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ON DEPOSIT GUARANTEE SCHEMES

Crisis management and deposit insurance schemes: the Italian experience and the European perspective

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1. Introduction

The international debate following the global financial crisis has made evident the key role of an effective framework to prevent, manage and resolve banking crises.

Well-defined rules for crisis management should explicitly define the roles and responsibilities of the authorities, provide for a wide toolkit and ensure fast access to financial resources, including the possibility to rapidly trigger the intervention of Deposit Guarantee Schemes (DGSs). Due consideration must also be given to coordinating those parties involved in crisis management and the resolution tools, at both domestic and international level. After the crisis, new special resolution regimes have been issued or modified by some governments.

Today I will focus on three aspects. First, I will summarise the Italian approach to banking supervision, with an emphasis on resolution regimes for troubled banks. Then, I will sketch the main features of deposit guarantee schemes in Italy. Finally, I will discuss some issues regarding the new EU Commission proposal on DGSs.

2. The Italian supervisory framework

The Italian regulation for troubled financial institutions has not undergone significant changes as a consequence of the recent financial turmoil. Our financial system has not been severely hit by the crisis, so confirming the effectiveness of the Italian regulatory framework established in 1993. The main features of the crisis management framework are:

- a preventive supervisory approach which enables early detection of bank problems;
- a resolution regime which provides procedures for banking restructuring and liquidation;
- the concentration of powers which allows the authority in charge to confront complex situations in order to pursue the stability and the efficiency of the financial system.

i) *The supervisory approach*. The prompt availability of supervisory information allows us to assess the sources, nature and severity of bank weaknesses before the beginning of a crisis. Early intervention enables us to avoid the crisis. Thanks to a wide and complex toolkit, ranging from light corrective measures to full crisis procedures, we are able to perform the actions needed in different situations. The availability of “soft” triggers based on a qualitative and quantitative assessment strengthens the robustness of the whole mechanism, giving the Bank of Italy flexibility in action.

When the supervisory authority detects serious weaknesses in a bank, the first question is whether shareholders and managers are able to solve the problems in a relatively short timeframe. If the bank is still viable, early intervention tools can be used by the Bank of Italy to restore sound and prudent management. To this regard, the Bank of Italy may:

1) request the bank’s directors and auditors to examine the situation and take corrective measures;
2) order the convening of the governing bodies or directly convene them and propose the adoption of certain decisions;
3) impose more stringent requirements for capital adequacy, risk limitation, eligible equity holdings, internal organization and control mechanisms
4) and finally restrict the on-going activities by prohibiting the bank from engaging in new business or closing branches.

To increase the effectiveness and flexibility of the supervisory action, it would be useful to have the opportunity to enhance the Bank of Italy’s toolkit with the power to remove individual board members or bank managers responsible for mismanagement or highly risky conduct. Such power is under consideration by the EC for adoption at Community level.

ii) *The resolution regime*. Crisis procedures are triggered when troubled banks are unable to recover from distress despite the implementation of own strategies or the Bank of Italy’s actions.

Special administration implies the replacement of the bank’s administrative and control bodies by a special administrator who will eliminate irregularities and promote solutions in the interest of the depositors in order to prevent a further decline of the bank’s situation. If the bank is not still able to carry on its business by itself, arrangements for a business combination may take place, such as takeover by or merger with a sound bank, as well as voluntary liquidation with the transfer of assets and liabilities to another intermediary.

Compulsory administrative liquidation is triggered when the crisis is deemed irreversible and the intermediary is unable to perform its functions. Compulsory liquidation is aimed at expelling the firm from the system, although even in this phase market solutions are still possible. The purchase of assets and assumption of liabilities by another bank (the so-called P&A) usually is the most frequent and preferred outcome of a liquidation. It allows to minimize the negative effects of a liquidation on stakeholders and financial markets while maintaining the business continuity and customers' confidence, providing DGSs with a proactive role and preserving the bank's going concern.

The financial crisis has unveiled the need to update the methods of handling distressed institutions. A speeding-up of supervisory processes has been made necessary, consistently with extremely fast-changing scenarios. New approaches have been explored to deal with the difficulties of conventional market-based resolutions due to the general economic downturn and special tools have been issued in order to tackle banks' liquidity imbalances.

iii) *The Bank of Italy's role.* The granting of more crisis management powers to central banks may help overcome coordination issues among relevant authorities. It is necessary to speed up the decision-making process and to ensure the effectiveness of the consequent actions, as the 2007 Northern Rock case showed. The availability of macro-prudential information to the Bank of Italy ensures early detection of areas of potential systemic risk, while micro-prudential supervision allows for the constant monitoring of each institution. The power to appoint special administrators, together with the supervision of special procedures, allows the supervisory authority to benefit from a thorough control of crisis management. The provision of emergency liquidity assistance helps finding solutions in case of illiquid but solvent banks. Supervision and coordination on DGSs enable the Bank of Italy to conduct a comprehensive assessment of the best options available for funding and arrange feasible solutions on a case by case basis. Oversight of payment and securities settlement system allows the Authority to prevent or manage possible spill-over effects of a crisis on these markets.

