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# Recent Reforms of the Deposit Insurance System in the United States: Reasons, Results, and Recommendations for the European Union

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The views expressed in this paper are solely those of the author and should not be attributed to any institution. The paper was first drafted during the author's Fulbright scholarship at Boston University (2006–2007 Hubert H. Humphrey Fellowship Program) and his visit to the Federal Deposit Insurance Corporation (FDIC) in Washington DC in August-October 2007 [Szeląg 2007a,b]. The final draft was completed in mid-2008 [Szeląg 2008]. It has been revised and updated in recent months, notably after the aggravation of the global financial crisis in fall 2008. The cut-off date for the EU chapter is 15 May 2009, while 22 May 2009 for the US chapters.

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# Abbreviations

| | |
|---|---|
| ABA | American Bankers Association |
| BAP | Bank Administration Procedure |
| BBA | British Bankers Association |
| BCBS | Basel Committee on Banking Supervision |
| BHCA | Bank Holding Company Act |
| BIF | Bank Insurance Fund |
| BIP | Bank Insolvency Procedure |
| CBR | closed-bank resolution |
| CPI | Consumer Price Index |
| CRD | Capital Requirements Directive |
| DGP | Debt Guarantee Program |
| DGS | deposit guarantee scheme |
| DIF | Deposit Insurance Fund |
| DIFA | Deposit Insurance Funds Act |
| DRR | designated reserve ratio |
| ECB | European Central Bank |
| EDIE | Electronic Deposit Insurance Estimator |
| EESA | Emergency Economic Stabilization Act |
| EFDI | European Forum of Deposit Insurers |
| ESFS | European System of Financial Supervision |
| EU | European Union |
| Fed | Federal Reserve System |
| FDIA | Federal Deposit Insurance Act |
| FDIC | Federal Deposit Insurance Corporation |
| FDICIA | Federal Deposit Insurance Corporation Improvement Act |
| FDIRA | Federal Deposit Insurance Reform Act |
| FDIRCAA | Federal Deposit Insurance Reform Conforming Amendments Act |
| FIRREA | Financial Institutions Reform, Recovery and Enforcement Act |
| FSA | Financial Services Authority |
| FSCS | Financial Services Compensation Scheme |
| FSLIC | Federal Savings and Loan Insurance Corporation |
| GDP | Gross Domestic Product |
| HICP | Harmonised Index of Consumer Prices |
| IADI | International Association of Deposit Insurers |
| IMF | International Monetary Fund |
| IOLTA | interest on lawyer trust accounts |
| LCFI | large and complex financial institution |
| MIMIC | mutual insurance model with incentive compatibility |
| NOW | negotiable orders of withdrawal |
| NPR | notice of proposed rulemaking |
| OBA | open-bank assistance |
| OCC | Office of the Comptroller of the Currency |
| OTS | Office of Thrift Supervision |
| P&A | purchase and assumption |
| PCA | prompt corrective action |
| PCE | Personal Consumption Expenditures (US price index) |
| RTC | Resolution Trust Company |
| SAIF | Savings Association Insurance Fund |
| SMDIA | standard maximum deposit insurace amount |
| SRR | Special Resolution Regime |
| TAG | Transaction Account Guarantee Program |
| TARP | Troubled Assets Relief Program |
| TLGP | Temporary Liquidity Guarantee Program |
| US | United States |

**EU member states**

| | | | | | |
|---|---|---|---|---|---|
| AT | Austria | FI | Finland | MT | Malta |
| BE | Belgium | FR | France | NL | Netherlands |
| BG | Bulgaria | GR | Greece | PL | Poland |
| CY | Cyprus | HU | Hungary | PT | Portugal |
| CZ | Czech Republik | IE | Ireland | RO | Romania |
| DE | Germany | IT | Italy | SE | Sweden |
| DK | Denmark | LT | Lithuania | SI | Slovenia |
| EE | Estonia | LU | Luxembourg | SK | Slovakia |
| ES | Spain | LV | Latvia | UK | United Kingdom |

# Abstract

The US deposit insurance system (managed by the Federal Deposit Insurance Corporation – FDIC) has been established in 1933 to ensure the safety of deposited money and the overall stability of the banking sector. Although over decades the system proved to be successful in accomplishing those goals, there were some discussions and efforts in the 2000s to reform it further. And indeed, it was reformed twice – in 2005-2007 and 2008-2009. But there was a fundamental difference between those reforms: the former had been carried out at a time of very good economic and financial conditions (strong economic growth, wealthy banking system, etc.) while the latter was prompted by a serious crisis situation (similarly like the reforms following the 1920-30s and 1980-90s crises).

The paper is mostly related to the United States. It first outlines the main features of the US deposit insurance system prior to the recent reforms. Then, the paper presents the reasons and results of the 2005-2007 reform of the deposit insurance system in the United States. The results are relating to merging the former insurance funds into a new one, providing the FDIC with greater flexibility in managing the fund and in setting risk-based premiums, maintaining the standard coverage limit at $ 100,000 but increasing the coverage limit for retirement accounts to $ 250,000, and indexing both to inflation, etc. Next, the paper presents the 2008-2009 reform that was prompted by the aggravation of the current financial crisis (which had been started by the US subprime mortgage crisis in 2007). It discusses two main elements of this reform, i.e. temporary increasing the standard coverage limit to $ 250,000 and the restoration plan in order to restore the fund's reserve ratio to the required level. Moreover, the paper discusses some potential changes to the US deposit insurance system that could be implemented in the future – suggesting that, even after the recent reforms, there is still some room for further reforming the system.

Finally, there is also a chapter relating to the European Union. In 2005-2006, the EU conducted the review of the directive on deposit guarantee schemes (adopted in 1994), but it concluded that there was no need to amend it. The financial turmoil, which started in the US and had serious impact in Europe in 2007 and 2008, caused much more urgency to reforming the EU deposit guarantee schemes. Thus, the paper presents the recent amendments to the directive (proposed in October 2008 and finally adopted in March 2009) that had been prompted by the aggravation of the current global financial crisis (in September 2008), as well as some potential changes to be discussed in the near future. It discusses the following issues: increasing coverage levels to € 50,000 and € 100,000, abandoning co-insurance, speeding up payouts, risk-based premiums, funding mechanisms, a pan-EU deposit guarantee scheme, potential roles of deposit insurers in early intervention and bank resolution, depositor awareness and literacy, etc. The paper includes some recommendations for the EU (e.g. € 100,000, € 200,000, and € 500,000 as fixed harmonized levels for standard deposits, retirement accounts, and temporary high balances respectively) based on the recent reforms of the US deposit insurance system (as well as some solutions adopted or proposed recently in the UK).

Key words: FDIC, deposit insurance system / deposit guarantee scheme, coverage limit / guarantee level, risk-based premiums/contributions/levies, risk categories, co-insurance, funding mechanisms (*ex-ante*, *ex-post*), payoff / payout / reimbursement, credit/depositary institutions (banks, thrifts), financial crisis/turmoil, bank run/panic

JEL Classification: G21, G28, G29

# Introduction

The US deposit insurance system (managed by the Federal Deposit Insurance Corporation – FDIC) was established in 1933 as a direct result of numerous banking failures during the 1920s and early 1930s (notably during the Great Depression). Its principal goal was to ensure the safety of deposited money and the overall stability of the banking sector. In fact, the US insurance system proved to be successful in accomplishing those goals, but the banking crisis in the 1980s and early 1990s in the United States was a serious reminder that a flawed deposit insurance system could be extremely costly. The crisis prompted the reform of the deposit insurance system in the early 1990s. Nevertheless, despite some important improvements, the US deposit insurance system still exhibited some flaws which undermined its fully effective functioning. Therefore, there had been the need that led finally to the reform of the deposit insurance system in the US – adopted in 2005 and implemented mainly in 2006 and 2007. It should be noted that the above reform was proposed and implemented at a time of very good economic and financial conditions (strong economic growth, wealthy banking system, well capitalized insurance funds, etc.).

Practically at the same time, in 2005-2006, the European Commission conducted the review of the EU directive on deposit guarantee schemes (adopted in 1994). It was aimed at identifying their potential weaknesses and proposing appropriate actions to strengthen them. However, on the basis of the EU member states' opinions, the Commission concluded that, at that time (i.e. good economic and financial conditions in the world, including the EU), there had been no political will to make any legal amendments of the directive (even if it had been adopted about 12 years ago in a significantly different reality and, in turn, it was out of date in some respects). Although the EU member states had realized that the changes to the directive were necessary and inevitable, the majority of them preferred to maintain the *status quo* related to their deposit insurance systems and avoid expensive investments to change the existing framework in the absence of a firmly established business case.

In mid-2007, the financial turmoil started in the United States and had serious consequences in Europe as well. First, in fall 2007, there was a bank run on Northern Rock in the United Kingdom (in September 2007) that forced the UK authorities to make some important changes in the domestic deposit insurance system (in October 2007). A year later, in fall 2008, the global financial crisis influenced financial systems and deposit insurance schemes in all member states of the EU. The spectacular aggravation of the crisis in mid-September 2008 (after the bankruptcy of Lehman Brothers Holdings) caused that both depositors' confidence in the banking system as well as confidence among banks fell dramatically in both the US and the EU. In order to maintain financial stability and avoid another bank run(s) – that could not have been excluded at that time – a number of emergency policy measures, including some urgent actions related to the deposit insurance systems in both the US and the EU (adopted in fall 2008 and implemented immediately and in 2009 as well). Therefore, the current financial crisis – compared not only to the US banking crisis in the 1980s and early 1990s, but even to the crisis in the 1920s and early 1930s (Great Depression) – proved to be a painful lesson that prompted some important reforms in the US and the EU. In particular, the crisis caused much more urgency to reforming the EU deposit guarantee schemes that had been needed in recent years in the EU but there had been no political will to do so at a time of good economic and financial conditions.

The paper is organized as follows. Chapter 1 outlines briefly the main features of the insurance systems in the United States prior to the recent reforms. Chapter 2 explains the reasons and results of the 2005-2007 reform of the US deposit insurance system, while Chapter 3 presents the 2008-2009 reform that was prompted by the aggravation of the current global financial crisis. Chapter 4 discusses some potential changes to the US deposit insurance system that could be implemented in the future (suggesting that even after the recent reforms, presented in Chapters 3 and 4, there is still some room for further reforming the system). Finally, Chapter 5 – relating to the European Union – presents the recent amendments to the EU directive on deposit guarantee schemes (proposed in October 2008 and finally adopted in March 2009) that – like in the US – had been prompted by the financial crisis, as well as some potential changes to be discussed (and perhaps implemented) in the near future. It includes some recommendations for the EU based on the recent reforms of the US deposit insurance system (and, in general, keeping in mind that the United States has had much longer experience with deposit insurance than the European Union as a whole – since 1933 and 1994 respectively). It also pays attention on some solutions adopted or proposed recently in the UK. The last part concludes.

# 1

# An overview of the deposit insurance system in the United States before the recent reforms (1933-2005)



The United States has the oldest federal deposit insurance system in the world. The system – managed by the **Federal Deposit Insurance Corporation** (FDIC) – was established on the basis of the Banking Act of 1933 (the so-called Glass-Steagall Act signed into law by President F.D. Roosevelt)[1]. It was a response to many banking panics and runs that occurred in the XIX and early XX centuries and finally contributed to the Great Depression (resulting in thousands of bank failures and suspensions at that time)[2] [FDIC 1998b; Martin 2003]. The US Congress created the FDIC to restore public confidence in the nation's banking system. Therefore, the FDIC's mission was (and still is) maintaining the stability and public confidence in the US financial system by:

- insuring deposits;
- supervising and examining financial institutions (banks and thrifts);[3]
- managing receiverships.

The FDIC is an independent agency of the United States government and its primary task is protecting against the loss of insured deposits if an FDIC-insured financial institution fails. The FDIC insures deposits at about 8,400 financial institutions, i.e. banks and savings associations (thrifts). As it is often underlined by the FDIC (in its documents, on its website, etc.), deposit insurance provided by the FDIC is backed by the full faith and credit of the United States government. At the same time, it should be noted that the FDIC's operations are totally funded by insured financial institutions (the FDIC receives no federal funds).

## 1.1 Main features of the US federal deposit insurance system (until 2005)

The US deposit insurance system always guaranteed the safety of deposit at insured banks and thrift institutions up to a certain level – **the coverage limit**. Initially, in 1934, the Congress set the coverage limit at the level of $ 5,000 (raising it from the temporary limit of $ 2,500 that was in effect for the first six months of that year). Since then, the basic coverage amount has been increased from time to time in the 1950s, 1960s, and 1970s

1 The Banking Act of 1933 established the FDIC as a temporary agency. Two years later, the Banking Act of 1935 established the FDIC as a permanent agency of the government. In 1950, the Federal Deposit Insurance Act (FDIA) revised and consolidated earlier FDIC legislation into one act and embodied the basic authority for the operation of the FDIC [see: FDIA 1950; FDIC website].

2 Whereas an average of about 600 banks were suspended every year from 1921 to 1929, that average climbed to over 2,250 from 1930 to 1934, with 4,000 suspensions in 1933 alone. When deposit insurance became effective in 1934, it contributed to a substantial decrease in the number of bank failures: from 1934 to 1941 the number of bank failures handled by the newly created FDIC fell to 370, a little over 50 banks a year [Martin 2003].

3 The FDIC – similarly like the Federal Reserve (Fed), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) – is one of federal banking regulators and supervisors in the United States (see: Annex 1a). The FDIC is the primary federal banking regulator and supervisor of all state non-member banks (i.e. banks which are not members of the Federal Reserve). As a supervisor, the FDIC performs safety and soundness examinations, visitations, and investigations.

(see: Table 1.1). **In 1980, the US Congress raised the coverage limit to $ 100,000**. However, it should be noted that although the nominal deposit insurance coverage limit was $ 100,000 per person per bank, complexities of the US deposit insurance laws caused that the limit was much greater in practice because the FDIC provided separate insurance coverage for deposits held in different "ownership categories" (e.g. single accounts, joint accounts, trust accounts, etc.). For example, depositors who had money in two, three or four different ownership categories at one bank could qualify for up to $ 200,000, $ 300,000 or $ 400,000 of deposit insurance provided by the FDIC. It was assessed that a four-person family could hold insured deposits of even $ 2 million in a single bank by maximizing the coverage available in the five different types of consumer accounts [FDIC 2000a].

As far as the scope of coverage is concerned, **the FDIC always insured depository products only**, i.e. customers' funds in their deposit accounts – in checking accounts (including money market deposit accounts), savings accounts (including passbook accounts), retirement accounts (including individual retirement accounts – IRAs), money market deposit accounts and certificates of deposit (CDs), etc. The FDIC's insurance has never covered other financial products and services that insured banks may offer, such as stocks, bonds, mutual fund shares, life insurance policies, annuities, Treasury and municipal securities, etc. [FDIC 2008b; FDIC website].

**Table 1.1 Increases of the FDIC basic coverage limit (in $, 1933-2005)**

| Year | 1934 | | 1950 | 1966 | 1969 | 1974 | 1980 |
|---|---|---|---|---|---|---|---|
| | 1st half | 2nd half | | | | | |
| Basic Coverage Amount | 2,500 | 5,000 | 10,000 | 15,000 | 20,000 | 40,000 | 100,000 |

Source: FDIC.

Until 2005, the FDIC administered **two deposit insurance funds** – the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) – to insure deposits in banks and savings associations (thrifts) respectively. The funds existed separately, but both of them provided identical insurance coverage (up to $ 100,000), both operated under the same statutory assessment system, and, in some cases, both insured deposits at the same institutions. An important difference was the fact that assessment rates for BIF and SAIF members (banks and thrifts respectively) – which determined their contributions to the system (premiums) – were set separately [FDIC 2001].

According to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), passed by the Congress after the US banking (savings and loan) crisis in the 1980s and early 1990s[4] in order to contribute to the recovery of the US banking system,[5] the FDIC was obliged to implement a risk-based insurance system. As a result, the FDIC used a **risk-based premium system** assessing higher rates and charging higher premiums to those institutions that posed greater risks to the BIF or the SAIF and lower rates/premiums for less risky ones. In order to assess premiums on a given institution, the FDIC put it in one of nine risk categories (a nine-cell matrix), having used a two-step process based on:

4 Prior to the crisis, during 40 years (from 1940 to 1979), on average, only 7 banks failed every year in the United States. The number of bank and thrift failures increased dramatically in the early 1980s and remained very high for about a decade. From 1983 to 1992, on average, almost 150 banks and 120 thrifts were closed every year, with 280 bank failures in 1988 and 327 thrift failures in 1989 [Martin 2003].

5 As it is argued by some authors, the recovery of the US banking system in the early 1990s was remarkable. The number of bank failures declined from 280 in 1988, to 127 in 1991, 41 in 1993, and finally just 5 in 1996. The improvement was not only due to the better health of the existing banks but also to the disappearance of many of the weakest institutions [Martin 2003].

• capital ratios (the capital group assignment);[6]

• other relevant information (the supervisory subgroup assignment).[7]

As of 1 January 1993, when the risk-based assessment system was introduced, each bank and thrift paid an annual assessment rate of between 23 and 31 cents per $ 100 of assessable deposits (see: Table 1.2a). After the BIF and the SAIF reached the designated reserve ratio (see the next paragraph) – in 1995 and 1996 respectively – the FDIC Board of Directors (which reviewed premium rates semiannually) approved a reduction in assessment rates for both funds. Finally, all insured institutions (both banks and thrifts) were required to pay premiums according to an identical range of between 0 and 27 cents per $ 100 of assessable deposits (see: Table 1.2b) – effective 1 January 1996, for BIF members, and 1 January 1997 at the latest, for all SAIF members [FDIC 2000a]. In this context, it should be noted that the Deposit Insurance Funds Act of 1996 (DIFA) **prohibited the FDIC from charging any premiums to well-capitalized and well-managed institutions** (risk category 1A), as long as the fund's reserve ratio exceeded (and was expected to remain above) the DRR.

**Table 1.2 Annual assessment rates for banks and thrifts in the United States (in basis points)**

a) as of 1 January 1993

| Capital Group | | Supervisory Subgroup | | |
|---|---|---|---|---|
| | | A | B | C |
| 1 | Well Capitalized | 23 | 26 | 29 |
| 2 | Adequately Capitalized | 26 | 29 | 30 |
| 3 | Undercapitalized | 29 | 30 | 31 |

b) as of 1 January 1997

| Capital Group | | Supervisory Subgroup | | |
|---|---|---|---|---|
| | | A | B | C |
| 1 | Well Capitalized | 0 | 3 | 17 |
| 2 | Adequately Capitalized | 3 | 10 | 24 |
| 3 | Undercapitalized | 10 | 24 | 27 |

Source: FDIC 2001.

The FDICIA also required the FDIC to maintain each of the above funds – the BIF and the SAIF – at or above the so-called **designated reserve ratio (DRR)**, i.e. the ratio of mandated reserves to insured deposits. The level of the DRR was set at 1.25%. If a given fund's reserve ratio fell below the DRR, the FDIC would have had to raise premiums by enough to bring the reserve ratio back to the DRR within a year. Otherwise, if the reserve ratio was not brought back to the DRR within a year, the FDIC would have had to establish a schedule for returning it to the target level within 15 years, and charge at least 23 cents per $ 100 of deposits (23 basis points) until the reserve ratio reached the DRR [FDIC 2001].

6 The capital group assignment was based on risk-based capital ratios and leverage capital ratios. Each institution was assigned to one out of three capital categories: well capitalized, adequately capitalized, and undercapitalized (with the numbers 1, 2, and 3, respectively). For more details, see: Annex 2.

7 The supervisory subgroup assignment was based on supervisory ratings (so-called CAMELS – see: Annex 1b) assigned by bank examiners. Each institution was assigned to one out of three supervisory subgroups: A (institutions with a CAMELS rating of 1 or 2), B (institutions with a CAMELS rating of 3), and C (institutions with a CAMELS rating of 4 or 5). For more details, see: Annex 2.

1

## 1.2 The FDIC role in resolving failing and failed financial institutions

As mentioned at the very beginning of the previous section, the FDIC has three main responsibilities: (1) to act as an insurer, (2) to act as a supervisor, and (3) to act as a receiver. The roles of insurer and receiver require that the FDIC play an active role in resolving failing and failed financial institutions (banks and thrifts) which are insured by the FDIC [FDIC 1998a]. It was the case prior to the recent reforms of the US deposit insurance system, and it is still the case today.

With regard to failing institutions, the FDIC interventions take place prior to the actual failure of a bank or thrift. When the overall situation of such an institution starts to deteriorate, the FDIC is required to initiate progressively severe restrictions on its activities – the so-called **prompt corrective action** (PCA) – introduced by the FDICIA in 1991. According to the the act, federal regulators (including the FDIC) are required to establish five capital categories for banks – ranging from well-capitalized to critically undercapitalized (see: Box 1.1). Those categories serve as the basis for mandatory prompt corrective action by regulators/supervisors. Increasingly stringent restrictions are being applied to institutions that are less than well-capitalized. The PCA stipulates that **a bank with a leverage ratio less than 2% (i.e. critically undercapitalized bank) has to be closed**[8] by the entity that charters the bank and which has the authority to revoke its license[9] – **if the situation is not corrected within 90 days** (in 1991, the FDIC was also given the power to close a failing bank[10]). The PCA has been based on the assumption that by closing institutions before their capital was totally depleted, losses to the deposit insurance funds would be mitigated [FDIC 1998b]. Since the 1980s, economists have contended that prompt closure of depository institutions minimizes the losses to uninsured depositors and to the deposit insurance funds [Buser, Chen and Kane 1981]. And it was indicated that the FDICIA's PCA provisions were similar to those proposed in the late 1980s by some economists [Benston and Kaufman 1988] who had seen early intervention as a practical way of altering depositories' incentive structure and allocating scarce regulatory resources [Pike and Thomson 1992]. In the years following the passage of the FDICIA, it was assessed that the PCA had been successful in getting banks to increase capital and, in turn, contributed to improving the safety and soundness of the US banking system [Aggarwal and Jacques 1998].

