory authorities and central banks of acceding countries will be invited to become parties to the MoU once these countries have joined the EU. The MoU has entered into effect on 1 March 2003.

2. The co-operation envisaged in the MoU is aimed at pursuing the common objective of banking supervisors and central banks of ensuring the stability of the financial system. The progress made in the integration of financial markets and market infrastructures in the EU, the growing number of large and complex financial institutions and the diversification of financial activities have increased the liquidity and efficiency of the relevant markets. At the same time, such developments may also increase the likelihood of systemic disturbances affecting more than one Member State, and possibly increase the scope for cross-border contagion. In this context, the MoU aims to enhance the practical arrangements for handling crises at the EU level, since smooth interaction between supervisory and central banking functions will facilitate an early assessment of the systemic scope of a crisis and contribute to effective crisis management.

   The MoU also represents a contribution by banking supervisors and central banks towards meeting the recommendations made by the Economic and Financial Committee in its Report on financial crisis management [1], as endorsed by the ECOFIN Council. In order to follow up on the recommendations of this report, the Banking Supervision Committee of the European System of Central Banks worked on the definition of co-operation principles and procedures, and these have now been formalised in the MoU.

3. The MoU, which is not a public document, consists of a set of principles and procedures for cross-border co-operation between banking supervisors and central banks in crisis situations. These principles and procedures deal specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level. The MoU also provides for the setting-up of a logistical infrastructure to support the enhanced cross-border co-operation between authorities.

The framework defined in the MoU will apply in crisis situations with a possible cross-border impact involving individual credit institutions or banking groups, or relating to disturbances in money and financial markets and/or market infrastructures (including payments infrastructures) with potential common implications for Member States. Co-operation will take the form required by the specific features of the crisis and with regard to all the relevant supervisory and central banking tasks and functions, and will be consistent with the necessary flexibility of action of each of the authorities involved.

4. Crisis management procedures will in practice involve a wider range of authorities and respective functions than those within the scope of this MoU. They include Ministries of Finance and deposit insurance funds, securities and insurance supervisors in the case of crises involving these financial sectors, as well as third-country authorities in the case of crises originating or having an impact outside the EU. The MoU can therefore be regarded as a contribution to other co-operation arrangements that might be implemented or may be developed in the future involving other relevant authorities.

---

[1] Economic Paper No. 156, European Commission, July 2001, (available at http://www.europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers156_en.htm)

ANNEX

Parties to the Memorandum of Understanding

Commission bancaire et financière/Commissie voor het Bank- en Financiewezen, Belgium
Nationale Bank van België/Banque Nationale de Belgique
Danmarks Nationalbank
Finanstilsynet, Denmark
Bundesanstalt für Finanzdienstleistungsaufsicht, Germany
Deutsche Bundesbank
Bank of Greece
Banco de España
Banque de France
Commission Bancaire, France
Central Bank of Ireland
Banca d'Italia
Banque centrale du Luxembourg
Commission de Surveillance du Secteur Financier, Luxembourg
De Nederlandsche Bank
Finanzmarktaufsicht, Austria
Oesterreichische Nationalbank
Banco de Portugal
Rahoitustarkastus, Finland
Suomen Pankki
Finansinspektionen, Sweden
Sveriges Riksbank
Bank of England
Financial Services Authority, United Kingdom
European Central Bank

European Central Bank
Press and Information Division
Kaiserstrasse 29, D-60311 Frankfurt am Main
Tel.: +49 69 1344 7455, Fax: +49 69 1344 7404
Internet: http://www.ecb.int