3. Deposit Guarantee Schemes: the Italian approach

Deposit Guarantee Schemes ensure the reimbursement of small depositors and contribute to prevent crises and facilitate orderly bank failures. In Italy they were officially recognized in 1996. There are two DGSs operating in Italy: the Mutual Bank Depositors Guarantee Fund, for mutual banks only, and the Interbank Deposit Protection Fund, for all other banks.

Insurance is compulsory and membership is a pre-requisite for engaging in banking activities. DGSs are private-law consortia of banks administered by member representatives, performing their functions under the supervision of the Bank of Italy, which has the power to recognise them, approve their by-laws, co-ordinate their activities with crisis management, authorise interventions and member banks exclusion. Information sharing with the Bank of Italy provides DGSs with statistics that are necessary for monitoring the fund's functions.

Italian DGSs do not perform supervisory functions nor can they oblige banks to adopt measures in case of difficulties. However, they may perform a proactive role, aimed at preventing a failure and facilitating a restructuring or a resolution. In the case of Compulsory Administrative Liquidation, the Italian DGSs can intervene either by repaying deposits or by providing support to P&A. Under a Special Administration regime, they carry out early intervention measures, such as granting loans, providing guarantees and acquiring equity interests, aimed at facilitating mergers and preventing banks' difficulties from worsening. DGSs verify whether preventive intervention or the shortfall shouldered in a P&A transaction is less costly than reimbursement. In the latter case, the value of goodwill usually makes the support cheaper than the depositors' payout.

As for funding and coverage, the Italian system already provides for some of the new provisions under consideration in the EU reform proposal. Contributions are risk-based and deposit reimbursement is already over € 100,000. It is worth noting that, in Italy, there have been very few cases where depositors had to be reimbursed by the DGSs during a banking crisis. In most cases, the schemes covered the so-called transfer deficit in a P&A transaction arranged by the liquidators.

4. *The European Directive on DGS: recent amendments and the new EU Commission proposal*

The minimum harmonisation clause introduced by the 1994 European Directive on Deposit Guarantee Schemes was an important step. However, the Directive did not aim at overcoming the discrepancies in DGS regimes across countries, especially with regard to relevant issues like level and scope of coverage, financing and payout delay. During the crisis, these inconsistencies created disruptive effects on financial stability, thus making room for competitive distortions.

In order to tackle such shortcomings, the Directive underwent a first amendment in March 2009 resulting in a higher coverage level, which was increased from a minimum of € 20,000 to at least € 50,000 by June 2009 and to € 100,000 by the end of 2010. Despite of these amendments, shortcomings and differences between countries still remain unaddressed.

The new proposal, issued in July 2010 by the EU Commission, represents a relevant effort towards a greater harmonisation. Main features are represented by a fixed level of coverage of € 100,000 for all Member States and by a mixed funding mechanism, mainly based on an ex-ante funding arrangement; ex-ante contributions should provide 75% of a DGS's total resources.

A pre-funded DGS allows to collect funds on a continuing basis during good times, ensuring anti-cyclical effects and the prompt availability of money to pay out once a default occurs. On the other hand, however large the amount of money available, even pre-funded DGSs will never be able to address all crises, like in the case of large and systemic distressed institutions.

Moreover, half of the target size of DGS funds may also be used for early intervention measures, as temporary liquidity support, aimed at helping a bank when facing difficulties in order to avoid to be wound up.

Under the new proposal of DGS Directive, the new European Banking Authority (EBA) would be entrusted with relevant powers aimed at facilitating the correct functioning of the whole mechanism such as collecting information on the amount of deposits, conducting peer review analyses, confirming whether a DGS can borrow from other DGSs, and settling disagreements between DGSs.

The proposal sets out other important provisions, as those aiming at facilitating the payout process in cross-border situations and those acknowledging the stabilising function of mutual schemes, which are systems where banks support each other. Such systems, in particular, are different from DGSs as they tend to prevent a bank from failing and maintain continuity of key banking services, thus protecting the credit institution, rather than reimburse the depositors when a bank fails. A dual membership of a bank in both schemes is allowed and a lower risk factor of a bank joining a mutual scheme can be taken into account when determining contributions.