Box 1.1
Bank capital categories and prompt corrective actions according to the FDICIA

According to the FDICIA, each appropriate federal banking agency shall, by regulation, specify for each relevant capital measure the levels at which an insured depository institution is well capitalized, adequately capitalized, undercapitalized, and significantly undercapitalized. The prompt corrective action (PCA) provisions of FDICIA provide a series of mandatory and optional supervisory responses to declining bank capital adequacy ratios. Therefore, taking into account the FDICIA provisions and the FDIC regulations, there are the following bank categories and coresponding actions to undercapitalized banks:

8 An institution is typically closed by its chartering authority when it becomes insolvent, is critically undercapitalized, is implicated in a discovery of a severe case of fraud, or is unable to meet deposit outflows [FDIC 1998a].

9 The chartering authority for state-chartered banks is usually the state banking department; for national banks – the Office of Comptroller of the Currency (OCC); and for federal saving institutions – the Office of Thrift Supervision (OTS).

10 Until the passage of the FDICIA, the FDIC did not have the authority to close a failing insured bank; that power rested with the chartering authority. In 1991, the FDIC was given the authority to close an institution that was considered to be critically undercapitalized and did not have an adequate plan to restore capital to a required level. The FDIC was also given the authority to close an institution that had a substantial dissipation of assets due to a violation of law, operated in an unsafe or unsound manner, engaged in a willful violation of a cease and desist order, concealed records, or ceased to be insured [FDIC 1998a,b].

(1) Well capitalized banks

An insured depository institution is "well capitalized" if it significantly exceeds the required minimum level for each relevant capital measure. In order to be classified as well capitalized, a bank must have a total risk-based capital ratio greater than or equal to 10%, a tier 1 risk-based capital ratio greater than or equal to 6%, and a tier 1 leverage ratio greater than or equal to 5%.

(2) Adequately capitalized banks

An insured depository institution is "adequately capitalized" if it meets the required minimum level for each relevant capital measure. In order to be classified as adequately capitalized, a bank must have a total risk-based capital ratio greater than or equal to 8%, a tier 1 risk-based capital ratio greater than or equal to 4%, and a tier 1 leverage ratio greater than or equal to 4%.

(3) Undercapitalized banks

An insured depository institution is "undercapitalized" if it fails to meet the required minimum level for any relevant capital measure. Undercapitalized banks (i.e. those with a total risk-based capital ratio lower than 8%, a tier 1 risk-based capital ratio lower than 4%, and a tier 1 leverage ratio lower than 4%) are required to submit a capital restoration plan for approval by its federal supervisor. Such banks are not allowed to increase their average total assets over a quarter unless the growth is consistent with an approved capital restoration plan and the bank's tangible equity-to-asset ratio is increasing at an acceptable pace. Moreover, undercapitalized banks may not acquire or merge with another company or establish or acquire additional branches unless they have an approved plan.

(4) Significantly undercapitalized banks

An insured depository institution is "significantly undercapitalized" if it is significantly below the required minimum level for any relevant capital measure. Significantly undercapitalized banks (i.e. those with a total risk-based capital ratio lower than 6%, a tier 1 risk-based capital ratio lower than 3%, and a tier 1 leverage ratio lower than 3%) are subject to all of the restrictions on undercapitalized banks. In addition, supervisors are instructed to take one or more of several actions, including requiring recapitalization by equity issuance of acquisition, restricting transactions with affiliates, restricting the interest paid on deposits, imposing stricter asset growth restrictions, changes in the board of directors or senior executive officers, prohibiting deposits by correspondent banks, requiring prior approval for capital distributions by the bank's parent holding company, and requiring the bank to divest one or more subsidiaries or the bank holding company parent to divest the bank. Undercapitalized banks may not pay bonuses or increase base compensation beyond the level of the prior 12 calendar months without supervisory approval.

(5) Critically undercapitalized banks

An insured depository institution is "critically undercapitalized" if it fails to meet any level specified in the FDICIA, and notably if its ratio of tangible equity to total assets (leverage ratio) is under 2%. Critically undercapitalized banks are subject to all of the restrictions on significantly undercapitalized banks. In addition, critically undercapitalized banks may not pay interest on their subordinated debt without supervisory approval. Critically undercapitalized banks – those with a leverage ratio lower than 2% and without an adequate plan and resources to restore capital to the required level – are prohibited to continue activities, and must be placed under receivership within 90 days.

Source: FDICIA 1991; FDIC 2000a; Eisenbeis and Wall 2002.

When an insured bank or thrift is about to fail, the FDIC initiates its resolution process. There are the following possible **resolution methods**:

• open-bank assistance (OBA),

• closed-bank resolution (CBR).

The OBA has been used rather rarely and the CBR is the standard procedure. The CBR, applied after the chartering authority closed the institution and appointed the FDIC as a receiver, can be of two types:

• purchase and assumption (P&A),

• deposit payoff.

For most of the FDIC's history, P&A transactions have been the preferred and most frequently used resolution method. In selecting the resolution method, the FDIC has changed procedures over the years. Before the adoption of the FDICIA in 1991, the FDIC could choose any resolution method that was less costly than a deposit payoff and liquidation of assets (deposit payoffs were discouraged since this resolution method reduced the availability of local banking services in smaller communities). Before making its final selection, the FDIC considered various factors (not only the estimated cost of the resolution method) [FDIC 1998a]. In 1991, as a result of the newly adopted law (FDICIA), the FDIC started to act in line with **the least-cost-resolution principle**. It requires the FDIC to choose the resolution method for failing banks that results in the lowest cost to the insurance fund, regardless of other factors. Therefore, if two resolution alternatives were less costly than a deposit payout, previously the FDIC could have chosen either method, and under the FDICIA, the FDIC must choose the least costly of the two [FDIC 1998b]. In general, the provision of least-cost-resolution is understood to limit the FDIC's ability to absorb losses that would otherwise be borne by uninsured depositors and nondeposit creditors [Eisenbeis and Wall 2002].

Box 1.2
The FDIC resolution methods

The basic resolution methods in the United States are the following:

• **Open Bank Assistance (OBA)**

In an open bank assistance agreement, the FDIC provides financial assistance to an operating insured bank or thrift determined to be in danger of closing. The FDIC can make loans to, purchase the assets of, or place deposits in the troubled bank. Where possible, assisted institutions are expected to repay the assistance loans.

The advantage of this procedure is that it has less negative effects on the relationships between the banks and its customers. However, it can be more costly and complex for the deposit insurance scheme and might increase moral hazard.

While used in a number of situations during the 1980s, including for the resolution of several larger failing banks, that method has not been used since 1992.

• **Purchase and Assumption (P&A)**

The P&A agreement is a closed bank transaction in which a healthy institution (generally referred to as either the acquirer or the "assuming" bank or thrift) purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The acquirer usually pays a premium for the assumed deposits, decreasing the FDIC's total resolution cost.

This procedure is often applied in case of a sudden failure of a small FDIC member. A different type of P&A is the bridge-bank* transaction, in which the FDIC acts temporarily as the acquirer, taking over the operations of the failing bank and maintaining the banking services for the depositors. This resolution is especially useful in particular types of situations, when the failing bank is large or unusually complex, or when there is no time to respect the normal procedures due to the unexpectedness of the failure.

For most of the FDIC's history, P&A transactions have been the preferred resolution method.

- Deposit payoff

In a deposit payoff, as soon as a bank or thrift is closed, the FDIC is appointed as a receiver, and all depositors with insured funds are paid the full amount of their insured deposits. Depositors with uninsured funds and other general creditors of the failed institution are given receivership certificates entitling them to a share of the net proceeds from the sale and liquidation of the failed institution's assets.

In case of deposit payoffs, no assets or liabilities are assumed by another institution: depositors are reimbursed either by issuing a deposited check (straight deposit payoff) or by transferring the amount of insured deposits to a bank willing to serve as an agent of the FDIC (insured deposit transfer).

Depositors are informed of the occurred failure. Besides the announcement via public press, the FDIC issues a letter to depositors with instructions on how to claim their money. Moreover, the FDIC may organize a claim team for the failed member with the tasks to meet depositors directly and take information on their claims.

* A bridge bank is a newly created national bank designed to maintain the operations of an institution until a more permanent solution can be completed.

Source: FDIC 1998a; Commission 2008a.

The FDIC is in charge of both the process of resolving a failed bank (resolution stage) and the process of liquidating its assets (receivership process). As mentioned above, the FDIC initiates its **resolution process** when an insured bank or thrift is about to fail. Between the time it receives notification from the chartering authority that a given institution is about to fail (the so-called "failing bank letter") and the time it develops the plan for closing the institution, the FDIC performs a number of specific tasks, including processing the failing bank letter, developing an information package, performing an asset valuation, determining the appropriate resolution structure, and conducting an on-site analysis to prepare for the closing. After collecting the necessary information and determining the appropriate resolution structure to be offered, the FDIC begins to market confidentially the failing institution as widely as possible to encourage competition among bidders, and then it compiles a list of potential acquirers (financial institutions and private investors). The final stage in the resolution process occurs when the institution is closed, and the assets that the acquirer purchased and the deposits that it assumed are transferred to the acquirer. Usually, the acquirer reopens the bank or thrift premises by the next business day and the failed institution's customers with insured funds automatically become customers of the acquiring bank and have access to their money. The resolution ends when the chartering authority appoints the FDIC as a receiver. The process usually lasts about 90-100 days [FDIC 1998a].

In the **receivership process**, the FDIC is responsible for settling the affairs of the bank or thrift, which includes balancing the accounts of the institution immediately after closing, transferring certain assets and liabilities, and determining the exact amount of payment due the acquirer. As a receiver, the FDIC is responsible for operating the receivership, including collecting any of the failed bank's assets retained by the receiver and satisfying the claims against the receivership of the failed institution [FDIC 1998a].

As mentioned above, **deposit payoffs** have never been the preferred and most frequently used resolution method; on the contrary, it has often been discouraged. Nevertheless, it should be emphasized that in case of deposit payoffs, thanks to adopted procedures (see: Box 1.2), **reimbursement is near immediate**, i.e. maximum a few days after a bank/thrift failure. The insured deposits are usually available for the depositors within 1-2 business days in almost every bank failure (see also: Section 3.2). This is a consequence of the fact that the FDIC – contrary to the EU deposit guarantee schemes – plays the central role in the receivership process, which allows arranging the payout as soon as possible, usually with no delays [Commission 2008a].

# 2

# The 2005-2007 reform of the deposit insurance system in the United States



## 2.1 Background: first reforms after the US banking crisis in the 1980s and early 1990s

In general, **the US system of federal deposit insurance proved to be successful**. It was apparent during the US savings and loan crisis in the 1980s and early 1990s. During the crisis, there were no depositor runs on banks in the US (like in the XIX and early XX century), and bank failures were resolved in a well organized and efficient way (contrary to the recent experience of some Asian and Latin American countries that also faced banking/financial crises but lacked explicit deposit insurance systems). As emphasized by the FDIC (in its documents, on its website, etc.), "*since the FDIC was established, no depositor has ever lost a single penny of FDIC-insured funds*". On the other hand, however, the 1980s banking crisis in the US was also a serious reminder that **a flawed deposit insurance system could be extremely costly**. According to the FDIC, at that time, the US taxpayers were billed for about $ 120-130 billion to clean up the savings and loan crisis following the demise of the Federal Savings and Loan Insurance Corporation[11] [FDIC 2000a; Curry and Shibut 2000]. Therefore, there was a need to make sure that the deposit insurance system would be operated in a financially, economically, and fiscally responsible way, i.e. ensure that the FDIC funds were adequate and banks and thrifts – rather than taxpayers – funded the system [Powell 2002].

The above banking crisis prompted **the reform of the deposit insurance system in the early 1990s**. In 1991, the US Congress passed the FDICIA (Federal Deposit Insurance Corporation Improvement Act – see: Chapter 1) which included a number of important reforms to improve the US deposit insurance system, such as the introduction of risk-based premiums and a mandate to maintain adequate insurance funds, principles of prompt corrective action and least-cost resolution, addressing the "too-big-to-fail" issue, and increasing (from $ 5 billion to $ 30 billion) the amount that the FDIC is authorized to borrow from the US Treasury to cover insurance losses, and other provisions [for an overview, see: American Bankers Association 1991]. The FDICIA was comprehensive in nature, covering both insurance funds and their finances as well as supervisory and resolution practices [FDIC 1998b], and its purpose was twofold: to provide funding for federal deposit insurance and to reduce taxpayers' exposure to losses when banks fail [Pike and Thomson 1992]. In general – taking into account that both bank failures declined and bank profitability increased following the passage of the FDICIA – the act was regarded as a major success in improving the safety and soundness of the US banking system. At the same time, however, there were opinions that despite this seemingly favorable performance, the FDICIA had mixed success in handling banks' losses [Eisenbeis and Wall 2002]. Nevertheless, it was regarded as the most important US banking legislation since the Banking Act of

[11] The Federal Savings and Loan Insurance Corporation (FSLIC) was created by the National Housing Act of 1934 in order to insure deposits in savings and loan associations (thrifts). It was administered by the Federal Home Loan Bank Board. The FSLIC had existed until 1989 when it was abolished by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) that passed responsibility for savings and loan deposit insurance to the FDIC. In the 1980s, during the savings and loan crisis, the FSLIC became insolvent and was recapitalized with taxpayer money several times. Currently, alongside with the DIF, the FDIC administers the FSLIC Resolution Fund that fulfills the obligations of the former FSLIC and RTC (Resolution Trust Company).

1933, although it raised some criticism and controversy as well [see, for example: Kaufman and Litan 1993; Kaufman 1994, 1995, 1997; Carnell 1996; Benston and Kaufman 1997, 1998; Aggarwal and Jacques 1998].

Next, **in mid-1990s, the reform of the deposit insurance system was extended**. In 1996, the US Congress passed the DIFA (Deposit Insurance Funds Act – see: Chapter 1) that introduced further changes to the system. The act set the DRR for both insurance funds (the BIF and the SAIF) at 1.25% and eliminated the range established in 1980.[12] As mentioned before, the DIFA prohibited the FDIC from charging any premiums to well-capitalized/well-managed institutions, as long as a fund's reserve ratio exceeded (and was expected to remain above) the DRR. Moreover, the act was adopted to ensure that members of the BIF and the SAIF would not face significant and arbitrary differences in deposit insurance pricing. Finally, it should be mentioned that the DIFA contained provisions to merge the BIF and the SAIF, effective 1 January 1999. However, the merger could become effective only if there were no insured savings associations in existence on that date. It was thought at the time that a new charter that was common both to banks and thrifts would be developed, and – as a result – the thrift charter would be eliminated. And because it had not happen, the BIF and the SAIF continued to exist separately [FDIC 1998b, 2000a].

## 2.2 The need for further reforms of the US deposit insurance system

**Despite some important improvements, the US deposit insurance system still exhibited some flaws which undermined its fully effective and fair functioning**. In 2000, the FDIC issued a special document – the so-called *Options Paper* – where it discussed main weaknesses of the system and offered potential solutions. The FDIC identified four key weaknesses of the deposit insurance system that had to be corrected relatively soon:

- the continued existence of two separate insurance funds based on an anachronistic distinction and providing deposit insurance at potentially different prices;
- the pricing system which could not ensure that deposit insurance be priced accurately to reflect risk, and thereby created inappropriate incentives and raised fairness issues;
- the requirement that banks were obliged to fund insurance losses when they can least afford it since premiums were highest at the wrong point of the business cycle (downturn);
- uncertainty for depositors as to the future real value of the FDIC's insurance coverage since the value of coverage did not keep pace with inflation in a predictable fashion [FDIC 2000a, 2001].

With reference to the first issue – **the existence of two insurance funds** – it was argued that originally, the BIF and the SAIF were intended to insure bank and savings association deposits separately. But, in practice, for depositors, there is practically no difference between banks and thrifts. Moreover, many institutions held both BIF- and SAIF-insured deposits, and more than 40% of SAIF-insured deposits were held by commercial banks [Powell 2002, 2003a,b]. Therefore, the BIF and the SAIF provided almost identical products to both commercial banks and thrifts, but their premiums were set separately. It raised the possibility that institutions posing similar risk could pay different premiums. And, indeed, it happened in late 1995 and 1996, when even the best-rated SAIF members

[12] In 1980, legislation established 1.25% as the midpoint of the range in which the reserve ratio was to be maintained. If the ratio surpassed 1.40%, refunds were required; and if the ratio fell below 1.10%, additional assessments were required [FDIC 1998b].

were still paying premiums while the best-rated BIF members were not [FDIC 2001]. For all those reasons, it was argued that a single fund (being a result of merging the BIF and the SAIF) would be stronger and better diversified than either fund standing alone, and it would eliminate the likelihood of a premium disparity between the BIF and the SAIF [Powell 2002, 2003a,b, 2005].

As far as the second of the above problems is concerned – inadequate pricing of risk – it was indicated that, on the one hand, the law (FDICIA) required the adoption of a risk-based pricing system, but on the other hand, it prevented the FDIC from doing so effectively. The most heavily criticized feature was a statutory zero-premium provision for the best-ranked institutions (introduced by the DIFA). As a result, since most banks and thrifts were well capitalized and well managed (1A category), the vast majority of them – about 91-93% of all insured institutions – have not been paying any premiums for deposit insurance for many years [Powell 2002, 2003a,b, 2005]. In turn, the FDIC provided free deposit guarantees of almost $ 3 trillion in bank and thrift liabilities [FDIC 2000a]. Such practices inevitably increased the potential for moral hazard (the problem that FDICIA intended to address with risk-based deposit insurance), and caused that safer institutions unnecessarily subsidized riskier ones [Powell 2005]. It was argued that all institutions pose some (higher or lower) risk to the insurance funds and, in turn, all of them should have paid (more or less) for deposit insurance; in other words, there were no institutions posing zero risk to the system, and for that reason none of them should have paid zero premiums (since it was in contradiction with basic market rules).



In this context, two problems were observed in practice. First, a zero price for the FDIC's guarantees encouraged banks and thrifts to bring new deposits into the system without paying any premiums (they enjoyed benefits of deposit insurance with sharing no costs). To illustrate the scale of the problem, it was estimated that between 1996 and 2005, almost 1,100 new banks and thrifts – with more that $ 260 billion in assessable deposits – had joined the system and never paid for deposit insurance [Powell 2005]. Second, underpriced (or practically free) deposit insurance created incentives for many institutions (especially new ones) to grow rapidly. Those new institutions, which had never paid for deposit insurance, grew rapidly and benefited at the expense of their older and usually slower-growing competitors. And, in turn, fast deposit growth lowered the reserve ratio and increased the probability that it would fall below the minimum required level (DRR), resulting in a huge increase in premiums for all institutions [FDIC 2001]. Indeed, over the period of 1996-2001, the BIF reserve ratio declined from 1.34% to 1.26%, but – fortunately for banks – it did not fall below the minimum required by law level of 1.25% before the reform of 2005 (see: Table 2.1).

Finally, it should be noted that since very little in premiums had been collected since 1996, the deposit insurance system was almost entirely financed by those institutions that had paid premiums in the past [FDIC 2001]. Moreover, since premiums had been paid only by a small number of institutions (about 7-9% of all insured institutions) with lower ratings (other than 1A category), it was argued that "*pricing of deposit insurance has evolved into a penalty system for the few, rather than a priced service for all*" and perceived as a significant departure from past practices [FDIC 2000a]. Overall, one can agree that it had nothing to do with the principles of fairness, equal treatment, and level playing field.

**Table 2.1 Actual reserve ratios of the BIF and the SAIF (1996-2005)**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| BIF | 1.34 | 1.38 | 1.38 | 1.36 | 1.35 | 1.26 | 1.27 | 1.32 | 1.30 | 1.32 |
| SAIF | 1.30 | 1.36 | 1.39 | 1.45 | 1.43 | 1.36 | 1.37 | 1.37 | 1.43 | 1.30 |

Source: FDIC 2006.

With reference to the third of the above-listed problems – **potentially highly volatile premiums** – it was argued that it might be caused by the rules governing at that time the operation of the deposit insurance system, i.e. maintaining the designated reserve-to-insured-deposits ratio (DRR) at a required minimum level. As mentioned above, if the DRR was above 1.25%, most institutions paid zero premiums, but if it fell below 1.25% (and was expected to remain there for more than a year), the FDIC would have had to charge much higher premiums (at least 23 basis points[13]) until the reserve ratio returned to the DRR again. With the minimum assessment rate moving from zero to 23 basis points, the system was subject to wide swings in premiums [Martin 2003]. It meant not only high volatility of premiums, but also inadequate charging them to financial institutions over time – since most banks and thrifts paid no insurance premiums in good times (when they were doing well and their earnings were enough to pay premiums), but they were expected to pay high premiums in bad times (when the industry was weaker and earnings depressed). It was likely because bank failures – and, in turn, FDIC insurance expenditures – were most likely to occur during an economic downturn, and thereby a fund was most likely to fall below the DRR during an economic slowdown or recession. And, as argued by the FDIC, high premiums could have diverted billions of dollars out of the banking system and raised the cost of gathering deposits at times when credit already might be tight. Moreover, it could have caused a further cutback in credit,[14] resulting in a further slowdown of economic activity at precisely the wrong time in the business cycle [FDIC 2001]. Therefore, high volatility of premiums could have hit negatively not only depositary institutions but their customers as well.

2

It was also argued that both of the above problems – inadequate pricing of risk and potentially volatile premiums – resulted from the conflicting mandates of the FDICIA which, on the one hand, required the FDIC to price deposit insurance premiums according to the risk posed by individual institutions, and on the other hand, to maintain a fixed target level of reserves within the insurance funds. The tension between the dual mandates of the FDIC became much more apparent when the DIFA seriously limited the FDIC's risk-based pricing ability [FDIC 2000a]. It clearly indicated the need to pass new legislation eliminating the above shortcomings of the FDICIA and DIFA.

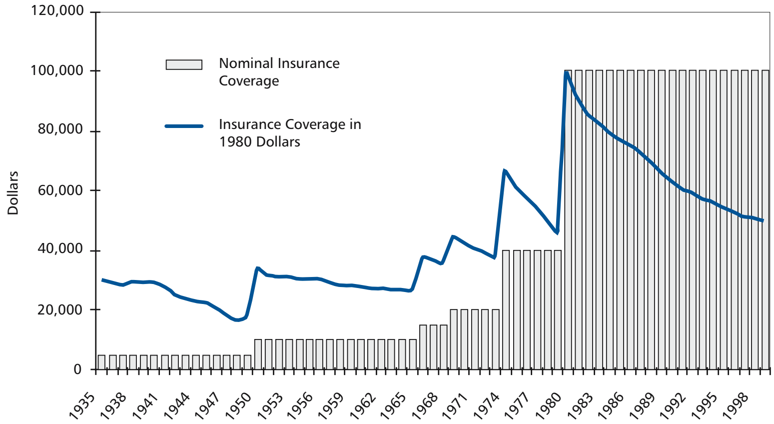
As far as the last, but not least, of the above issues is concerned – **the coverage limit** – it was often complained that the basic coverage amount had been increased by the US Congress several times on an *ad hoc* and arbitrary (and, therefore, unpredictable) basis. Moreover, it was argued that most of the increases more or less reflected changes in the price level (cost-of-living adjustments), but the one of 1980 was an exception. The increase from $ 40,000 to $ 100,000 far exceeded the amount needed to keep pace with inflation and had more to do with retaining outstanding deposits and attracting new deposits to insured institutions (which, at that time, faced disintermediation because of high inflation and interest rates) to offset part of the outflows [FDIC 2000a]. It is indicated that the US level exceeded the IMF guidelines that had recommended limiting coverage to at most 1-2 times GDP *per capita* – while the US limit of $ 100,000 was approximately 9 times higher than GDP *per capita* at that time [McCoy 2006; Garcia 1999, 2000]. It is also widely viewed that the 1980 "jump" to $ 100,000 increased moral hazard in the banking industry and was an important factor that contributed to the banking crisis in the 1980s and early 1990s [see, for example, FDIC 1997; Martin 2003; McCoy 2006]. Another important issue was the fact that the 1980 increase was related to the nominal value of coverage and had never been

[13] In practice premiums could have been much higher. According to the FDIC, in 1991 (when the reserve ratio was below 1.25% and the FDICIA had not been adopted yet), on a strict pay-as-you-go basis, banks would have had to pay about 62 basis points [FDIC 2000a].

[14] According to the FDIC, it was possible that, in bad times (economic downturn), deposit insurance premiums could have reduced the pre-tax net income of insured institutions by almost $ 9 billion. Based on average capital and loan-to-assets ratios for all insured institutions, that reduction in income could have led to a contraction in lending of more than $ 65 billion at the precise time in the business cycle when loans were most needed [FDIC 2000a].

indexed according to inflation. As a result, the real value of coverage had fallen by about half, based on the Consumer Price Index (CPI). For example, in 2000, it was below the level of the mid-1970s, when the nominal coverage limit was $ 40,000 (see: Figure 2.1).

**Figure 2.1 Nominal and real values of deposit insurance coverage in the United States (1935-2000)**




Source: FDIC 2000a.

## 2.3 Recommendations of the early 2000s for reforming the US deposit insurance system

In order to address the above weaknesses in the US deposit insurance system, in 2001, the FDIC issued a special document – ***Recommendations for Deposit Insurance Reform*** – where it proposed the following reforms:

- merging the BIF and the SAIF;
- eliminating the existing statutory restrictions on the FDIC's ability to charge risk-based premiums to all institutions (and providing it with the possibility to charge regular premiums for risk regardless of the level of the fund);
- eliminating sharp premium swings triggered by deviations from the DRR – by gradual increasing premiums (if the fund falls below a target level) or gradual rebating funds (if the fund grows above a target level);
- basing rebates on past contributions to the fund, not the current assessment base;
- indexing the coverage level to keep pace with inflation.[15]

As stated in the above document, the FDIC did not view deposit insurance reform as a revenue-raising exercise, and its proposals related to pricing were not intended to increase the assessment burden, but to spread that burden more evenly over time and more fairly across financial institutions. It also was stressed that all proposed reforms would require legislative changes, and they should be implemented as a package because putting into practice only one or a few of them without the others could work in an opposite direction than intended, i.e. weaken the deposit insurance system instead of strengthening it [FDIC 2001].

[15] It should be noted that in 2000, the FDIC suggested that the level of insurance coverage be doubled from $ 100,000 to 200,000 [Tanoue 2000], but later on, the FDIC opted for regular periodical indexing the level of coverage instead of increasing it ad hoc.

It is worth to note that **the reform was proposed at a time of very good economic and financial conditions** (strong economic growth, wealthy banking system with high capital levels and profitability, well capitalized insurance funds, etc.). The then FDIC Chairman, describing that situation, stated "*the sun is shining on our deposit insurance system*", but at the same time she recalled an old adage which was relevant to that situation: "*fix your roof when the sun shines*" [Tanoue 2000]. It was an entirely opposite approach than in case of the reform of 1991 prompted by "the storm of the 1980s and early 1990s".

Having proposed the reform of the deposit insurance system (not only in the above *Recommendations for Deposit Insurance Reform* of 2001, but also in the *Options Paper* of 2000), the FDIC reached out to hundreds of individual bankers, and the industry groups that represent them, to solicit their opinions. Further, the FDIC conducted intensive internal analysis, including modeling insurance fund performance under various reform scenarios [FDIC 2001]. Thus, the reform recommendations made by the FDIC were preceded by the **wide pre-reform public debate** (which was continued after the publication of the above FDIC proposals as well). It seems to be worth to outline some opinions from that debate.

The opinions of various experts related to the key issues of the proposed deposit insurance reform were mostly positive. Although there were some arguments against **a merger of the funds** emanated primarily from bankers who had opposed exposing their insurance fund to a repeat of the thrift losses of the 1980s [see: FDIC 1998b], most authors agreed that the BIF and the SAIF should be merged [see, for example: Isaac 2000; Furlong and Kwan 2002]. The proponents indicated many arguments in support of that proposal, such as simplifying administrative procedures and lowering administrative costs for both financial institutions and the FDIC, reducing the paperwork processed by banks and thrifts that before had deposits covered by both funds, lowering probability of insolvency of a combined fund compared to either of the funds existing separately, decreasing the taxpayer risk associated with federal deposit guarantees, etc. [Oshinsky 1999; Thomson 2000b; Martin 2003].

With regard to the proposed provisions which would give the FDIC **more flexibility in setting deposit insurance premiums**, there were mixed opinions among observers. On the one hand, it was argued that such provisions would be positive steps toward reform [see, for example, Furlong and Kwan 2002]. On the other hand, however, it was argued that some of the changes proposed by the FDIC – and chief among them was a measure that would allow the FDIC greater flexibility in the way it charges insurance premiums on banks – might actually return the system to one in which the taxpayer would be again at greater risk for funding bank losses. In particular, it would alleviate the requirement to increase premiums as harshly and rapidly when losses drive the fund below the designated 1.25 % ratio to replenish the fund within one year. But, according to some experts, it would increase the likelihood of the fund going and staying negative and increase the probability of putting the taxpayer back on the hook [Kaufman 2002]. And, as it was recalled from time to time, "*the major public policy concern should be to prevent any change in the deposit insurance structure that might intentionally or inadvertently put the taxpayer back on the hook for FDIC losses from bank failures*" [Kaufman 2001], as it was the case in the pre-FDICIA system of almost unlimited taxpayer liability.

The issue of coverage attracted the most attention and the most controversy. The debate was related to choosing **the appropriate amount of coverage**. As it was argued by some authors [Martin 2003], that issue presented a challenge for policymakers to strike **a balance between promoting financial stability and avoiding moral hazard**. On the one hand, financial stability requires adequate coverage, but on the other hand, higher coverage reduces depositors' incentives to monitor the behavior of depository institutions. Also, finding the right level of coverage to balance financial stability and moral hazard is difficult because neither the stability/fragility of the financial system nor the extent of the moral hazard problem can be measured precisely. Therefore, in the early 2000s, similarly like in 1980, there was a **significant disagreement about the appropriate coverage level**. Those who believed that moral hazard is a big problem in the United States (and it was one of the main factors of the 1980/90s banking crisis), as well as internationally (some cross-country evidence suggested that a higher coverage level tended to make banking crises more likely [Demirgüç-Kunt and Detragiache 1999, 2002]), opposed any increase in the level of coverage (in particular, the Federal Reserve and the US Treasury strongly opposed the increased coverage level [Greenspan 2002; Fisher 2002]). In general, it was argued that the increase of coverage would exacerbate the problem of moral hazard and lead to increased risk taking by banks [Vaughan and Wheelock 2002].



Moreover, it was argued that **an average depositor would not benefit from a higher deposit insurance level** because the $ 100,000 coverage was sufficient (or even perceived as too high) to meet the average depositor's requirements. Keeping in mind that about 98% of all domestic deposit accounts were fully insured, only 2% of depositors would need an increase in coverage. Therefore, keeping in mind that the existing limit provides coverage that is well in excess of the real coverage granted in 1934, there were even **suggestions to reduce the existing deposit insurance ceiling** as a potentially more appropriate solution [Thomson 2000a]. It was also indicated that there is little evidence that taxpayers would benefit from an increase of the coverage limit. On the contrary, the experience of the 1980/90s banking crisis suggested they might even be harmed [Thomson 2001].

Some authors argued not only against provisions that would raise the level of coverage, but also against **indexing the current insurance limits to the rate of inflation.** According to them, given the underlying purposes of deposit insurance (protection depositors, ensuring financial stability, reducing moral hazard, etc.), at that time, there did not appear to be a strong case for raising the coverage limit further or indexing it to the inflation rate in the near-to-intermediate horizon, and it should be left for the future [Furlong and Kwan 2002]. There were also opinions that the coverage level should not be subject to annual changes stemming from indexing as it would be difficult for depositors to remember. Instead, the coverage level should be unchanged for a relatively long period of time until the increasing value of GDP requires a coverage increase as well. It was suggested to postpone necessary adjustments until they could be expressed in round numbers being easier for customers to remember [Garcia 2000].

As far as the **opinion of the banking industry** is concerned, the American Bankers Association (ABA) presented its view some months before the mentioned *Options Paper* of 2000. In its opinion, the most important areas to be addressed included:

- adjusting the insurance limit of $ 100,000 upward in recognition of the decline since 1980 in the real value of the insurance level. The ABA believed that an adjustment needed to be made to reflect the loss of real value of this limit, and therefore, in order to restore the "purchasing power" of the 1980 level, it would require a doubling of the current limit ($ 200,000);

- permanently indexing the insurance limit to account for the future effects of inflation (in order to ensure that depo`sitors could be sure that their protection would not be reduced by inflation in the future). According to the ABA, it was not an issue that should be subject to congressional reviews from time to time, but needed to be resolved permanently;

- limiting the size of the fund (by setting a maximum reserve ratio) and providing for rebates. The ABA believed that there should be a limit to the size of the FDIC fund – since not only were the BIF and the SAIF at that time fully capitalized, but they were even $ 4 billion over the DRR. And the excess amounts were not necessary to ensure the soundness of the deposit insurance system, but rather they represented a significant loss of potential investment by banks. Therefore, some (significant) rebates should be provided to the industry.

The ABA stated that it could only support a merger of the insurance funds if the above elements have been adequately addressed [Smith 2000].

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There were some other opinions as well – expressed, for example, in a special report to the FDIC on the deposit insurance reform (issued just before the FDIC's *Recommendations for Deposit Insurance Reform*) [Blinder and Wescott 2001]. The authors of that report, having agreed with many of the FDIC's recommendations, also presented **an alternative view on the issue of the coverage limit**. They suggested: (i) sizeable increasing the coverage limit; then (ii) indexing it; and (iii) legal simplification by applying the limit to all accounts per person, per institution; and finally, (iv) introducing optional excess coverage. In their opinion, the first step could be raising the coverage limit from $ 100,000 to, for example, $ 125,000 or 150,000, and applying the coverage limit to all accounts held by a single individual in a single institution (and not to each right and capacity separately). Or, alternatively, it could also be considered to establish even a higher coverage limit (for example, $ 300,000), but to apply it to all accounts held by an individual (under a given social security number), no matter how many institutions were involved. As far as indexing is concerned, the authors of the report preferred to adjust it over time rather to nominal GDP per capita (to reflect the growth of nominal income or wealth) than to price developments (inflation). They argued that since nominal GDP *per capita* had almost tripled since 1980, indexing the $ 40,000 or $ 120,000 limit in that way would have raised it to about $ 120,000 or $ 300,000 respectively. Finally, the authors argued that if some banks wanted to insure account balances larger than the standard coverage limit, such optional excess insurance might be purchased from private insurance companies (as it happened before on a limited scale) and/or from the FDIC (which could set higher than standard premiums for excess insurance).

Some authors [Eisenbeis and Wall 2002] indicated that the debate on deposit insurance reform tried to address quite many problems but, in fact, most of discussions focused on a limited number of issues, such as the size of insurance premiums paid by different groups of insured institutions, the size of the fund and the timing of premium collections, the size of the coverage limits, etc. In their opinion, the discussions largely reflected a concern with how to allocate the losses arising from bank failures and, in this respect, they represented a significant step back from the FDICIA which focused on the more important question, i.e. how to minimize the losses to the deposit insurer. According to the authors, all the above issues, while important, did not affect the performance of the deposit insurance system and, therefore, they should not be the focus of deposit insurance reform. The authors tried to refocus attention on the policies needed to implement the original goals of the FDICIA and stated that reform efforts should be directed toward strengthening the incentives to enforce the least-cost-resolution provisions of the FDICIA. They suggested that useful steps forward would be, *inter alia*, adopting fair-value reporting as encouraged by the FDICIA (which would increase the transparency of bank risk taking and, in turn, improve regulators' and supervisors' ability to monitor bank risk exposures), weakening perceptions that some banks are "too big to fail" by developing and publicizing plans to resolve such banks (which would strengthen market discipline at the largest banks), etc. According to the authors, those reforms, combined with a different approach to risk-based premiums and measures to strengthen market discipline (such as the expanded use of subordinated debt, particularly effective when combined with the least-cost-resolution and prompt-corrective-action provisions of the FDICIA [Evanoff and Wall 2000]), merited further consideration as potential (although partial) solutions in the debate on deposit insurance reform.

There were also many other specific issued discussed at that time, such as proposals to increase depositors' risk exposure (including reduced insurance limits, co-insurance for insured depositors, mandatory loss for uninsured depositors, abolition of the "too big to fail" principle), proposals to impose increased costs on bank owners commensurate with their banks' risk characteristics, proposals to use market mechanisms to ensure prompt action with regard to troubled banks, proposals to restrict the range of banking activity financed by insured deposits, etc. [for an overview, see: Hanc 1999]. There was also a proposal to introduce a mutual insurance model with incentive compatibility (MIMIC) as an alternative model for deposit insurance which would emulate the incentives and procedures of a mutual insurance organization in order to better align the incentives of banks and the FDIC with those of the government and taxpayers [Wilcox 2001]. It is, however, outside the scope of this paper to present all of the above proposals.



## 2.4 The reform of the US deposit insurance system in 2005-2007

The first attempt to implement the US deposit insurance reform discussed in the early 2000s was made in 2003 when the US Congress discussed the provisions of the draft Federal Deposit Insurance Reform Act. The drafted legislation proposed, *inter alia*, merging the BIF with the SAIF, increasing the standard deposit insurance limit from $ 100,000 to $ 130,000 and indexing the limit for inflation, doubling the limit for certain retirement accounts, increasing coverage for certain municipal accounts, authorizing the FDIC to set the ratio of reserves to estimated insured deposits within a range of 1.15% to 1.40%, and removing legal constraints on the FDIC's authority to charge risk-based premium assessments. However, the proposed act was never passed by the Congress [Jackson 2003; US House 2003; FDIC 2004].

Finally, after five years of the debate and preparation (including hearings/testimonies of the FDIC's top officials and the representatives of the banking industry before relevant committees of the House of Representatives and the Senate – see: US Congress/House 2000, 2001a-c, 2003; US Congress/Senate 2001a-b, 2002a, 2003a; or FDIC 2004 for an overview), the Congress passed necessary reform legislation – consisting of two legal acts: **the Federal Deposit Insurance Reform Act of 2005 (FDIRA), and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (FDIRCAA)** – known, collectively, as the Reform Act [Reform Act 2005/2006]. The latter was passed by the Congress in December 2005, while the former – due to some amendments submitted by the Senate – was finally passed on 1 February 2006. Immediately after the passage of the act, the then Acting FDIC Chairman stated: "*This legislation is good for depositors, the financial services industry and the safety and soundness of the deposit insurance system. The FDIC looks forward to the challenge of implementing this law in the coming months*" [Gruenberg 2006]. Finally, the FDIRA and the FDIRCAA were signed by President Bush into law on 8 and 15 February 2006 respectively [US Congress/House 2005/2006; US Congress/Senate 2005/2006].

The Reform Act introduced the following changes:

- merging the BIF and the SAIF into a new fund – the Deposit Insurance Fund (DIF);
- establishing a range of 1.15% to 1.50% within which the FDIC may set the DRR, and allowing the FDIC to manage the pace at which the reserve ratio varies within this range;
- eliminating the restrictions on assessment rates (premiums) and providing the FDIC with the discretion on pricing deposit insurance (i.e. charging premiums to all insured institutions according to actual risk they pose, regardless of the level of the reserve ratio);

- maintaining the general (basic) coverage limit at $ 100,000, but indexing it to inflation;
- increasing the coverage limit for retirement accounts to $ 250,000, and indexing it to inflation;
- granting eligible institutions a one-time initial assessment credit (of about $ 4.7 billion) to recognize their past contributions to the fund.

As it is apparent, the Reform Act enacted virtually all the FDIC's recommendations made in 2001 (as a package). The Reform Act required, among other things, that the FDIC, within 270 days, prescribe **final regulations (rules) implementing provisions of the Reform Act**. The FDIC was required to do so after providing the banking industry with the opportunity to comment the proposed rules. Some final rules were adopted by the FDIC and made effective very soon after the signing the Reform Act into law.[16] Other rules also were proposed within 270 days after enactment (in May and July 2006), but their effective dates were set beyond that deadline.[17] Moreover, in May 2007, the FDIC published its final guidelines on adjustments to large institution assessment rates [for more details, see: Final Rules 2006a-g, Final Guidelines 2007].

According to the FDIC Chairman, there were two main reasons why the reform had been needed. The first one was providing the FDIC with **considerably greater flexibility in managing the fund**, i.e. greater latitude to maintain the fund at prudent levels and spread the assessment burden more evenly over time. The second major goal of the reform was **making assessments more risk sensitive** and, as a consequence, ensuring that the assessment burden falls more fairly across insured institutions. Both of them should contribute to maintaining stability and public confidence in the banking system [Bair 2006]. Therefore, the most important provisions of the Reform Act were those related to (i) granting the FDIC more room for maneuver in managing the fund, and (ii) introducing the new risk-based pricing rules.

With regard to greater flexibility in managing the fund, the FDIC final rule stipulated **replacing the fixed reserve ratio (DRR) with a range**. After the reform, the ratio for any year may not be less than 1.15% and not exceed 1.50% of estimated insured deposits. In this context, the Reform Act stipulated that:

- if, whenever, the reserve ratio falls below 1.15% (or is expected to fall within 6 months), the FDIC must establish and implement within 90 days a restoration plan that provides that the DIF will return to 1.15% within 5 years;
- if, at the end of a calendar year, the reserve ratio equals or exceeds 1.35% but is not more than 1.50%, the FDIC must declare one-half of the excess amount as dividends to be paid back to DIF members (unless the FDIC, considering statutory factors, suspends the dividends);
- if, at the end of a calendar year, the reserve ratio exceeds 1.50%, the FDIC must declare the excess amount as dividends to be paid back to insured depository institutions (DIF members).

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[16] The final rule on merging the BIF and the SAIF into the DIF was made effective on 31 March 2006, and the interim rule on the coverage level and inflation indexing – on 1 April 2006 (the final rule, which made no substantial changes to the interim rule, was made effective on 12 October 2006).

[17] It was related to one-time assessment credit (effective on 17 November 2006), as well as to dividends, assessments, risk-based assessments, DDR (all effective on 1 January 2007). It should be noted, however, that in case of dividends, the FDIC proposed a temporary rule for an initial two-year period (from 1 January 2007 until 31 December 2008), which would allow the FDIC to undertake a more comprehensive rulemaking that would not be subject to the 270-day deadline. Lastly, the final rule on advertising FDIC membership became effective on 13 November 2007.

In designating a reserve ratio for any year, the FDIC is obliged to take into account the risk of losses to the DIF in such year and future years, economic conditions generally affecting insured depository institutions, and all other relevant factors. It also has to prevent sharp swings in the assessment rates for DIF members [Reform Act 2005].

As far as improving the risk-based assessment system is concerned, the FDIC final rule stipulated **consolidating the existing previously nine risk categories into four** and named them Risk Categories I, II, III, and IV (see: Table 2.2 and Annex 3). As we can see, the new Risk Category I replaced the former 1A risk category. Since most US banks and thrifts are well-capitalized and well-managed institutions, as of 30 June 2006, approximately 95% of all insured institutions were included in Risk Category I (it was the case of the former 1A category as well). But keeping in mind that a "one size fits all" principle is usually not necessarily the best approach, some further **differentiating risk within Risk Category I** was needed. It shall be done by using one of two methods: (1) for small institutions within Risk Category I and for large institutions within Risk Category I that do not have long-term debt issuer ratings, and (2) for all large institutions.[18] It this regard, the following sources of information on potential risks posed by institutions should be used:

- *CAMELS ratings* – i.e. a weighted average of a bank's CAMELS components computed by combining them as follows: C – 25%, A – 20%, M – 25%, E – 10%, L – 10%, S – 10%. The weights are to reflect the FDIC's opinion on the relative importance of each of the CAMELS components for differentiating risk among institutions for deposit insurance purposes;

- *financial ratios* – i.e. the following indicators: the tier 1 leverage ratio; loans past due 30-89 days/gross assets; non-performing assets/gross assets; net loan charge-offs/gross assets; and net income before taxes/risk-weighted assets;

- *long-term debt issuer ratings* – i.e. the current long-term debt issuer rating (or ratings) assigned by the major US rating agencies (Moody's, Standard & Poor's, and Fitch).