In Italy, a mutual scheme (the "Institutional Mutual Bank Guarantee Fund") was established in 2008 and recently submitted for approval to the Bank of Italy by the Federation of Mutual Banks. The Fund should be regarded as an additional system relevant to the new proposal of the DGS Directive, reducing the contributions to be paid to the DGS by the banks that have joined it.

The Bank of Italy strongly supports the EU Commission's work to reform the DGS Directive, in order to harmonise national regulations. At this stage, further work might be undertaken mainly in respect of funding arrangements and early interventions. It would be convenient to redefine the aspects affecting contributions in order to mitigate the economic impact of the reform on banks. In particular, the 2 per cent overall level - adopted by the Commission in order to enable DGSs to cope with a medium-large failing bank - takes into account eligible deposits instead of covered deposits (or repayable funds). It would be preferable to refer the 2 per cent to covered deposits because they represent the real risk assumed by the guarantee scheme, as acknowledged by the same EU proposal which provides for a possible switch to that system by 2015. As an alternative, the effects of the proposal could be mitigated by reducing the ex-ante ratio – especially on those systems switching to the pre-funded model.

DGSs' borrowing facilities need harmonised supervisory systems among Member States in order to prevent an imbalance between DGSs under stricter supervision and DGSs whose countries invest fewer resources in crisis prevention. This can be achieved by harmonising not only rules but also supervisory practices in Europe, notwithstanding the challenge of this goal.
Moreover, the establishment of common rules for crisis management – with reference to both preventive interventions and crisis management and resolution – is an essential pre-requisite, given the strong impact that regulation has on the cost of guarantee schemes.

5. Conclusions

Let me conclude with some remarks on the role of deposit insurance in the safety net framework for banks.

Deposit insurance has been traditionally justified as a way to eliminate bank runs, to protect household saving and to share responsibility for bank stability between public supervision and private insurers. The US was the first country to adopt deposit insurance in the 1930s. In the 1980s the Saving and Loans insolvencies, and the subsequent crisis of the Deposit Insurance Corporation, justified the introduction of reforms, confirming that bank distress is, as we observe today, the main driver leading to regulation reform. In Europe the introduction of deposit insurance took place later than in the US, probably because public-sector ownership of banks was much more common and a sceptical view prevailed over private involvement in bank regulation. However, some European countries introduced DGSs between the 1960s and the 1980s. As I have already said, in 1994 the European Directive introduced harmonised rules on deposit insurance. In the mid-1990s about 50 countries implemented explicit deposit guarantee all over the world. Later on, the new nations joining the EU had to comply with the Directive too. The IMF and the World Bank also recommended adopting explicit deposit insurance for developing countries in light of the growth of bank crises in the 1990s. At the beginning of the new millennium, around 90 countries had established explicit deposit insurance systems. The institutional details of deposit insurance schemes vary across countries with regard to ex-ante or ex-post nature of the mechanism, coverage limits, kind of covered deposits, amount of the premiums paid by banks, risk premium sensitivity, source of funding and nature of administration (private, public or joint).

During the years of its greater diffusion, deposit insurance was proposed as an instrument capable of substituting public supervision for some time. But this view soon became unacceptable by most of the observers. The distress of large banks or portions of the banking systems – the US Saving and Loans, Scandinavian banks and so on – demonstrated the necessity of combining nationalization, State aid and, chiefly, takeover from other intermediaries in order to solve banking instability. Empirical analysis mainly produced by the World Bank has since shown that poorly designed explicit deposit insurance actually increased the likelihood that a country would experience a banking crisis. Deposit insurance contributed to bank fragility in countries where the institutional environment lacks transparency and deterrence. It was not a significant factor in countries whose institutional environment is strong. According to this literature, before adopting DGSs governments should improve banking regulation and supervision, protect property rights, strengthen contract enforcement, as well as upgrade accounting and disclosure rules. These prerequisites help to contrast the traditional accusation flung at deposit insurance, that of raising moral hazard. When regulation and supervision are effective, public action is able to punish bank shareholders and managers for their risky behaviour, thus decreasing the ex-ante incentives to moral hazard. Lastly, the view that deposit insurance is complementary to public supervision was well expressed in the “Core Principles for Effective Deposit Insurance Systems” issued in June 2009.

The design of an optimal DGS is a difficult task. Let’s consider, for instance, limiting coverage. It was often suggested in the past as a tool to ensure depositor discipline but it did not work properly, as the UK case showed, providing an important motivation for the reform of the European Directive we are now discussing.

I am sure that the contributions presented to this conference will improve our understanding of how deposit insurance works and will help to refine its design.