Both of the above-mentioned methods share a common feature (CAMELS ratings) but, at the same time, each method combines it with different sources of information on risk. The method (1), for small institutions and for large institutions that do not have long-term debt issuer ratings, combines weighted CAMELS component ratings with current financial ratios to differentiate risk and determine an institution's assessment rate. The method (2), for large institutions that have long-term debt issuer ratings, combines weighted CAMELS component ratings with these debt ratings [Final Rule 2006f].

**Table 2.2 Risk categories in the FDIC risk-based assessment system**

a) before the 2005-2007 reform

| Capital Group | | Supervisory Subgroup | | |
|---|---|---|---|---|
| | | A | B | C |
| 1 | Well Capitalized | 1A | 1B | 1C |
| 2 | Adequately Capitalized | 2A | 2B | 2C |
| 3 | Undercapitalized | 3A | 3B | 3C |

[18] A Risk Category I institution is defined as a "small institution" if it has assets of less than $ 10 billion, and as a "large institution" if it has $ 10 billion or more in assets. This determination has initially been made as of 31 December 2006 [Final Rule 2006f].

b) after the 2005-2007 reform

| Capital Group | | Supervisory Subgroup A | Supervisory Subgroup B | Supervisory Subgroup C |
|---|---|---|---|---|
| 1 | Well Capitalized | I | | |
| 2 | Adequately Capitalized | | II | III |
| 3 | Undercapitalized | III | | IV |

Source: Final Rule 2006f.



Another issue relating to improvements to the risk-based assessment system was **the base rate schedule**. In November 2006, the FDIC final rule set the base rate schedule with the annual assessment rates for institutions ranging from 2-4 to 40 basis points for those in Risk Categories I and IV respectively (see: Table 2.3a). The final rule also set **actual rates** beginning on 1 January 2007, which were three basis points above the base rate schedule[19] (see: Table 2.3b). As we can see (analyzing Tables 2.3a and 2.3b), after the reform, all institutions in a given risk category, other than Risk Category I, started to be charged the same annual assessment rate; the only exception was Risk Category I where assessment rates for institutions ranged from 5 to 7 basis points. Since the Reform Act eliminated the rule (introduced by the DIFA) that had prohibited charging the best-ranked institutions if the fund was at or above the DRR, **well-capitalized and well-managed institutions, being in the same risk category, were no longer charged the same rate**; institutions posing the least risk were charged a minimum rate and those posing the greatest risk were charged a maximum rate that was two basis points higher than the minimum rate (institutions posing an intermediate risk were charged a rate between the minimum and maximum). It was estimated that, as of 30 June 2006, roughly 45% of all institutions in Risk Category I (other than new institutions[20]) would have been charged the minimum assessment rate, and about 5% of institutions in that risk category (other than new ones) – the maximum rate [Final Rule 2006f; Bair 2006]. It was related to both small and large institutions in Risk Category I.[21]

It was assumed that all **new institutions** in Risk Category I (regardless of their size), beginning in 2010, would be charged the maximum rate applicable to that category (with certain exceptions) since usually newly established banks and thrifts tend to engage in more high-risk lending activities, fail at a higher rate than older ones, and their financial data is much more difficult to interpret [Final Rule 2006f; Bair 2006; see also: DeYoung 2000; Yom 2005]. Moreover, according to the FDIC final guidelines of May 2007 [Final Guidelines 2007], in case of **large institutions** in Risk Category I, there was some room for maneuver in correcting their initial assessment rates (up to ½ basis point) after considering some additional risk information.[22]

[19] The FDIC final rule allowed the FDIC Board of Directors to adjust rates uniformly up to a maximum of 3 basis points higher or lower than the base rates without the necessity to seek further public comment, provided that any single adjustment from one quarter to the next cannot move rates more than 3 basis points (and no assessment rate may be negative) [Final Rule 2006f].

[20] A "new institution" is defined by the FDIC final rule as the one being in business for less than 5 years. In fact, the FDIC proposed to regard all institutions younger than 7-year old as new ones [Bair 2006], since empirical studies show that many financial ratios of new institutions generally begin to resemble those of established institutions by about the seventh or eighth year of their operation [Final Rule 2006f], but there were complaints from the industry that it would be too long, and finally that period of time was shortened to 5 years.

[21] The situation has changed quite considerably within the next two years (notably, in relation to small institutions). According to the FDIC, as of 30 June 2008, about 28% of small institutions in Risk Category I (other than new institutions) were charged the minimum rate and approximately 19% were charged the maximum rate. In case of large institutions in Risk Category I, the respective numbers were 45% (minimum rate) and 11% (maximum rate) [FDIC 2008d].

[22] In case of large institutions in Risk Category I, after determining their initial assessment rates (using supervisory ratings and financial ratios or long-term debt issuer ratings), the FDIC – after consultation with the primary federal regulator – may decide, upon consideration of additional risk information, to make some adjustments to these initial assessment rates. Any adjustments must be limited to 0.50 basis point higher or lower than the initial assessment rate, and in no case can result in exceeding the maximum rate or falling below the minimum rate for Risk Category I [Final Guidelines 2007].

**Table 2.3 Annual assessment rates for different risk categories introduced by the 2005-2007 reform** (in basis points)

**a) the base rate schedule** (introduced in November 2006)

| | Risk Category | | | | |
|---|---|---|---|---|---|
| | I* | | | | |
| | Minimum | Maximum | II | III | IV |
| Annual rates** | 2 | 4 | 7 | 25 | 40 |

2

**b) actual assessment rates** (from 1 January 2007 onwards)

| | Risk Category | | | | |
|---|---|---|---|---|---|
| | I* | | | | |
| | Minimum | Maximum | II | III | IV |
| Annual rates** | 5 | 7 | 10 | 28 | 43 |

* Rates for institutions that did not pay the minimum or maximum rate vary between these rates.
** Quarterly rates computed by the FDIC were one-fourth of the annual rates.

Source: Final Rule 2006f.

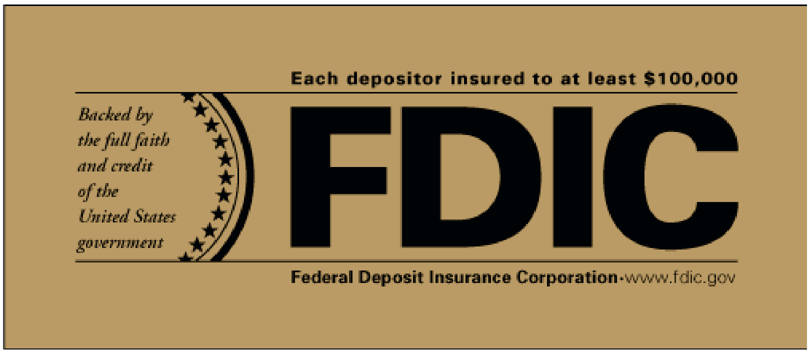
With regard to the other elements of the reform, notably an increase in deposit insurance coverage, the Reform Act stipulated that **the standard maximum deposit insurance amount would not be increased** and, therefore, it would be maintained at the level of $ 100,000. However, it stipulated an **inflation adjustment of the coverage level** (a cost-of-living adjustment). The first adjustment should be made by 1 April 2010 (and then, and every succeeding five years). It is to be jointly determined by the FDIC and the National Credit Union, which should consider all relevant factors, such as the overall state of the DIF, economic conditions and potential problems affecting insured institutions, the risk that the increase will cause the reserve ratio to fall below the 1.15% ceiling. The amount by which the standard maximum deposit insurance amount should be increased is to be calculated on the basis of the ratio of the published annual value of the Chain-Type Price Index for Personal Consumption Expenditures (PCE), or any successor index thereto, published by the Department of Commerce, for the calendar year preceding the year in which the adjustment is calculated. If the amount is not a multiple of $ 10,000, it should be rounded down to the nearest $ 10,000 [Reform Act 2005].

Although, as mentioned above, the nominal value of the standard maximum deposit insurance amount had not been increased by the Reform Act, it stipulated **an increase of the deposit insurance limit for "certain retirement accounts" from $ 100,000 to $ 250,000** (which is also subject to the above-outlined inflation adjustment). The following types of accounts were regarded as eligible for the increased coverage limit of $ 250,000: all types of individual retirement accounts (IRAs), deferred compensation plan accounts provided by state and local governments – regardless whether self-directed or not ("Section 457 plan accounts"), self-directed defined contribution plan accounts (such as, for example, popular self-directed 401(k) plans), and self-directed Keogh plan accounts (or H.R.10 plan accounts) designed for self-employed individuals. It should be emphasized that **all above-listed retirement accounts owned by the same customer in the same FDIC-insured institution are added together and the total is insured to $ 250,000** [Final Rule 2006a, FDIC 2007a].

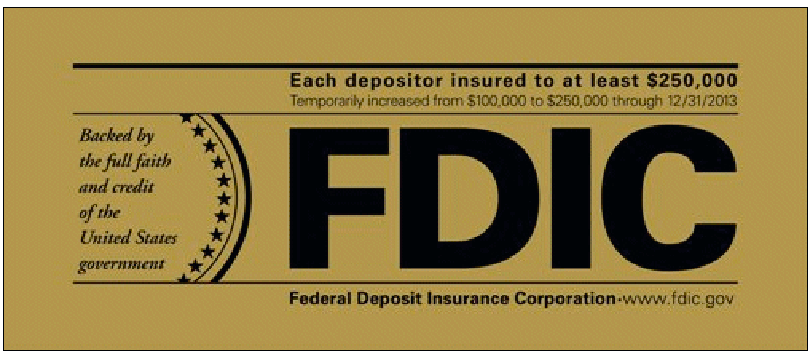
As a result of the above reforms, the rules governing **official FDIC signs and advertising of FDIC membership** have been revised. It was neccessary to replace the two separate official FDIC signs – one for insured banks, and the other for insured savings associations (previously used by the BIF and the SAIF respectively) – with a new single official sign (or insurance logo). After the reform, the FDIC official sign has a new look (see: Figure 2.2)[23] and new information, which all insured banks and savings associations are required to display where deposits are received (at teller stations, ATMs, branch locations, etc.). Its revised wording notes that "*Each depositor* [is] *insured to at least $ 100,000*" (instead of "*Each depositor insured to $ 100,000*" as before) since certain retirement accounts started to be insured up to $ 250,000. Moreover, as it was argued, by stating that each depositor is insured "to at least" rather than "up to" $ 100,000, the new official sign would remain accurate even if there are future increases in insurance coverage (as a result of inflation indexing). The FDIC believed that the new sign – indicating the minimum dollar amount of insurance coverage – would provide customers with the most important information. In addition, the new sign also indicates the FDIC's website (www.fdic.gov), where consumers can get more information about their deposit insurance coverage and other topics of interest. Last but not least, the new sign highlights the fact that FDIC insurance is "*backed by the full faith and credit of the United States government*". The final rule on the new official FDIC sign and advertising of FDIC membership became effective on 13 November 2007 [Final Rule 2006d; FDIC website].

**Figure 2.2 New FDIC signages on deposit insurance in banks and thrifts**

a) permanent – effective from 13 November 2007 awards




b) temporary – until 31 December 2013




Source: FDIC.

As mentioned above, the new sign also indicates the FDIC's website, where consumers can get not only information about their deposit insurance coverage but also other top-

[23] The new offcial sign has left out the FDIC seal and has been bordered by a semi-circle of stars, a design that partially reflects the current savings association sign.

ics of interest. On the FDIC website, there are deposit insurance guides – both a basic one and a comprehensive one [FDIC 2007a,b]. Moreover, in the consumer protection section, there are resources provided by the FDIC to educate and protect consumers. For example, *FDIC Consumer News* provides practical guidance on how to become a smarter, safer user of financial services – by offering in each issue helpful hints, quick tips, and common-sense strategies to protect and stretch money). And the section on financial education and literacy allows obtaining education on important financial issues and topics. For example, there are financial education programs (*Money Smart*) to help individuals outside the financial mainstream (both youth and adults) build financial knowledge, develop financial confidence, use financial services effectively, create positive relationships with financial institutions, etc. (see: Box 2.1).



In May 2009, after the extension of the temporary coverage limit (see: Section 3.2), the FDIC encouraged its member banks to post the following statement, or affix a sticker with this statement, next to the official FDIC sign (teller station sign): "*FDIC deposit insurance temporarily increased from $100,000 to $250,000 per depositor through December 31, 2013*". The FDIC also issued a temporary FDIC sign reflecting the $ 250,000 increase in the coverage level through 2013 (see: Figure 2.2.b), but the use of this temporary sign is optional and banks may continue to use the official FDIC sign.

In the context of financial education and literacy, it should be mentioned that the Reform Act of 2005 required the FDIC to conduct biennial surveys of insured depository institutions' efforts to bring so-called unbanked and underbanked[24] into the conventional finance system (financial mainstream). In order to fulfill its obligation, in 2008, the FDIC conducted a survey of banks' efforts to serve the unbanked and underbanked (it was the first survey of its kind at the national level in the US). The results of the survey, including some recommendations,[25] were published in February 2009 [FDIC 2009a]. As stated by the FDIC Vice Chairman, "*access to a basic bank account and to financial services is a starting point for economic opportunity. Unfortunately, millions of Americans lack access to insured financial institutions. The FDIC survey shows that most banks are aware that significant unbanked and underbanked populations exist in their areas, but more can be done to reach out to this significant market. Government and industry need to work together to increase these individuals' access to the mainstream banking system*." [FDIC 2009b]. Keeping in mind that a significant number of American families (up to 10%) are unbanked and a substantial share of the population may be underbanked,[26] there are several activities undertaken by the FDIC to encourage economic inclusion, such as running some special programs and establishing special committees and coalitions of financial institutions, community-based organizations and other partners in order to bring all unbanked and underserved populations into the financial mainstream (see: Box 2.1). Last bout not least, it is worth mentioning that the FDIC is a member of the US Financial Literacy and Education Commission established by the US Congress in 2003 in order to improve the financial literacy and education of people in the US through development of

[24] Unbanked individuals and families are those who rarely, if ever, held a checking account, savings account, or other type of transaction or check cashing account at an insured depository institution in the conventional finance system. Underbanked individuals and families are those who have an account with an insured depository institution but also rely on non-bank alternative financial service providers for transaction services or high-cost credit products [FDIC 2009a].

[25] The study recommends (i) defining a national shared government-industry goal in order to lower the number of unbanked and/or underbanked individuals and households in the US, and (ii) creating a national task force in order to provide oversight and guidance to encourage banks to offer products/services designed to increase access of unbanked and/or underbanked people to the mainstream banking system [FDIC 2009b].

[26] The Board of Governors of the Federal Reserve System, in its Survey of Consumer Finances, reported that 8.7% and 7.9% of households in the US lacked transaction accounts in 2004 and 2007 respectively [Bucks *et al.* 2006, 2009]. The Center for Financial Services Innovation estimated that approximately 40 million US households – i.e. about 106 million people – are financially underserved (underbanked) [CFSI 2008; Tescher 2008].

a **national strategy** to promote financial literacy and education [Financial Literacy and Education Commission 2006].

Box 2.1
FDIC activities to support and encourage financial education and economic inclusion

**The FDIC's Money Smart financial education curriculum** is designed to help individuals outside the financial mainstream enhance their money skills and create positive banking relationships. The FDIC also oversees the Money Smart Alliance, which consists of over 1,500 financial institutions, nonprofit organizations, schools, government authorities and others that partner with the FDIC to provide financial education targeted to LMI households and others.

**The FDIC's Advisory Committee on Economic Inclusion** was established by Chairman Bair and the FDIC Board of Directors in November 2006 pursuant to the Federal Advisory Committee Act. The mission of the Committee is to provide the FDIC with advice and recommendations on important initiatives focused on expanding access to banking services by underserved populations. This may include reviewing basic retail financial services such as check cashing, money orders, remittances, stored value cards, short-term loans, savings accounts, and other services that promote asset accumulation by individuals and financial stability.

**The FDIC's Alliance for Economic Inclusion** is the FDIC's national initiative to establish broad-based coalitions of financial institutions, community-based organizations and other partners in ten markets across the country to bring all unbanked and underserved populations into the financial mainstream. The Alliance focuses on expanding basic retail financial services for underserved populations, including savings accounts, affordable remittance products, small-dollar loan programs, targeted financial education programs, alternative delivery channels and other asset-building programs. As of early February 2009, 952 banks and organizations have joined the Alliance nationwide; more than 65,000 new bank accounts have been opened; 45 banks are in the process of offering or developing small-dollar loans; 33 banks are offering remittance products; and more than 61,000 consumers have been provided financial education.

**The FDIC's Affordable and Responsible Consumer Credit small dollar loan pilot program** is a two-year pilot project to review affordable and responsible small-dollar loan programs in financial institutions. The purpose of the study is to identify effective and replicable business practices to help banks incorporate affordable small-dollar loans into their other mainstream banking services. Best practices resulting from the pilot will be identified and become a resource for other institutions.

Source: FDIC 2009a.

Finally, it is worth to mention about providing a **one-time initial assessment credit** to eligible insured depository institutions (or its successors) in order to recognize their past contributions to the fund – i.e. contributions that institutions made to build the deposit insurance funds following the bank and thrift crisis of the 1980s and early 1990s [Bair 2006]. The aggregate amount of the one-time assessment credit was determined as more than **$ 4.7 billion** (i.e. an equivalent of the amount that the FDIC could have collected if it had imposed an assessment of 10.5 basis points on the combined assessment base of the BIF and the SAIF as of 31 December 2001). According to the FDIC final rule, to be regarded as an "eligible insured depository institution" to receive a share of the one-time assessment credit, an insured depository institution must have been in existence on 31 December 1996, and paid a deposit insurance assessment prior to that date – or be a successor to such an institution (taking into account that many (about 4,000) institutions that had existed at the end of 1996 no longer existed in 2006. A "successor" was defined as (i) the resulting institution in a merger or consolidation, or (ii) an insured depository institution that acquired/assumed substantial part (at least 90% of deposit liabilities and assets) of another insured depository institution's 1996 assessment base ratio. As of 30 June 2006, there were **about 7,300 institutions** (out of about 8,800 FDIC-insured institutions) that might be **eligible for the one-time assessment credit**. The FDIC also identified institutions which were not eligible for that credit, i.e. (i) institutions that voluntarily terminated their insurance or failed after 1996 (since, in the FDIC's opinion, institution that has failed would not have a successor), and (ii) institutions newly in existence as of end-1996 (so-called de novo institutions) that did not pay deposit insurance premiums prior to that date [Final Rule 2006b]. The latter confirmed the statement of the former FDIC Chairman, made some years before the reform, that "*institutions that never paid premiums would receive no assessment credit*" [Powell 2002].

# 3

# The 2008-2009 reform of the deposit insurance system in the United States

## 3.1 Background: the 2007-2008 financial crisis as a trigger for further reforms



After the implementation of the 2005-2007 reform of the US deposit insurance system, one could expect that there would be no need for further reforming the system in the coming years, and the next major reform could be expected in a decade or later. In the meantime, it was to be time for examining the results of the above reform. But those expectations proved to be wrong very soon.

In mid-2007, the US subprime mortgage crisis emerged and escalated rapidly over time. In early 2008, some major US banks (Citigroup, Bank of America, Merill Lynch) disclosed first serious subprime-related writedowns (ranging from $ 10-18 billion per institution). In March 2008, the first significant bank failure took place in the US – Bear Stearns (although the Federal Reserve provided an emergency loan, it suddenly collapsed and was sold to J.P.Morgan Chase). In mid-2008, banks and savings institutions insured by the FDIC reported a sharp decline in net income – from almost $ 37 billion to $ 5 billion in the second quarter of 2007 and second quarter of 2008 respectively (the worst score since end-1991). At the same time, the FDIC's "problem list" increased from 90 to 117 institutions at the end of the first and second quarter of 2008 respectively (the largest number since mid-2003). Total assets of problem institutions increased from $ 26 billion to $ 78 billion, including about $ 31 billion from IndyMac Bank that failed in July 2008 (the FDIC was named a conservator for the new institution, IndyMac Federal Bank, which continued some operations of the failed bank [Bair 2008d; Krimminger 2008]). The failure of IndyMac (with total deposits of about $ 19 billion) meant a huge loss to the DIF – about $ 10-11 billion. Despite the FDIC had announced the implementation of a systematic loan modification program for troubled residential borrowers who had mortgages owned or serviced by IndyMac [Bair 2008a], it was expected that the overall situation in the banking industry would deteriorate further [FDIC 2008a].

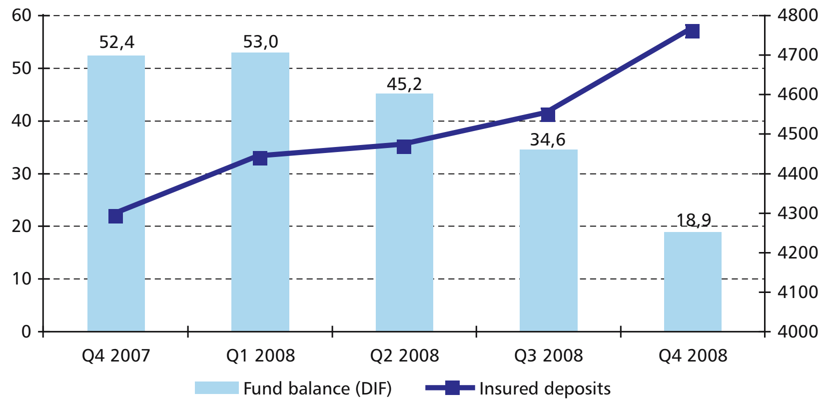
And indeed, those expectations materialized very soon, in mid-September 2008, when Lehman Brothers Holding (with total assets of about $ 690 billion) suddenly collapsed. Although it was the most spectacular failure (the largest bankruptcy in the US history), it was not the only one. In the third quarter of 2008, nine FDIC-insured institutions failed (the largest number since 1993). The failures included Washington Mutual Bank (WaMu) which – with more than 2,200 branch offices in 15 states, assets of $ 307 billion and over $ 188 billion in deposits – had been the largest savings association (thrift) supervised by the OTS (the OTS closed the institution and appointed the FDIC as a receiver, and the FDIC held the bidding process that resulted, at the end of September 2008, in the acquisition of WaMu by J.P.Morgan Chase) [OTS 2008]. A few days later, Citigroup acquired Wachovia, the forth largest US financial institution by assets – in a transaction facilitated by the FDIC (via rarely used open bank assistance – see: Section 1.2 and Box 1.2), in consultation with the Federal Reserve, US Treasury, and US President. As assessed by the US Treasury, the FDIC's actions helped to mitigate potential systemic risk to the US financial system that a failure of Wachovia would have posed [US Treasury 2008]. During the third quarter of 2008, the FDIC's "problem list" grew quickly from 117 to 171 institutions (the highest number since 1995), and their total assets grew from $ 78 billion to almost $ 116 billion. In the third quarter 2008, commercial banks and savings institutions insured by the FDIC reported a further decline in their net income – to $ 1.7 billion (compared to $ 28.7 billion in the third quarter of 2007), which was the lowest level since end-1990 [FDIC 2008h].

As a consequence of the above situation in the banking sector, especially several failures of both small and large institutions, the DIF's loss provisions increased significantly and, in turn, the reserve ratio fell considerably. The DIF balance fell from $ 52.4 billion at the end of the first quarter to $ 45.2 and $ 34.6 billion at the end of the second and third quarter 2008 respectively (see: Figure 3.1.a). And having regard to the fact that insured deposits rose only 0.5% and 1.8% during the second and third quarter respectively, the decline in the DIF balance caused that the reserve ratio fell from 1.19% as of end-March to 1.01% and 0.76% as of end-June and end-September 2008 respectively (see: Figure 3.1.b). The latter was the lowest level of the reserve ratio since early 1990s [Konstas 2005], and it might continue to decline as the FDIC expected a higher number of bank failures in the coming years [FDIC 2008a,d,h]. And, as mentioned before, after the 2005-2007 reform, the reserve ratio may not fall below 1.15% for any year. If this happens (or is expected to occur within 6 months), the FDIC must establish and implement a restoration plan within 90 days that provides that the fund will return to 1.15% within 5 years (see: Section 2.4).

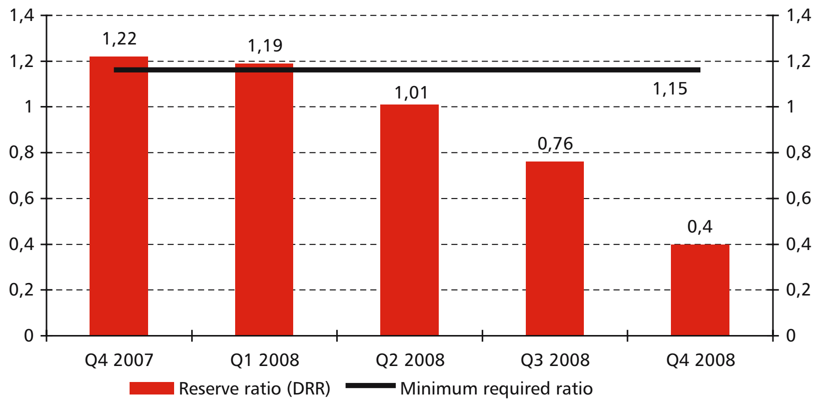
3

**Figure 3.1 Fund balance, insured deposits and the reserve ratio (2007-2008)**

a) DIF fund balance and insured deposits ($ billion)




b) reserve ratio - DRR (%)




Source: Own elaboration based on FDIC 2008a,d and FDIC 2009d.

As it is known, the above-mentioned failure of Lehman Brothers Holding in mid-September 2008 (after 158 years in existence) proved to be a turning point of the current financial crisis. After that failure, and the subsequent public disclosure of serious problems of another giant financial institution – American International Group (AIG) with total assets of about $ 1 trillion and branches/subsidiaries in more than 130 countries worldwide – which had to be temporarily nationalized by the US government in mid-September 2008 in order to avoid bankruptcy, the level of social confidence in the financial system dropped dramatically in the United States. Keeping in mind the run on Northern Rock in the United Kingdom a year earlier, potential runs on US banks could not have been excluded as well – unless some decisive actions were undertaken. And, of course, a bank panic – depending on its scale – would be extremely dangerous not only to the financial system but to the economy as a whole.

3

All the above developments and events posed immediate risk to the stability of the US financial system. Therefore, in fall 2008, the FDIC – in coordination with the US Congress, US Treasury, Federal Reserve Board, and some other federal regulators – had to take several steps in order to restore public confidence in the banking/financial sector (and notably in FDIC-insured institutions), as well as to meet its obligation stipulated by law (the Reform Act of 2005).

## 3.2 Temporary increase of the basic insurance coverage limit

Taking into account the above situation in the financial sector – and notably the potential threat of bank runs after the failure of Lehman Brothers Holding in mid-September 2008 – President Bush signed on 3 October 2008 the Emergency Economic Stabilization Act (EESA), which provided authority for the purchase of troubled assets and direct investments in financial institutions, a mechanism for reducing home foreclosures, a temporary increase in the FDIC's borrowing authority, and a temporary increase in deposit insurance coverage [see, for example: Bair 2008d; Krimminger 2008]. The Act stipulated **increasing the basic coverage limit of deposit insurance provided by the FDIC – from $ 100,000 to $ 250,000** (the act became effective immediately, i.e. upon the President's signature). As before, the increase in deposit insurance coverage is related to various categories of deposits, such as e.g. single accounts, joint accounts, trust accounts, etc. (see: Table 3.1). In case of certain retirement accounts (including IRAs), which had been insured up to $ 250,000 prior to the passage of the above act, the coverage limit remained unchanged [FDIC 2008e].

Since the very beginning, the FDIC emphasized and repeated that **the increase of the basic coverage limit of deposit insurance is temporary**. It was stipulated in the EESA that this higher deposit insurance would be effective until 31 December 2009, and on 1 January 2010, the standard coverage limit would return to $ 100,000. However, on 19 May 2009, the Congress adopted the Helping Families Save Their Homes Act, which extended the temporary increase in the standard maximum deposit insurance amount (SMDIA) to $ 250,000 **until 31 December 2013**. The extension of the temporary $ 250,000 coverage limit became effective immediately upon the signature of President Obama (20 May 2009). The legislation provides that the SMDIA will return to $ 100,000 on 1 January 2014 [FDIC 2009g,h]. In its letters to financial institutions, the FDIC advised insured institutions they should inform depositors that the coverage increase is temporary, particularly when opening new accounts and certificates of deposit maturing after the expiration date [FDIC 2008b, 2009g].

**Table 3.1 Temporary basic FDIC deposit insurance coverage limits (until 31 December 2013)**

| Type of account | Coverage limit | Beneficiary |
|---|---|---|
| Single accounts (owned by one person) | $250,000 | per owner |
| Joint accounts (two or more persons) | $250,000 | per co-owner |
| IRAs and certain other retirement accounts | $250,000 | per owner |
| Trust accounts | $250,000 | per owner per beneficiary subject to specific limitations and requirements |
| Corporation, partnership and unincorporated association accounts | $250,000 | per corporation, partnership or unincorporated association |
| Employee benefit plan accounts | $250,000 | for the non-contingent, ascertainable interest of each participant |
| Government accounts | $250,000 | per official custodian |
| Non-interest bearing transaction accounts | unlimited coverage | per owner/s (only at participating FDIC-insured banks and savings associations*) |

* Unlimited deposit insurance coverage available through 31 December 2009, for non-interest bearing transaction accounts at institutions participating in FDIC's Temporary Liquidity Guarantee Program (see: Box 3.1).

Source: adapted from FDIC 2008b.

In fall 2008 – in order to help consumers understand the above changes in deposit insurance coverage – the FDIC published a special edition of its *FDIC Consumer News entitled "Your New, Higher FDIC Insurance Coverage: How You Can Be Fully Protected*" [FDIC 2008i]. It contained many **useful information for consumers: an explanation of the new provisions, some advices, tips, etc**. Apart from the two key messages – i.e. the new basic coverage limit and its temporary character – the 8-page brochure reminded and/or informed about the following issues:

- depositors may qualify for more than the basic insurance coverage at one insured bank since the FDIC provides separate insurance coverage for deposits held in different "ownership categories" (e.g. single accounts, joint accounts, etc.). However, depositors should remember that additional coverage may be available depending on some specific factors (e.g. when deposits are owned jointly with another person);

- the FDIC has eased the rule governing "revocable trust accounts" that pass to named beneficiaries when the account owner dies. Before, the FDIC considered only the account owner's spouse, child, grandchild, parent or sibling as "qualifying beneficiaries" for additional insurance coverage ($ 250,000 if there is one beneficiary, $ 500,000 if there are two beneficiaries, etc.). Currently, an account owner can name any person or charity as a beneficiary and the owner will qualify for the additional deposit insurance coverage;
- by the end of 2009, certain checking accounts will be fully insured by the FDIC (no matter how much money is in them, even if more than the coverage limit). This special insurance coverage applies only to no-interest checking accounts and some other low-interest transaction accounts, and it is available only at participating banks (see: below). Although this facility is principally for businesses with large balances in their checking accounts, consumers also can benefit.

In its brochure, the FDIC also explained various steps depositors can take to be sure they are fully protected by federal insurance, why and how to use the FDIC's online/interactive deposit insurance calculator (so-called EDIE – Electronic Deposit Insurance Estimator), common depositors' misconceptions about federal insurance that can unintentionally result in being at risk of loss if their institution fails [FDIC 2008j].

It should be noted the FDIC not only temporarily increased the basic coverage limit of deposit insurance, but also ensured **temporary unlimited insurance for certain accounts**. This full insurance is available until the end of 2009 at institutions participating in the FDIC's Temporary Liquidity Guarantee Program which includes, *inter alia*, the Transaction Account Guarantee Program (see: Box 3.1). Under the transaction account program, a participating institution is able to provide customers with **full coverage of non-interest bearing transaction accounts**. In order to explain this program to consumers, the FDIC indicated the following example: a customer and his/her spouse sell their home in 2009 and they are going to to use the proceeds – e.g. $ 800,000 – to buy another house soon (e.g. a week later). If they deposit $ 800,000 jointly into an eligible checking account at a participating bank – and the bank fails – all their money will be protected by the FDIC in full (irrespective of the standard maximum coverage limit). Otherwise, if their money is not in an eligible checking account at a participating institution, it would only be covered to $ 500,000 (i.e. $ 250,000 x 2 persons; assuming they have no other joint accounts at the same bank), leaving $ 300,000 at risk of loss if the bank fails [FDIC 2008i].



Box 3.1
FDIC's Temporary Liquidity Guarantee Program

On 21 November 2008, the FDIC Board of Directors adopted the final rule related to the Temporary Liquidity Guarantee Program (TLGP). The TLGP was announced by the FDIC on 14 October 2008, as an initiative to counter the current system-wide crisis in the US financial sector (being part of coordinated efforts of the US Treasury, Federal Reserve, and FDIC in this regard). The FDIC Board adopted the TLGP in response to credit market disruptions, particularly in the interbank lending market. The goal of the TLGP is to decrease the cost of bank funding, so that bank lending to consumers and businesses would normalize.

The TLGP is a voluntary program consisting of two programs:

- **Debt Guarantee Program** (DGP) – a program that guarantees newly-issued senior unsecured debt of insured depository institutions and most US holding companies;

- **Transaction Account Guarantee Program** (TAG) – a program that guarantees certain non-interest bearing transaction accounts at insured depository institutions.

The DGP is designed to help stabilize the funding structure of financial institutions and expand their funding base to support the extension of new credit. Eligible entities had to opt out of the program until 5 December 2008 (those that have chosen to opt out will not be able to participate at a later date). Once in the program, a participating entity is in for the duration. Initially, the guarantees applied to all senior unsecured debt issued by participating entities on or after 14 October 2008 until 30 June 2009. In mid-March 2009, the DGP was extended until 31 October 2009. With the extension, all insured banks and additional participants (e.g. holding companies) that have actively participated in the DGP (by issuing guaranteed debt before 1 April 2009) may continue to issue guaranteed debt through 31 October 2009 without application. The guarantee on debt issued before 1 April 2009 will expire no later than 30 June 2012, and the guarantee on debt issued on or after 1 April 2009 will expire no later than 31 December 2012. The extension is to reduce the potential for market disruption when the TLGP ends and should provide a gradual phase-out period as institutions return to reliance on the private non-guaranteed debt markets.

Under the TAG, a participating institution is able to provide customers with full coverage on non-interest bearing transaction accounts. The coverage will be in effect for participating institutions until 31 December 2009. After that date, these accounts will be subject to the basic insurance amount. The FDIC Board decided to include in the transaction account program some other accounts, such as negotiable orders of withdrawal (so-called NOW accounts) with interest rates of 0.5% or less, and lawyer trust accounts (so-called IOLTAs).

The TLGP does not rely on taxpayer funding or the FDIC funds (DIF). Instead, both programs are paid for by direct user fees. With regard to the DGP, premiums are charged on a sliding scale depending on the length of the debt maturity (shorter-term debt has a lower fee structure and longer-term debt has a higher fee). The range is 50 basis points on debt of 180 days or less, and a maximum of 100 basis points for debt with maturities of one year or longer, on an annualized basis. In mid-March 2009, the FDIC Board imposed surcharges on guaranteed debt issued on or after 1 April 2009 with a maturity of one year or more (surcharges will be in addition to current fees for guaranteed debt and deposited into the DIF instead of being set aside to cover potential TLGP losses). For the TAG, an annual fee of 10 basis points is applied to deposits in non-interest bearing transaction deposit accounts not otherwise covered by the existing deposit insurance limit of $ 250,000.

Eligible entities include: (i) FDIC-insured depository institutions, (ii) US bank holding companies, (iii) financial holding companies, and (iv) US savings and loan holding companies which either engages only in activities that are permissible for financial holding companies to conduct under the Bank Holding Company Act of 1956 (BHCA) or has at least one insured depository institution subsidiary that is the subject of an application that was pending on 13 October 2008, pursuant to the BHCA, or any other affiliate of an insured depository institution that the FDIC, after written request and positive recommendation by the appropriate federal banking agency, designates as an eligible entity.

The TLGP has a high level of participation. As of early February 2009, nearly 7,000 out of about 8,450 FDIC-insured institutions have opted in to the TAG, and nearly 7,100 banks and thrifts and their holding companies have opted in to the DGP.

Source: Final Rule 2008a; FDIC 2008g; Bair 2008d; Krimminger 2008; Bovenzi 2009a,b; US Treasury / Federal Reserve / FDIC / OCC / OTS 2009; FDIC 2009e.

As we can see, the FDIC undertook various actions – notably the substantial increase of the coverage limit – to maintain depositors' confidence in the banking sector. As stated by the FDIC Chairman, "*this temporary increase in deposit insurance coverage should go far to help consumers maintain confidence in the banking system and the marketplace" and "the public's confidence is key to a healthy and stable economy*" [FDIC 2008e; Bair 2008b]. Nonetheless, **depositors still felt not fully convinced that their deposited money is totally safe**. In December 2008, the CNBC released a survey (*Wealth in America*) on, *inter alia*, the confidence level of consumers that money would be safe if their bank failed (or, in other words, their trust in the FDIC). The survey found that about 64-65% of respondents were totally / mostly confident that their money saved in a federally insured bank would be safe if their bank failed (of which 32% and 33% were totally and mostly confident respectively). At the same time, however, about 31-32% of respondents indicated they were only somewhat confident (20%) or not confident (11%) that their money would be safe in case of their bank failure. It should be noted that parents were the most skeptical; among people with children, 38% said they were either only somewhat or not confident that their money would be safe in such a case [CNBC 2008]. Taking into account that about one out of three respondents had some doubts about federal deposit insurance, the FDIC decided to reiterate the key issues related to the recent changes in this respect, notably the new, higher deposit coverage limit. Moreover – in order to confirm that **FDIC-insured deposits are safe in 100%** – the FDIC reminded the fact that since its creation (i.e. in 75-year history), it has handled the failures of more than 2,200 depository institutions and no depositor has lost even a penny of federally insured funds. The FDIC also added that its insurance fund is **backed by the full faith and credit of the United States government**. Finally, the FDIC assured depositors who had doubts or questions about their insurance coverage that they can always turn to the FDIC for assistance (e.g. calling the FDIC toll-free) [FDIC 2008k].

Last but not least, it should be confirmed that despite a substantial increase in the coverage level in the coming years, the FDIC's strategic objective – as stated in its Strategic Plan for 2008-2013 – is ensuring that customers of failed banks have timely access to insured funds and financial services (see: Annex 5). More precisely, **the FDIC's goal is still to provide customers with access to their insured deposits** – either through transfer of deposits to the successor insured bank or depositor payout – **within one to two business days after the failure of the insured bank**, i.e.:



- depositors have access to insured funds within one business day if the failure occurs on Friday;

- depositors have access to insured funds within two business days if the failure occurs on any other day of the week [FDIC 2008m, 2009f].

However, as stated in the FDIC Strategic Plan, "*the goal of providing customers of failed institutions with access to their insured deposits within one to two business days is very aggressive and might be difficult to achieve in the case of an extremely large or complex institution or a sudden and unexpected failure*". Moreover, the FDIC explains that the completion of the deposit insurance determination is based solely on depositors providing relevant documentation required by the FDIC, and therefore, it may take a little longer in case of some deposits that require some supplementary documentation from depositors (e.g. accounts linked to a formal written trust agreement, funds placed by a fiduciary on behalf of an owner such as a deposit broker or deposits placed by an administrator of an employee benefit plan). Anyway, the FDIC ensures that even if it takes a bit longer to complete all deposit insurance determinations, no depositor would ultimately lose any portion of insured deposits [FDIC 2008m, 2009f; FDIC website].

## 3.3 Restoration Plan

Prior to starting further considerations, it should be recalled that in November 2006, the FDIC set the reserve ratio at the level of 1.25%[27] (effective on 1 January 2007). A year later, in November 2007, the FDIC decided to maintain the DRR unchanged for 2008. The decision was based on the fact that, at the time, banking industry performance was very good (notably, banks' returns on assets were near all time highs) and bank failures were at historic lows (the FDIC experienced the longest period in its history without a bank failure – no insured institution had failed in almost 2½ years before the rulemaking). Therefore, the FDIC projected the continued and sustained strength of the banking industry. But due to the intensifying financial turmoil as a result of US subprime lending, the situation of the industry deteriorated substantially in the first quarter of 2008, and the FDIC assumed higher number of bank failures and, in turn, higher insurance losses than in recent years. Nonetheless, the DRR was still estimated to reach the target of 1.25% in 2009, so the FDIC Board decided in March 2008 to maintain the existing assessment rate schedule [FDIC 2008d].

[27] It was the same level of the DRR that had been generally set prior to the passage of the Reform Act of 2005. It was also within the range 1.15% – 1.50% introduced by the Reform Act.

However, the situation deteriorated further in the subsequent months. As mentioned before, there were several bank failures and it has significantly increased the DIF's loss provisions, resulting in a decline in the reserve ratio – from 1.19% as of end-March to 1.01% and 0.76% as of end-June and end-September 2008 respectively (see: Section 3.1). Taking into account that **the reserve ratio has fallen below the minimum level** (1.15%) and is expected to remain below it, the FDIC – on the basis of the Reform Act of 2005 – was required to establish and implement a restoration plan in order to restore the reserve ratio to 1.15% within 5 years. At the end of August 2008 – when banks and savings institutions insured by the FDIC had reported a significant decline in net income in the second quarter of 2008 (see: Section 3.1) – FDIC Chairman announced that in early October 2008 the FDIC would consider **a plan to replenish the DIF which experienced a large drop** due to added loss reserves for insured institutions (including IndyMac Bank that failed in July 2008). And in fact, on 7 October 2008 – just a few days after the temporary increase in deposit insurance coverage (see: Section 3.2) – the FDIC Board of Directors adopted a relevant restoration plan [Federal Register Notices 2008; FDIC 2008a,d]. As explained by the FDIC Chairman [see: FDIC 2008a], the **Restoration Plan** – which was **primarily aimed at restoring the reserve ratio to at least 1.15% within 5 years, i.e. until 31 December 2013** – included the following elements:

1) **increasing the premium/assessment rates** that banks paid into the fund (in order to raise assessment revenue);

2) **changing the assessment system** that would shift a greater share of any assessment increase to institutions engaging in high-risk behavior (in order to encourage and reward safer behavior).

Keeping in mind that at the moment of adopting the Restoration Plan premium/assessment rates were already 3 basis points uniformly above the base rate schedule established in the 2006 assessments rule (see: Table 2.3), and the final rule of 2006 allowed the FDIC Board to adjust rates up to a maximum of 3 basis points higher or lower than the base rates without further notice-and-comment rulemaking (see: Section 2.4), a new rulemaking was required. Therefore, on 16 October 2008, the FDIC published a notice of proposed rulemaking (NPR) in the Federal Register [Federal Register Notices 2008]. And following the NPR, the FDIC adopted relevant final rules. The final rule on risk-based assessment rates for the first quarter of 2009 was published in the Federal Register in December 2008 [Final Rule 2008b]. And the final rules on new assessment rates were published in 2009 [Final Rule 2009a,b].

With regard to the first part of the Restoration Plan, the FDIC was of the opinion that the goal of restoring the reserve ratio to 1.15% within 5 years might only be accomplished by **imposing higher premium/assessment rates** that banks pay for deposit insurance (while, if possible, avoiding sharp swings in assessment rates).[28] Prior to the adoption of the Restoration Plan, banks paid anywhere from 5 to 43 basis points for deposit insurance. According to the FDIC proposal, on 1 January 2009, the assessment rate schedule was raised uniformly by 7 basis points [Final Rule 2008b; see also: FDIC 2008f]. It was a measure for the first quarter of 2009 and it meant that temporarily banks had to pay premium rates from 12 to 50 basis points into the fund (see: Table 3.2).

[28] It should be mentioned that imposing higher premium/assessment rates and avoiding sharp swings in these rates might prove to be contradictory goals. On the one hand, the 2005 Reform Act required the FDIC Board to consider preventing sharp swings in assessment rates for insured depository institutions (see: Section 2.4). On the other hand, however, the 2008 Restoration Plan required increasing assessment rates in order to ensure that the reserve ratio could meet or exceed 1.15% until 2013. As stated by the FDIC, depending on the level of projected losses and insured deposit growth, that requirement might potentially limit the Board's ability to prevent sharp swings in assessment rates [FDIC 2008c].

**Table 3.2 Assessment rates for the first quarter of 2009** (in basis points)

| | Risk Category | | | | |
|---|---|---|---|---|---|
| | I* | | | | |
| | Minimum | Maximum | II | III | IV |
| Annual rates | 12 | 14 | 17 | 35 | 50 |

* Rates for institutions that did not pay the minimum or maximum rate would vary between these rates.

Source: Final Rule 2008b.

3

As far as the second part of the Restoration Plan is concerned, the FDIC has proposed some other **changes to the assessment system – in order to ensure that riskier institutions will pay more**, i.e. a larger share of the proposed increase in assessments. These changes have been implemented and applied from 1 April 2009 onwards. As explained by the FDIC [FDIC 2008f], the key proposed changes to the existing assessment system include:

- assessing higher rates to institutions with a strong reliance on *secured liabilities* that generally raises the FDIC's loss in the event of failure without providing additional assessment revenue;
- assessing higher rates for institutions with a significant reliance on *brokered deposits* but, for well-managed and well-capitalized institutions, only when accompanied by rapid asset growth. Brokered deposits combined with rapid asset growth have played a role in a number of costly failures, including some recent ones;
- providing incentives in the form of a reduction in assessment rates for institutions to hold *long-term unsecured debt* and, for smaller institutions, high levels of *tier 1 capital*;
- making conforming changes in the treatment of *new institutions* insured by the FDIC.[29]

In order to implement the above changes to risk-based assessments, as well as to ensure that the goals of the Restoration Plan are accomplished within the required period of time, **initial base assessment rates** – effective on 1 April 2009 – needed to be set accordingly. To this end, the FDIC has proposed rates ranging from 10 to 45 basis points (see: Table 3.3a). Among other things, it has proposed to broaden the spread between minimum and maximum initial base assessment rates in Risk Category I from the current 2 to 4 basis points, and adjust the percentage of institutions being subject to those initial minimum and maximum rates.

However, it proved very soon (in early 2009) that the Restoration Plan needed to be corrected – taking into account the data as of end-2008 (and notably for the last quarter of the year). In 2008, there were 25 failures with a combined $ 372 billion in assets, and five banks with combined assets of $ 1.3 trillion received open-bank assistance under a systemic risk determination. Those **bank failures reduced the DIF balance dramatically**. During the fourth quarter of 2008, the DIF decreased by about 45% and stood at $ 18.9 billion as of end-2008 – down from $ 52.4 billion a year earlier (see: Figure 3.1.a). The reserve

[29] For assessment periods beginning before 1 January 2010, until a new institution in Risk Category I received CAMELS component ratings, it would have an initial base assessment rate being 2 basis points above the minimum initial base assessment rate applicable to institutions in this risk category (under the current rule this is 1 basis point above the minimum rate). For assessment periods beginning on or after 1 January 2010, any new institution in Risk Category I would be assessed at the maximum initial base assessment rate applicable to institutions in this risk category, as this is the case under the current rule [FDIC 2008d].

ratio was 0.40%, i.e. 82 basis points lower than the 1.22% ratio at end-2007 (see: Figure 3.1.b); it was **the lowest reserve ratio** for the combined bank and thrift insurance fund **since mid-1993**, when the reserve ratio was 0.28% [FDIC 2009d,f]. Therefore, on 27 February 2009, the FDIC Board of Directors decided to adopt the following **amendments to the Restoration Plan**:

- **extending the Restoration Plan horizon from 5 to 7 years (until 31 December 2015)** – in recognition of the current significant strains on banks and the financial system and the likelihood of a severe recession;

- implementing changes to the risk-based assessment system, and setting rates beginning the second quarter of 2009 – banks in the best risk category, which paid 12-14 cents per $100 of deposits in the first quarter of 2009, would pay **initial base rates** ranging from 12 to 16 cents, beginning on 1 April 2009;

- an interim rule imposing an **emergency special assessment** on insured institutions of 20 basis points on end-June 2009 (to be collected on end-September 2009); it would also permit the FDIC to impose an emergency special assessment after end-June 2009 (up to 10 basis points) if necessary to maintain public confidence in federal deposit insurance [FDIC 2009c].

After applying all possible adjustments (related to, *inter alia*, the above secured liabilities and brokered deposits adjustments), **minimum and maximum total base assessment rates for each risk category** were set as below (see: Table 3.3b). Those rates and other revisions to the assessment rules took effect for the quarter beginning 1 April 2009, and were expected to be reflected in the fund balance as of end-June 2009, and assessments due end-September 2009 and thereafter [FDIC 2009c; Final Rule 2009a].

However, again, it proved very soon – in May 2009 (just after raising the coverage limit to $ 250,000) – that given the FDIC's estimated losses from projected institution failures, those assessment rates would not be sufficient to return the reserve ratio to 1.15% within 7 years and were unlikely to prevent the DIF fund balance and reserve ratio from falling to near zero or becoming negative in 2009. For that reason, on 22 May 2009, the FDIC adopted the final rule imposing a 5 basis point **special assessment on each insured depository institution's assets minus its Tier 1 capital** (as of end-June 2009). The amount of the special assessment for any institution is not to exceed 10 basis points times the institution's assessment base for the second quarter of 2009. The special assessment is to be collected on 30 September 2009 (at the same time, regular quarterly risk-based assessments for the second quarter of 2009 are to be collected as well). In the final rule, the FDIC announced that an **additional special assessment** of up to 5 basis points is likely later in 2009, but the precise timing and amount remain uncertain (although the latest possible date for imposing such an assessment is 31 December 2009, with collection on 30 March 2010). The FDIC may impose such an additional special assessment if it estimates that the reserve ratio will fall to a level that – in the FDIC Board's opinion – would adversely affect public confidence or to a level that will be close to or below zero. According to the FDIC's projections, the special assessment imposed in May 2009, combined with the rates adopted in February 2009, should result in maintaining the fund balance and reserve ratio positive, albeit close to zero, at the end of 2009; otherwise, **without a special assessment, the reserve ratio of the DIF would become negative by the end of 2009** [FDIC 2009i; Final Rule 2009b].

**Table 3.3. Initial and total base assessment rates (in basis points)**

a) **initial base assessment rates** (from 1 April 2009 onwards)

| | Risk Category | | | | |
|---|---|---|---|---|---|
| | I* | | | | |
| | Minimum | Maximum | II | III | IV |
| Proposed annual rates | 10 | 14 | 20 | 30 | 45 |
| Amended annual rates | 12 | 16 | 22 | 32 | 45 |

b) **total base assessment rates** **

| | Risk Category I | Risk Category II | Risk Category III | Risk Category IV |
|---|---|---|---|---|
| Initial base assessment rate | 12 – 16 | 22 | 32 | 45 |
| Unsecured debt adjustment | -5 – 0 | -5 – 0 | -5 – 0 | -5 – 0 |
| Secured liability adjustment | 0 – 8 | 0 – 11 | 0 – 16 | 0 – 22.5 |
| Brokered deposit adjustment | | 0 – 10 | 0 – 10 | 0 – 10 |
| Total base assessment rate | 7 – 24 | 17 – 43 | 27 – 58 | 40 – 77.5 |

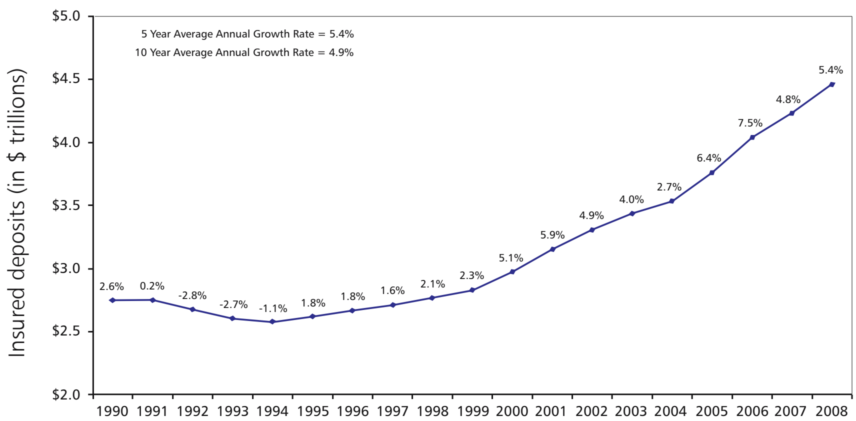
* Initial base rates that were not the minimum or maximum rate would vary between these rates.
** All amounts for all risk categories are in basis points annually. Total base rates that were not the minimum or maximum rate would vary between these rates.

Source: FDIC 2008d, 2009c; Final Rule 2009a.

One of the key assumptions on the Restoration Plan is the rate of **annual growth of insured deposits**. Initially, the FDIC was of the opinion that it would be reasonable to expect annual growth of about 5% [FDIC 2008d].[30] Some time later, it made a slight correction – indicating the range between 5% and 6% as a potential growth rate [Final Rule 2008b]. Those assumptions were based on the actual figures observed in the past. For example, analyzing the 12-month-period ending in end-September 2008, estimated insured deposits[31] grew by 7.1%. But the most recent 5-year and 10-year average growth rates are 5.9% and 5.1% respectively (see: Figure 3.1b).

**Figure 3.2 Annual insured deposit growth rates (1990-2008)**

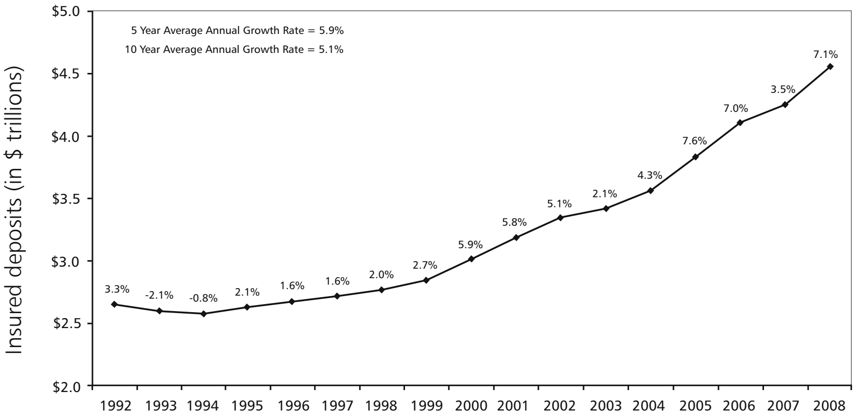
a) June to June




30 Analyzing the period from mid-2007 until mid-2008, insured deposits grew by 5.4%. Similarly, analyzing the data for 1990s and 2000s, the 5-year and 10-year average growth rates were 5.4% and 4.9% respectively (see: Figure 3.1a).

31 Estimated insured deposits do not include those resulting from the temporary coverage limit increase to $ 250,000 under the Emergency Economic Stabilization Act of 2008, or those non-interest bearing transaction deposits covered by the Temporary Liquidity Guarantee Program (see: Section 3.2 and Box 3.1).

b) September to September




Source: FDIC 2008d (top figure); Final Rule 2008b (bottom figure).

However, it should be mentioned that projections relating to **annual growth of insured deposits** – like all projections – are subject to some uncertainty. On the one hand, deposit growth in the short term could rise relatively quickly due to a "flight to quality" attributable to financial and economic uncertainties. On the other hand, the experience of the late 1980s and early 1990s showed that lower overall growth in the economy (and, in turn, in the banking industry) could lower overall growth of deposits as well. But, as the FDIC assumes, differences in annualized growth rates of insured deposits in the short term (until the end of the first quarter of 2009) will have little effect on the projected reserve ratio (see: Table 3.4a). Similarly, in the medium term, a one percentage point increase/decrease in average annual insured deposit growth rates (other factors equal) – due to total costs of actual and potential bank failures in 2008-2013 – should not have a considerable effect on the assessment rates necessary to meet the requirements of the Restoration Plan, i.e. to raise the reserve ratio to 1.15% until the end of 2013 (see: Table 3.4b) [Final Rule 2008b; FDIC 2008d].

As far as **total costs of actual and potential bank failures in 2008-2013** are concerned, in fall 2008, the FDIC – having estimated a range of possible failure costs over that period – regarded $ 40 billion as the most likely outcome. But in early 2009, taking into account the most recent data on banking scetor performance and ample evidence of deteriorating economic and financial conditions, the FDIC suggested that the range of losses to the insurance fund will probably be higher over the next few years (while, as of the end of the third and fourth quarter of 2008, the DIF had a balance of about $ 35 billion and $ 19 billion respectively - available to absorb losses from the failures of insured institutions). According to the most recent estimates, the situation looks even worse – currently, **the FDIC projects approximately $ 70 billion in losses due to insured depository institution failures over the next 5 years (the great majority of which are expected to occur in 2009 and 2010)**; this projection of losses is about $ 5 billion higher than the FDIC's estimate in February 2009 [Final Rule 2009b]. Therefore, both the last year's events as well as the uncertain and changing outlook for bank failures in the coming years have confirmed the importance of contingency planning to cover unexpected developments in the banking industry. To this end, as part of contingency planning, the FDIC suggested in early 2009 that the US Congress provide additional support for federal deposit insurance guarantees by **increasing significantly the existing FDIC's line of credit with the US Treasury – from $ 30 billion to $ 100 billion** – in order to ensure that the public has no doubts about the US government's commitment to insured depositors. In this context, the FDIC reminded that the above line of credit had not been adjusted since the passage of the FDICIA in 1991 (see: Section 2.1), although assets of the banking sector had increased from $ 5 billion to $ 30 billion since then [Bovenzi 2009b]. In early March 2009, the Congress adopted the Depositor Protection

Act that increased the FDIC's borrowing authority to **$ 100 billion (permanent level)** and – as a **temporary measure (by end-2010 only)** – the act authorized the FDIC to borrow from the US Treasury, if necessary, up to a maximum of **$ 500 billion** (according to a multilateral decision-making process involving the US Treasury, the US President, the Board of Governors of the Federal Reserve System, and the FDIC Board of Directors).[32] It is expected that the above increase will give the FDIC a sufficient cushion against unforeseen bank failures and, in turn, it will allow to reduce the size of the special assessment significantly [Final Rule 2009b].

**Table 3.4 Projected impact of insured deposit growth on the reserve ratio in the short and medium term**

a) projected reserve ratios until the end of the first quarter of 2009 (in %) *

| Quarter ending | If annualized insured deposit growth: ** | | | |
|---|---|---|---|---|
| | 4% | 5% | 6% | 7% |
| 31 December 2008 | 0.61 | 0.61 | 0.61 | 0.60 |
| 31 March 2009 (without rate increase) | 0.60 | 0.60 | 0.60 | 0.59 |
| 31 March 2009 (with 7 b.p. rate increase) | 0.63 | 0.63 | 0.62 | 0.62 |

b) minimum initial base assessment rates needed to raise the reserve ratio to 1.15% in 2013 (in basis points)

| Insured deposit growth rate | If institution failures from 2008 to 2013 cost in total: *** | | | | | |
|---|---|---|---|---|---|---|
| | $ 20 billion | $ 30 billion | $ 40 billion | $ 50 billion | $ 60 billion | $ 70 billion |
| 3% | 5 | 6 | 8 | 11 | 13 | 16 |
| 4% | 5 | 6 | 9 | 11 | 14 | 16 |
| 5% | 5 | 7 | 9 | 11 | 14 | 16 |
| 6% | 5 | 7 | 9 | 12 | 14 | 17 |
| 7% | 5 | 8 | 10 | 12 | 15 | 17 |

* Reference value: reserve ratio as of 30 September 2008 = 0.76%
** Assumed assessable (domestic) and insured deposits increase at the same rate. Estimated insured deposits do not include those resulting from the temporary coverage limit increase to $250,000 under the EESA, or those non-interest bearing transaction deposits covered by the TLGP.
*** Costs included $ 12.8 billion for actual and projected failures in 2008.

Source: Final Rule 2008b (top table); FDIC 2008d (bottom table).

Summing up, the Restoration Plan was adopted to ensure the reserve ratio's return to at least 1.15% within 5 years, i.e. until the end of 2013 (as initially planned). In this context, it is worth mentioning that despite the very low level of the reserve ratio at that time (1.01% and 0.76% as of end-June and end-September 2008 respectively – see: Section 3.1), and the fact that it was practically impossible to reach the minimum required level of the DRR (1.15%) in the following year, and not easy to do so over the next few years too, the FDIC Board of Directors – having adopted the Restoration Plan in early October 2008 – decided to maintain the DRR at 1.25% as a signal of its long term target for the fund [FDIC 2008f]. Therefore, the goal of reaching the 1.25% DRR remained in effect. Last year, the FDIC projected that, under the rates proposed in 2008, the reserve ratio would reach 1.26% by the end of 2013 [FDIC 2008d]. However, according to the most recent FDIC's projections, **the combination of regular assessments and the additional special assessment** of 5 basis points (likely to be imposed this year) **should return the reserve ratio to 1.15% in 2016**, i.e. later than it is required by the amended Restoration Plan (by the end of 2015). However, the Restoration Plan allows the FDIC the flexibility to adjust assessment rates as

[32] In October 2008, the US Congress adopted the EESA (see: Section 3.2), which allowed the FDIC to borrow, if necessary, unlimited amounts from the US Treasury (as a temporary measure – by end-2009).

needed throughout the plan period to ensure that the fund reserve ratio reaches 1.15% within 7 years [Final Rule 2009b].

The changes proposed by the FDIC are expected to make **the assessment system more sensitive to risk**. The proposal should improve the way the system differentiates risk among insured institutions and make the risk-based assessment system fairer by limiting the subsidization of riskier institutions by safer ones [FDIC 2008f; FDIC 2008d]. It is to be accomplished by drawing upon some measures of risk that were not covered by the previous reform, including the revision of the assessment system under the Reform Act of 2005.

# 4

# Potential changes to the US deposit insurance system in the future

The Reform Act of 2005 required the FDIC to conduct some studies related to, among other things, further potential changes to the deposit insurance system in the United States. In response to that call, in February 2007, the FDIC published its staff study on this issue [Bradley and Craig 2007], which examined the feasibility and consequences of taking actions relating to:

- privatizing deposit insurance;
- establishing a voluntary deposit insurance system for deposits in excess of the coverage limit of federal insurance;
- increasing the limit on deposit insurance coverage for municipalities and other units of general government.

Moreover, in the context of the 2008 Emergency Economic Stabilization Act that temporarily increased the basic coverage limit, the FDIC reported that there had been some proposals to make permanent this temporary increase in deposit insurance coverage [Bovenzi 2009b].

## 4.1 Proposals to privatize deposit insurance

In its 2007 study, the FDIC reviewed pros and cons related to the idea of privatizing deposit insurance. First of all, the FDIC was of the opinion that privatization would not result in the elimination of moral hazard since it is an effect of all types of insurance, and moreover, recent regulatory and statutory improvements in federal banking law had provided the FDIC with better tools to control moral hazard. Next, it was argued by the FDIC that much of the regulatory burden on banks was not related to deposit insurance and would not go away with privatization. Finally, the FDIC emphasized that privatization would not remove the taxpayer from ultimate responsibility for losses arising from a systemic crisis (keeping in mind that government intervention in case of a systemic bank failure – in order to prevent broader problems in the banking sector – is, in fact, an economic (and not a deposit insurance) issue [Bradley and Craig 2007].

Moreover, as argued by the FDIC, there were **some facts from the 1980s, 1990s, and 2000s, which argued against a private deposit insurance system**. In this context, the FDIC indicated some relatively recent failures of private insurance systems in the United States (Ohio and Maryland in 1985, and Rhode Island in 1991). As a result, many insured depositors had to wait months – and sometimes years (in the case of Maryland) – to receive the full return of their principal [Todd 1994]. Those events in the past caused rather low public confidence of depositors in the private deposit insurance systems – contrary to the federal deposit insurance system that enjoys much higher confidence of depositors because they are aware that the US government stands behind such guarantees. And, with regard to the 2000s, the FDIC regarded the availability of private risk capital to underwrite a private deposit insurance system as rather limited. It was confirmed after the terrorist attacks in the United States on 11 September 2001 when private insurance companies demonstrated their unwillingness to provide terrorism insurance without a government loss-sharing agreement.

The issue of **private deposit insurance systems** was widely discussed in the economic literature in the 1990s, i.e after the reform of the US deposit insurance system in the early 1990s (FDICIA) and before the formal proposals that led finally to the 2005-2007 reform. Some authors indicated that in the past, both in the XIX and XX centrury; numerous private deposit insurance programs had been organized by various states for mutual savings banks, savings-and-loan associations, credit unions, and other depository institutions operating in those states. However, their assessments of those private deposit insurance systems were quite different. On the one hand, there were opinions that, historically, **non-government arrangements had worked very well**. The systems in Ohio, Iowa, and Indiana, which had existed prior to the Civil War (1861-1865), were regarded as the most successful depositor protection plans in the US history. In those systems all banks were guarantors, and there was no government monetary involvement [Golembe 1995; Burstein 1998]. On the other hand, some authors indicated that in the early 1980s, about 30 such programs existed (as of 1982), but since then most had failed because they could not meet their obligations or had been phased out because adverse public reactions were feared. In general, historically, **many private insurance programs at the state level suffered from the following weaknesses** (one or more): the lack of risk diversification because of geographic limitations or the dominance of a few large institutions, adverse selection resulting from the fact that the stronger institutions were able to withdraw from the program, insufficient funding to meet systemic losses, inadequate supervision, and conflicts of interest.[33] It was argued that some of these weaknesses would have been eliminated if a private fund were organized on a national basis and if membership were mandatory [Hanc 1999].

In the context of private deposit insurance systems, one of the most famous concepts was the so-called Ely proposal assuming **100% cross-guarantees within the banking sector** (consisting of private institutions – banks and thrifts). As explained by the author, the cross-guarantee concept was to be **a self-insurance mechanism for banks/thrifts that could entirely replace the existing federal system of deposit insurance**. According to that concept, all deposits and most other liabilities of banks/thrifts would be unconditionally guaranteed against any loss under a contract with an *ad hoc* syndicate of voluntary guarantors. As a result, banks/thrifts would periodically pay risk-sensitive premiums to their guarantors to compensate them for the risk they had assumed. Moreover, the guarantors – acting through a syndicate agent – would have the right to monitor the activities and financial health of the bank or thrift they were guaranteeing [Ely 1994]. Some authors believed that the above proposal – which pointed back to the above-mentioned experience of the non-government private insurane arrangements that had existed in the XIX century (before the Civil War) [Burstein 1998] – would eliminate the moral-hazard problem associated with flat-rate deposit insurance [Gorton 1994].

There were also some other **proposals to privatize deposit insurance** in the economic literature of the 1990s and 2000s. For example, there were both proposals of "**direct privatization**", i.e. converting the FDIC into a privately owned and operated insurance company, as well as proposals of "**indirect privatization**", i.e. retaining the FDIC as a public entity but reducing its powers and/or transferring the FDIC ownership and management

[33] Other authors stated that the failed private deposit insurance systems in the United States, usually shared five characteristics: (1) free exit from the system; (2) concentration risk (the failure of large institutions often brought down the whole system); (3) fraudulent acts by regulators, banks, and politicians; (4) limited regulatory powers; and (5) inaction on the part of insurers and state regulators [English 1994; Bradley and Craig 2007].

to the banks it insured. It was argued that the FDIC Board should be composed of private sector representatives with banking experience because the interface between representatives of those whose money is at risk (i.e. insured institutions) and bank regulators would lead to more effective bank supervision and lower risk of failures [Kovacevich 1996]. It also was argued that implicit government guarantees of banks would remain as long as the deposit insurance system was a government-operated one and, for that reason, in order to reduce those guarantees, insured banks should, at least, be given a greater voice in the FDIC management [Kaufman 2002].

In general, even the authors who suggested that the banking industry should take over the function of the FDIC, were not sure that the federal government would be kept out of it completely, at least in terms of providing back-up guarantees [Golembe 1995; Burstein 1998]. Some other authors, having stated that although in certain respects private deposit insurance might be preferable to federal insurance, added that many problems would have to be resolved before it could develop into a major force [Mantripragada and Banarjee Rau 1995]. And the other authors asked some **key questions raised by privatization proposals** [Hanc 1999]:

4

- why would a private deposit insurance system be superior to federal deposit insurance?
- how would a private system deal with catastrophic losses?
- how would a private system deal with a potential credibility problem – the belief that, *in extremis*, the federal government would come to rescue and bail out the private fund in order to ensure protection of depositors?

First of all, with reference to the first question, it was argued that federal deposit insurance was broadly available to all qualifying banks through long-term contracts (which, once issued, were rather seldom terminated), and, in contrast, private deposit insurance organizations would presumably focus more narrowly on the objective of earning maximum profits from the business of insuring deposits. For that reason, **private insurance companies might have stronger incentives to assess risk accurately** if they stood to profit from correct assessments and suffer losses from incorrect assessments [Hanc 1999]. Next, as far as the second question is concerned, most observers agreed that **the resources available to private deposit insurers** (including reinsurance arrangements, catastrophe securities, etc.) **would probably fall short of the resources available to a government deposit insurer**. And, in practice, the supply of private capital for catastrophic losses is limited. Therefore, it might be hard to maintain public confidence in the ability of a private fund to protect depositors under extreme conditions. In this regard, proponents of privatization would assign the above-mentioned back-up, or reinsurance, role for the FDIC [Ely 1998]. Finally, with regard to the third question, it was indicated that – if the FDIC formally reinsured the private program – such **federal sponsorship of a private deposit insurance system** might lead to expectations that the federal government would rescue the private system if the latter could not protect depositors. And such an explicit or implicit federal backstop **could generate moral hazard problems** comparable to those existing in the present system and thereby defeat the purpose of privatizing deposit insurance [Bohn and Hall 1999]. All in all, the author of the above questions noted that it seemed to be more than coincidental that, within the banking industry, the institutions that favored privatizing deposit insurance were mainly large and geographically diversified, whereas local community banks supported federal deposit insurance [Hanc 1999].

In general, the FDIC emphasized that there were **serious doubts that a private (funded by the banking sector) deposit insurance system would be able to replace**

**successfully the current federal one**. It was argued that, according to the history of private deposit systems, in order to fulfill all three responsibilities traditionally assumed by federal deposit insurance – i.e. promoting financial market stability by maintaining depositor confidence in the banking system, protecting the economy from the disruptive effects of bank failures, and protecting the deposits of small savers – such a private deposit insurer would not only need enough resources to protect small depositors, but also must be capable of providing stability to the entire banking system, notably in times of serious financial turmoil. Insufficient public confidence in the deposit insurance could potentially render the system unable to prevent or stem banking panics [Bradley and Craig 2007]. This statement was made in February 2007 and some months later, in September-October 2007, the UK experience with Northern Rock confirmed how important public confidence in deposit insurance was for the banking sector stability.

## 4.2 Proposals to establish a voluntary deposit insurance system

4

In its study of 2007, the FDIC also examined the need for voluntary excess deposit insurance and several potential options in this respect (including both private and public sector solutions). As reminded by the FDIC, **several private excess deposit insurance plans were started in the 1990s**, but most have been terminated since then. Nevertheless, **a few private companies and states still provide excess deposit insurance**. For example, in Massachusetts, excess deposit insurance is being provided to state-chartered banks by the Share Insurance Fund of the Co-Operative Central Bank (for co-operative banks) and the Depositors Insurance Fund (for savings banks). Both funds are private excess deposit insurance companies – backed solely by their own assets and owned by the banking industry (neither the Commonwealth of Massachusetts nor the US government has any liability for the companies' obligations). Both funds insure deposits above the FDIC limit – in full and without restrictions [Bradley and Craig 2007].

The FDIC study found that depositors in need of additional coverage had some options as a result of technological advances and private sector initiatives, such as:

- deposit placement services;
- deposit sweep programs.

The above options – as private sector solutions – would potentially reduce the need for public sector (FDIC) involvement.

As far as **deposit placement services** are concerned, the FDIC argued that such services would allow participating banks/thrifts to provide their customers with deposit insurance exceeding the statutory coverage limit while retaining the bank-customer relationships. In this context, the FDIC gave the following example related to a customer who would like to make a deposit of $ 500,000 into a participating bank/thrift. The bank/thrift originating the deposit would retain $ 100,000 in an insured account and distribute the remaining $ 400,000 among four other participating institutions, with the depositor having full standard coverage provided by the FDIC.[34] According to the FDIC, deposit placement services are a form of brokerage in which the risk associated with the increased coverage is passed to the FDIC (a condition contrasting sharply with existing private excess deposit insurance coverage), and moreover, deposits placed through this type of service

[34] Of course, it was related to the standard coverage of $ 100,000 that was the case in 2007 and it will be applied again from the beginning of 2010 onwards (following the expiration of the current rules on temporarily increased coverage to $ 250,000 until the end of 2009).

are regarded as brokered deposits (thus, only well-capitalized institutions could participate in providing such services). All in all – taking into account the FDIC's opinion that deposit insurance would "pass through" from the agent (the deposit placement service) to the owner of the funds if disclosure, record keeping, and other requirements were adhered to in the process [DiNuzzo 2003] – deposit placement services became an alternative for depositors who were seeking deposit insurance coverage of funds in excess of $ 100,000.

With regard to **deposit sweep programs**, the FDIC indicated in its study that many insured depository institutions had already (since the 1960s) offered customers the option of "sweeping" funds held in a demand deposit into an alternative investment vehicle, including certain money market instruments or money market mutual funds. If a depositor would like to be fully protected in case of a bank failure, any funds held in his/her deposit account above the FDIC insurance limit may be swept into a money market mutual fund or securities sold under agreements to repurchase (repos). There are also some other alternatives, but the above instruments are the most widely recognized by the general public.

In addition to the above options, the FDIC analyzed in its study the following ones as well:



- FDIC provision of excess deposit insurance directly to banks;
- reinsurance on the FDIC's exposure (by a private sector reinsurer);
- FDIC loss-sharing arrangements.

As far as the first option is concerned, the FDIC – having considered how it might provide voluntary excess deposit insurance – stated that issues needed to be resolved would include the availability of such excess insurance, limits to excess coverage in order to protect taxpayers and the insurance fund, and a price for excess coverage. Alternatively, with regard to the second option, the FDIC might guarantee its exposure with a private sector reinsurer; in such a case, the FDIC would continue to provide deposit insurance coverage up to its statutory limit, but the FDIC's risk on the excess would be transferred to a competitive market of private insurers. However, the FDIC indicated some potential problems related to the above options. In both cases, congressional authorization would be required. Moreover, the FDIC would probably be expected to retain some additional risk because private reinsurers' capacity was limited and such reinsurers had only limited interest in engaging in reinsurance agreements with the FDIC on terms acceptable to the FDIC [FDIC 1993]. The reason for this limited interest might be conflicts between the goals of federal deposit insurance and the goals of private reinsurers [Hanc 1999]. Finally, the study found that developing a vibrant private sector excess deposit insurance market would require some FDIC loss-sharing arrangements (stipulating that the FDIC would assume some of the risk) because otherwise – i.e. in the absence of such arrangements – the pricing for excess private insurance of deposits would probably be prohibitive.

Therefore, taking into account the above arguments, the FDIC did not recommend providing a voluntary deposit insurance system for deposits above the maximum amount of FDIC insurance [Bradley and Craig 2007].

## 4.3 Proposals related to the limit on deposit insurance coverage

After the recent reforms of the US deposit insurance system, there were the following proposals related to the coverage level:

- to increase the limit on deposit insurance coverage for general government and municipalities;
- to make permanent the current temporary increase in deposit insurance coverage to $ 250,000.

First, after the 2005-2007 reform, the FDIC considered in its study some **proposals to increase deposit coverage for municipalities and other units of general government**. In the FDIC's opinion, municipalities and other units of general government have some other alternatives that could address this need, such as surety bonds or deposit placement services (see: Section 4.2). Additionally, the FDIC concluded that such increased coverage would represent a departure from the traditional goals of deposit insurance. Furthermore, the FDIC indicated that it had never been in favor of treating one class of depositors in a different way than others – as it would have been the case if municipal deposits received increased coverage. Providing greater coverage for municipal deposits would also remove an aspect of market discipline inherent in the system and have some cost implications [Bradley and Craig 2007].

In its study, the FDIC made a review of **legislative proposals related to insurance coverage for municipal deposits that had been discussed by the US Congress in 2000-2005**. In 2001, some bills were introduced in the US House of Representatives and Senate that provided full insurance for in-state municipal deposits [US Congress / House 2001d / Senate 2001c], but finally they were rejected in their respective committees. Next, in 2002-2003, some other bills that provided extra protection for municipal deposits were passed by the House [US Congress/House 2002, 2003]. The bills would have increased the coverage limits for individual accounts from $ 100,000 to $ 130,000, but the Senate never took action related to them [US Congress/Senate 2002b, 2003b]. Finally, several bills that included provisions on municipal deposits were introduced in 2005, e.g. Municipal Deposit Insurance Protection Act of 2005 [US Congress/House 2005a] that – unlike the previous attempts to enact deposit insurance reform – was not comprehensive and solely dealt with municipal deposits (but it was not the subject of any legislative action). The other bill provided that in-state municipal deposits would be insured up to $ 2 million or 80% of deposits over $ 130,000 (the new basic coverage for deposit accounts), whichever is less [US Congress/House 2005b]. But finally, in the Reform Act of 2005 that became law in February 2006 – although it stipulated inflation indexing for general depositors beginning on 1 April 2010 (see: Section 2.4) – municipal deposits received no additional coverage [Reform Act 2005/2006].

During the 2008-2009 reform, and especially in the context of the 2008 Emergency Economic Stabilization Act that temporarily increased the basic coverage limit, the FDIC reported that there had been some **proposals to make permanent the current temporary increase in deposit insurance coverage to $ 250,000**. For example, in the US Congress, there was a draft act (of January 2009) to amend the Troubled Assets Relief Program (TARP), which stipulated making the $ 250,000 coverage limit permanent and adjusting it by an inflation index from 2015 onwards. There was also another draft act (of February 2009) that proposed to amend the Federal Deposit Insurance Act in order to increase the coverage limit from $ 100,000 to $ 250,000. The former bill was sent to Senate Finance Committee in late January 2009, and the latter one was sent to the House Financial Services Committee in early February 2009, but no further action has been reported [Gonzales and Getter 2009].

With regard to such proposals, the FDIC is of the opinion that, on the one hand, the level of deposit insurance coverage is a policy determination that appropriately should be made by the US Congress, but on the other hand, any increase in the coverage level would increase exposure to the insurance fund (DIF). Therefore, such a change would also have to permit the FDIC to assess premiums against the newly insured deposits to maintain the DIF. And, referring to the current situation, the FDIC indicated that **permanently increasing the coverage limit would have the effect of immediately reducing the reserve ratio** of the DIF. Therefore, it would worsen the present situation since the ratio is currently below the statutorily mandated range. In this situation, the FDIC was required to implement a restoration plan to return the reserve ratio to at least 1.15% of estimated insured deposits within five years, and the FDIC Board instituted premium increases necessary to implement the Restoration Plan (see: Section 3.3). Taking into account that permanently increasing coverage to $ 250,000 would have an immediate dilutive effect on the DIF, it would be appropriate (or even necessary) to extend the time period for restoring the DIF reserve ratio to the required level [Bovenzi 2009b].

For all the above reasons, the FDIC would recommend neither increasing the limit on deposit coverage for municipalities and other units of general government nor making permanent the current temporary increase in deposit insurance coverage to $ 250,000. The former, despite several attempts in the 2000s, proved to be very difficult or practically impossible to be successfully passed by the Congress and become law. It seems that currently it could be a similar situation in case of the latter as well (although in 2014, after more than five years of maintaining the $ 250,000 coverage level, there may be some pressure to keep a higher coverage limit beyond thet date as well).

# 5

# Some recommendations for the European Union on reforming deposit guarantee schemes

It seems that the US experience related to the deposit insurance system and its recent reforms could serve – at least to some extent – as a quite useful source of inspiration and/or recommendations for the European Union related to reforming deposit guarantee schemes. The usefulness of such recommendations also stem from the fact that the United States has had much longer experience with the deposit insurance system (since 1933) than the EU as a whole (since 1994). Moreover, the current global financial crisis, which started in the US and had serious consequences in Europe (first of all, in the United Kingdom), is a painful lesson which should serve as a basis for both the US and the EU authorities to draw some conclusions for their deposit guarantee systems. In this context, some recent UK experience with reforming the domestic deposit guarantee scheme in response to the financial crisis may be another source of inspiration for the EU.

In 1994, the EU adopted the Directive 94/19/EC on deposit guarantee schemes [EU 1994] that required the EU member states to have at least one statutory (mandatory) deposit guarantee scheme in place – in order to protect depositors' money if banks fail. In 2005-2006 – when the US reformed its deposit insurance system – there was also a review of these existing rules in the EU. The review indicated a number of areas where improvements would be needed. However, there was no political will to amend the directive (although it was almost 12-year-old at that time) and the member states decided that at that stage many of the improvements could be achieved without amending the legislation [Commission 2006]. It should be noted that the above decision was made at a time of good economic and financial conditions in the world, including the EU.

The situation – notably in the international financial markets – deteriorated relatively soon. Events in 2007 and 2008, i.e. the growing turmoil on the financial markets that finally evolved into the severe global financial crisis (regarded as "*the most serious and disruptive financial crisis since 1929*" [de Larosière et al. 2009]), had severe consequences for the EU banking systems, including national deposit guarantee schemes in the EU. The first wave of the crisis had resulted in a bank run on Northern Rock in the United Kingdom (in September 2007) that forced the UK authorities to make some important changes to the domestic deposit insurance system (in October 2007) and finally nationalize Northern Rock a few months later. But, from the point of view of the EU as a whole, it was an isolated episode. The second (much more significant) wave of the crisis in the EU occurred a year later, following the collapse of Lehman Brothers Holdings (in September 2008) when both depositors' confidence in the banking system as well as confidence among banks fell dramatically. As a result, several banks in many EU member states faced serious problems with liquidity (e.g. Fortis and Dexia in the Netherlands, Belgium and Luxemburg, Bradford & Bingley in the UK, Grupo Santander in Spain, Hypo Real Estate in Germany, UniCredit in Italy). In that situation, a number of emergency policy measures (such as, for example, state guarantees of bank liabilities, capital injections, asset purchases, partial nationalization, etc.) had to be undertaken in order to rescue the banks at risk. Moreover, in late September and early October 2008, several governments of the EU member states (including Ireland, Greece, Denmark, Austria, Germany, Benelux countries, Portugal, Spain, and the UK) – in an uncoordinated way – raised significantly their deposit insurance levels that led to harmful competition between the EU banking systems. In order to avoid significant deposit flows from one country to another and/or bank runs – that could not have been excluded at that time – it was clear that significant changes to the deposit guarantee systems were not only inevitable but extremely urgent as well (especially keeping in mind the flaws in the EU directive that had not been addressed in advance).

Therefore, in fall 2008 – when a significant economic slowdown or even recession was foreseen in 2009 in both the US and the EU – the EU member states realized that (contrary to the United States) they had lost a chance to reform their deposit guarantee schemes at a time of good economic and financial conditions and they would have to do it urgently under stress and time pressure.

## 5.1 Recent recommendations and proposals adopted in the EU (2008-2009)

On 7 October 2008, the ECOFIN Council (EU Ministers of Finance) stated that a priority was to restore confidence and proper functioning of the financial sector and, to this end, all necessary measures should be taken to protect deposits of individual savers. In this context, the Council welcomed the intention of the European Commission to bring forward urgently an appropriate proposal to promote convergence of deposit guarantee schemes [ECOFIN 2008].



On 15 October 2008, the European Commission – in order to put into action the above commitments made by the ECOFIN – put forward **a revision of the EU rules on deposit guarantee schemes**. The new rules were designed to improve depositor protection and to maintain the confidence of depositors in the financial safety net [Commission 2008d]. In its formal legislative proposal, the Commission suggested the following key amendments to the EU directive on deposit guarantee schemes (Directive 94/19/EC):

- increasing the minimum coverage level;

- abandoning co-insurance;

- significant reduction of the payout delay.

The Commission stated that – due to the urgency of the matter – neither an impact assessment nor a public consultation would be carried out for its proposal [Commission 2008c]. However, the Commission indicated that it had gained some important insights from the review process of the Directive 94/19/EC (2005-2006) and some reports elaborated in recent years [Commission 2005a,b, 2006, 2007a, 2008a]. This work has been taken into account by the Commission while drafting its legislative proposal (i.e. a draft directive amending the original Directive 94/19/EC). The Commission proposal was regarded as an important step to improve the protection of depositors and, in general, the existing regime of deposit guarantees that was perceived as a major weakness in the EU banking regulatory framework [de Larosière *et al.* 2009].

The new Directive 2009/14/EC amending the Directive 94/19/EC on deposit guarantee schemes as regards the coverage level and the payout delay was agreed in December2008 and formally adopted by the European Parliament and the EU Council on 11 March 2009 [EU 2009a].

*5.1.1 Coverage level*

According to the original Directive 94/19/EC, the minimum coverage level was set at € 20,000 (with the option for the EU member states to adopt a higher coverage on an individual basis, or for branches to use the so-called topping up arrangements[35]). It had not been changed since its introduction in 1994. And the Commission indicated that it did not reflect an average size of deposit in the EU (about € 30,000 per EU citizen), and in order to maintain depositors' confidence (notably at a time of financial stress), the coverage level should be raised significantly. It was confirmed by the ECOFIN Council on 7 October 2008 when the EU member states agreed that all of them would – for an initial period of at least one year – provide deposit guarantee protection for individuals for at least € 50,000, acknowledging that many countries determined to raise their minimum to at least € 100,000 [ECOFIN 2008]. Therefore, on 15 October 2008, the Commission proposed in the draft directive that **the minimum coverage level in the EU should be first raised to at least € 50,000 and, after one year, to at least € 100,000**. According to its estimates, about 65% of eligible deposits were covered under the original regime, and the new (higher) guarantee levels would cover an estimated 80% (with coverage of € 50,000) and 90% (with coverage of € 100,000) of deposits [Commission 2008c].

In the new Directive 2009/14/EC [EU 2009a] – amending the Directive 94/19/EC as regards, *inter alia*, the coverage level – the previous provisions on the minimum coverage limit (€ 20,000) were replaced by the following ones:

- by 30 June 2009,[36] the EU member states shall ensure that the coverage of the aggregate deposits of each depositor shall be at least € 50,000 in the event of deposits being unavailable;

- by 31 December 2010,[37] the EU member states shall ensure that the coverage of the aggregate deposits of each depositor shall be set at € 100,000 in the event of deposits being unavailable.

All the EU institutions (Commission, European Parliament, Council) agreed that in order to maintain depositors' confidence and greater stability of the financial markets in the EU, the minimum coverage level should be increased to at least € 50,000 by mid-2009 (and, in practice, as soon as possible). According to the Directive 2009/14/EC, by end-2010, this level should be set at € 100,000 but it depends on **the Commission's impact assessment** (to be submitted to the European Parliament and the Council by end-2009). The impact assessment is to analyze **whether such an increase and harmonization of the coverage limits in the EU (at the level of € 100,000) are appropriate and financially viable (or not) for all member states** (in order to ensure consumer protection and financial market stability as well as avoid distortions of competition between the member states). If it reveals that such an increase and harmonization are not appropriate, the Commission should submit to the European Parliament and the Council appropriate proposals [EU 2009a].

In practice, some of the EU member states increased their coverage levels to € 50,000 (mostly the new member states) and some of them to € 100,000 (mostly the old member

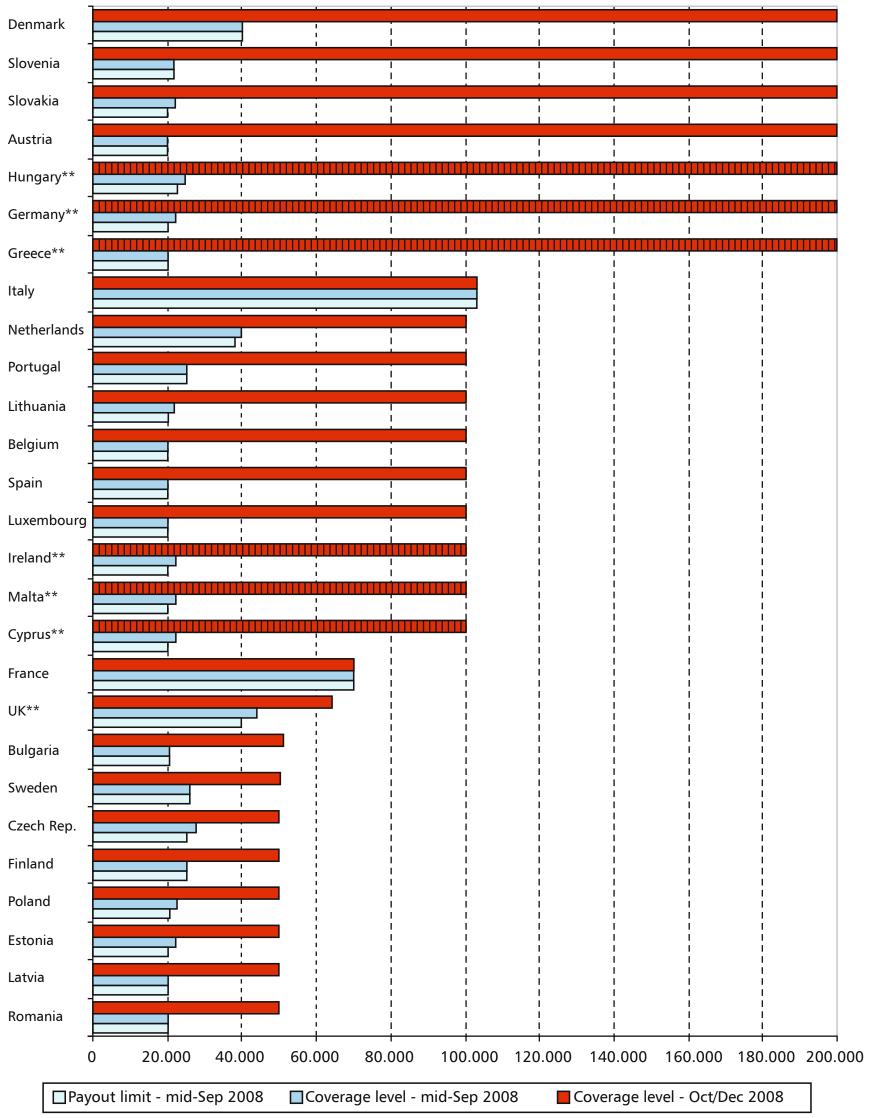
[35] According to the Directive 94/19/EC, under "topping up" arrangements, if a bank branch operates in another EU member state (host country) where the level of coverage is higher (or the scope is broader) than in its home country, such a branch has the possibility to join the host country's deposit guarantee scheme. Thanks to such "topping up" arrangements, the bank branch can offer its depositors the same level of guarantees as is offered by the scheme in the country in which the branch operates (and, therefore, the bank branch is competitive to the local banks in the host country).

[36] In the Commission's legislative proposal of 15 October 2008, it was proposed to apply the coverage level of € 50,000 more than eight months earlier, i.e. as of 15 October 2008 [Commission 2008c].

[37] In the Commission's legislative proposal of 15 October 2008, it was proposed to introduce the coverage level of € 100,000 a year earlier, i.e. by 31 December 2009 at the latest [Commission 2008c].

states, but also some of the new ones) (see: Figure 5.1). It should be noted that some of the above countries increased their coverage limits as a result of the above-mentioned ECOFIN conclusions and/or Commission proposal (of early/mid-October 2008) while some others (e.g. Ireland, Austria, UK, Greece, Germany) did it even before – as an initial response to the aggravation of the financial crisis in mid-September 2008. A few countries – which had high coverage levels prior to the crisis (Italy and France) – did not increase those levels as a result of the crisis. Moreover, some governments declared explicitly or implicitly unlimited deposit guarantees, if needed (see: further part of this subsection and Annex 7). In general, as of end-2008, most of the EU member states had the high coverage limit of at least € 100,000, and about one third of them had the low limit of € 50,000 (see: Figure 5.1).

**Figure 5.1 Coverage levels in the EU member states before and after the 2008 financial crisis (in €)***




* For illustrative purposes, unlimited coverage has been shown as € 200,000.
** Unlimited or limited deposit guarantees declared (explicitly or implicitly) by the EU governments in fall 2008, which were not followed by relevant legislative actions at that time.
*** The UK authorities abolished co-insurance on 1 October 2007 (after the run on Northern Rock – see: Subsection 5.1.2).

Source: Own elaboration based on the Commission data and information from the member states.

As far as the coverage limit is concerned, it should be discussed in various dimensions. Therefore, this subsection will discuss a range of aspects relating to:

- the nominal coverage limit;

- the real coverage limit.

The coverage limit in both nominal and real terms will be discussed in relation to the EU situation in the context of the recent US reforms and experiences presented in the previous chapters.

Speaking of the **nominal coverage limit**, it seems that the current financial crisis caused similar reforms in the United States and Europe, i.e. a significant increase of the coverage level (from € 20,000 to € 50,000 or even € 100,000 in the EU, and from $ 100,000 to $ 250,000 in the US). But it should be noted that there is a fundamental difference relating to these actions. **In the US, the coverage limit was increased temporarily – only for a limited period of time (initially until end-2009, then extended until end-2013) and after its expiration date it will return to the pre-crisis level** (see: Section 3.2). Prior to the crisis, there was no rationale for further increasing the US level of $ 100,000 as the coverage limit of $ 100,000 seemed to be high enough (sometimes, before the crisis, it was regarded as perhaps too high, but it does not seem that such opinions could be repeated after the crisis as well). **In the EU, the recent increase of the deposit guarantee level was not temporary; on the contrary, it is intended to be raised permanently**. Therefore, after the crisis, the limit being a multiple of $ 20,000 will (and should) be maintained. The only question is: what will be the new (higher) coverage limit in the EU?

In the EU, the return to € 20,000 is no longer an option and the new minimum coverage limit must be set at the level of at least € 50,000. On the one hand, this level would be enough (or even too high) for countries that had relatively low coverage before the crisis (like Estonia, Latvia or Lithuania – with the coverage levels lower than € 20,000 as of end-2007[38]). On the other hand, however, this level would be too low for countries with much higher pre-crisis coverage (like the UK, France or Italy – with the coverage levels from about € 50,000 to more than € 100,000 as of end-2007). The latter countries would be interested in adopting the minimum coverage limit in the EU at the level € 100,000 or even higher. Taking into account substantial differences related to the guarantee levels between the EU member states, as well as significant disparities in average deposits in these countries,[39] both before and after the recent aggravation of the financial crisis, it seems that reaching a compromise will not be an easy task. At the same time, it seems **it would not be recommendable for the EU to continue maintaining different levels of deposit insurance in various member states**, e.g. € 50,000 in less developed countries and € 100,000 in richer ones. Such an approach would be in contradiction with the idea of the Single Market and level playing field (as this is the case today). Therefore, the EU should use this opportunity (i.e. the current financial crisis) and try to improve the present situation. As a result, after the crisis, there should be **a single harmonized limit for all member states in the EU**. The limit would be **both a minimum and maximum level** of standard deposit insurance in every member state, i.e. countries would not be allowed to set lower

[38] In 2004, Estonia, Latvia and Lithuania joined the EU with transitional periods related to the coverage level. It was agreed that: (i) Estonia would ensure coverage of not less than € 6,391 until 31 December 2005, and not less than € 12,782 from 1 January 2006 to 31 December 2007; (ii) Latvia would ensure coverage of not less than € 10,000 until 31 December 2005, and not less than € 15,000 from 1 January 2006 to 31 December 2007; and (iii) Lithuania would ensure coverage of not less than € 14,481 until 31 December 2006, and not less than € 17,377 from 1 January to 31 December 2007 [Commission 2005b].

[39] According to the European Commission's data, as far as average eligible deposits *per capita* are concerned, on the one hand, there are some member states with very low deposit levels (e.g. Romania and Bulgaria with € 1,400 and € 2,300 respectively), and on the other hand, there are countries with much higher deposits (e.g. Belgium, Cyprus, or Ireland with € 42,800, € 46,700, and € 47,000 respectively)

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or higher limits. It would allow **avoiding harmful competition between national deposit guarantee schemes and banking systems within the EU**. Moreover, in order to avoid such competition within a given country, one could suggest that so-called **voluntary guarantee schemes** (currently allowed by the directive), which offer additional deposit guarantees beyond the statutory coverage level, should be no longer an option for the member states (such schemes were not recommended in the US as well – see Section 4.2).

The above considerations and recommendations were confirmed by the de Larosière report published in late February 2009. According to the authors of the report, it should be required that "***all Member States apply the same amount of DGS protection for each depositor***" and "***the EU cannot indeed continue to rely on the principle of a minimum coverage level, which can be topped-up at national level***" [de Larosière *et al*. 2009]. The authors considered this principle as presenting some important flaws that could potentially lead to (i) applying different coverage levels to depositors within the same member state, and (ii) moving deposits from some member states to the others (these with more protective deposit guarantee schemes) (see: Annex 10). It should be noted that the latter was observed in the EU in fall 2008 when the government of Ireland introduced unilaterally full guarantees for deposits in major Irish banks and, as a result, some depositors from the United Kingdom decided to move their deposits from UK to Irish banks. Serious problems with the practical application of topping up were also observed in some EU member states during the Icelandic banking crisis [40]. Therefore, the possibility of **topping up should be abandoned**. And it will be possible in case of full harmonization of the coverage level, i.e. if a single (fixed) level is introduced in all the member states.

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Considering the above-mentioned coverage levels, one could indicate two potential solutions: (i) accepting – by all member states in the EU, including less developed countries – € 100,000 as the single standard coverage level in the EU; or (ii) accepting – by all member states, including richer countries – € 50,000 as such a level. It seems that in practice the first option would be much more likely to occur. And the second option does not seem to be feasible. Therefore, **the amount of € 100,000 could be considered as a potential future level of standard deposit insurance in the EU**. However, if this amount is regarded as too high for many member states, one could ask whether the US coverage limit could serve (or not) as a potential benchmark for the EU. Given the current euro/dollar exchange rate, the US limit of standard deposit insurance is somewhere between the above-mentioned amounts of € 50,000 and € 100,000 (for example, according to the ECB data, as of end-December 2008 and end-April 2009, the US limit of $ 100,000 was equal to about € 71,900 and € 75,200 respectively). Of course, there is no need to adjust the EU coverage level exactly to the US one, but perhaps it could be helpful for setting a **compromise limit for the EU** – somewhere between € 50,000 and € 100,000, e.g. at the level of € 75,000. Although it would be rather difficult for the EU member states with higher coverage limits (e.g. Italy or Benelux countries) to accept this limit, it could be seen as an alternative to existing two different limits within the EU. Perhaps it would be easier to accept it, if it is decided that the suggested limit of € 75,000 would be **a temporary measure** prior to adopting – after a relatively short transitional period – the ultimate solution, i.e. € 100,000 as the single limit of standard deposit insurance in the EU. But it seems that such a temporary measure would unnecessarily complicate the system and it should not be recommended. Therefore, **the EU should adopt as soon as possible the ul-**

[40] In early October 2008, after the collapse of the Icelandic bank Landsbanki, most of 300,000 British depositors at Icesave (the UK branch of Landsbanki) expected deposit payouts from the FSCS. However, the FSCS informed that it is only responsible for "top-up" payouts to customers of Icesave, i.e. amounts between € 20,887 (the coverage limit of the Icelandic government's deposit protection scheme) and £ 50,000 (the new compensation limit of the FSCS). The amounts up to € 20,887 should have been paid out by the Icelandic scheme, but the government of Iceland refused to honor its international obligations, i.e. declared deposit guarantees only for depositors in Iceland, but not for those at foreign branches of Icelandic banks (which was clearly in contradiction with the directive 94/19/EC). Similar problems were observed in the Netherlands at the Dutch branch of Landsbanki with about 120,000 depositors.

timate solution, i.e. € 100,000 as the single (fixed) coverage level (which would cover most of eligible deposits).

Despite what limit (e.g. € 50,000, € 75,000, € 100,000, or another one) will be finally adopted in the EU after the current financial crisis, one important issue should be emphasized. Prior to the crisis, the European Commission – having received feedback from the EU member states – was of the opinion that possible changes to the minimum guarantee level, i.e. its (substantial) increasing, could only be considered in the much longer term. And until then, as long as coverage levels have not been harmonized, the topping-up arrangements should be used within the EU [Commission 2006]. Thus, it seemed it was not recommended for the EU to increase substantially the minimum guarantee level until economic conditions (income levels, general welfare of societies) are more comparable in the EU countries – thanks to the strong catching up process in the new member states. However, the crisis proved to be a strong trigger for making decisions that seemed to be impossible before (just a few years earlier). Therefore, the Commission should regard it as a turning point and use this opportunity to propose by the end of 2009 a more ultimate approach to the coverage limit in the EU to replace the present one (still transitional).

As it is known and confirmed by the current financial crisis, emergency situations require prompt actions, also in case of deposit insurance (e.g. increasing the nominal coverage limit in order to maintain depositors' confidence and avoid bank runs). In this context, in October 2008, the European Commission proposed that, in principle, changes of the coverage level should be subject to the standard comitology procedure. In fact, it is much more simplified and less time consuming in comparison with the standard co-decision procedure (i.e. adopting a directive by both the EU Council and the European Parliament), but in emergency situations – if depositors' confidence of in the financial market's safety is at issue, and prompt and coordinated action would be needed in the EU – it may not be enough. Therefore, according to the Commission, it is critical for the EU to have an urgency procedure to act quickly if needed [Commission 2008c]. In general, keeping in mind the recent experience with amending the Directive 94/19/EC (that included an urgent increase of the coverage level), the above proposal seems to be justified and recommended for the EU. And one should agree with the Commission that such an emergency measure should be restricted to a given period of time, i.e. upon its introduction it should be specified when this extraordinary measure (higher deposit guarantees or blanket guarantees) will be over. It should be long enough but not too long (it seems that no longer that 18 or 24 months) and it must be clearly communicated to depositors. This would be a kind of the so-called "exit strategy" that is crucial to allow for limiting moral hazard and maintaining market discipline.[41] As argued by some authors, if there is no credible "exit strategy", government guarantees once implemented could be hard to withdraw – as confirmed by Japan's experience during the financial crisis in the late 1990s [Schich 2008]. Despite the above arguments, the Commission proposal on introducing the urgency procedure for the adoption of a temporary increase of the coverage level has been rejected by the EU Council and the European Parliament [EU 2009a]. Nevertheless, it seems that this issue should be considered once again in the future – in order to avoid such ad hoc measures and uncoordinated (or, simply speaking, chaotic) actions like those undertaken by the EU member states at the turn of September and October 2008.

Speaking of the nominal coverage level, some further issues – that could be regarded as exceptions from the standard coverage limit – should be considered in the EU:

[41] As suggested by the Basel Committee and the IADI, "*when a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard*." [BCBS and IADI 2009].

• permanently higher coverage for certain types of deposits (retirement accounts);

• unlimited (full) coverage for all deposits;

• higher or unlimited coverage for so-called temporary high balances.

The first of the above-mentioned issues is **permanently higher coverage for certain types of deposits, i.e. retirement accounts** (as introduced by the US legislation in 2005 – see: Section 2.4). Taking into account the ageing of populations in Europe and the importance to ensure financial safety for retirees, it seems it could be recommended for the EU to introduce a higher coverage level for retirement accounts. The nature and purpose of retirement accounts are essentially different in comparison with standard current (checking) accounts in banks, so there is a rationale to treat the former and the latter in a different way (but there must be clear and legally binding definitions of these types of accounts). **Retirement accounts need stronger protection since they are intended to ensure financial means for the period when depositors will have limited (or none) opportunities to replenish them in case of a financial loss (stemming from a bank failure)**. For example, it could be two times higher than the minimum guarantee sum of € 75,000 or 100,000 (i.e. € 150,000 or € 200,000). It would be a similar solution to the US one, stipulating that the standard limit is $ 100,000 while the coverage level for retirement accounts is $ 250,000. **Even if currently special retirement accounts in the EU are not as popular as in the US, their special treatment in the directive (i.e. higher protection) could prompt the development of this type of bank products**. It does not seem that a permanently higher coverage limit for retirement accounts could obstruct the single approach adopted for the EU; it should rather be perceived as an exception confirming the single EU coverage limit. But the question is whether the EU could afford it (especially the new member states). If this is not an option in the short or medium term, it could be considered in a longer perspective.

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Another issue is **unlimited (full) deposit insurance coverage**. First, in some member states, there are so-called **mutual guarantee schemes** which offer unlimited guarantees to their member banks. In the context of the proposed single coverage level in the EU, their existence seems to be questionable (it is argued that the same coverage limit should apply to all banks in the deposit insurance system [BCBS and IADI 2009]). Moreover, in fall 2008, in response to the financial crisis, some governments – explicitly or implicitly – significantly extended deposit guarantees. However some member states adopted relevant legislation stipulating unlimited deposit coverage (Austria, Denmark, Slovakia, Slovenia), while some others made only political declarations on full deposit guarantees, which were not followed by any legislative action at that time (Germany, Greece, Hungary) (see: Figure 5.1 and Annex 7). Anyway, such unlimited guarantees of all deposits are being criticized since they may give rise to moral hazard and/or it may not be clear how the unlimited coverage (either explicit or implicit) would relate to the deposit guarantee arrangements in a given country [Schich 2008]. Therefore, such measures should be withdrawn once the crisis seems to be over.[42]

Finally, there is also **higher or unlimited deposit insurance coverage of some specific types of deposits**. For example, in early October 2008, the US introduced temporarily (until end-2009) full coverage of non-interest bearing transaction accounts (see: Section 3.2). This US solution seems to be interesting and it could be considered in the EU (at least to some extent). In this context, it should be noted that there was a proposal to put in the

[42] It is argued that unlimited coverage should not be withdrawn too early, i.e. not earlier that the financial system is resilient enough again. However, it should not be withdrawn too late as well, because if governments wait for complete addressing or reforming all deficiencies in their economies and/or financial systems, blanket guarantees could become entrenched [FSF 2000; Schich 2008].

draft directive amending the Directive 94/19/EC provisions stipulating that the standard coverage limit shall not preclude the retention of provisions which offered, before 1 January 2008, notably for social considerations and for temporarily increased account balances, not exceeding one month, a full coverage for certain kinds of deposits. But it was questionable because of the suggestion that it only covers existing arrangements and the one-month time limit, and it was regarded as entirely insufficient for almost any kind of the so-called temporary high balances. Therefore, the above proposal has been changed and in the final text of the new Directive 2009/14/EC, there are provisions stipulating that the standard coverage limit "*shall not preclude the retention of provisions which offered before 1 January 2008, notably for social considerations, full coverage for certain kinds of deposits" and that "the Commission should assess, by 31 December 2009, whether full coverage for certain temporarily increased account balances should be maintained or introduced*" [EU 2009a].

The above provisions were included into the new directive as some of the EU member states (e.g. the UK) had established or planned to establish deposit guarantee schemes providing full coverage for certain temporarily increased account balances. As argued by the UK authorities in fall 2008 and spring 2009, **temporary high balances can arise from a number of different types of life events** including, for example, the following ones:

- sale of a house (primary residence);
- pension lump sum payments;
- inheritance payments;
- divorce settlements;
- redundancy payments;
- proceeds of pure protection contracts;
- court awards and out-of-court settlements for personal injury.

It seems that a relatively great number of people may find themselves at some point (such as the period between selling one property and buying another, or immediately after receiving an inheritance or a pension lump sum) with deposits in their accounts that significantly exceed the coverage limit. Such consumers should be regarded as being in a completely different position to those with permanent high balances [FSA 2008a].

In this context, in March 2009, the UK authorities stated that the simplest solution would be to apply no upper limit or a single limit for all types of protected temporary high balances, but in practice, such a single limit would be too high for some cases (e.g. inheritance payments) and too low for other cases (e.g. personal injury cases where a court award or out-of-court settlement may be intended to provide an income for the whole of the injured person's life). Therefore, the FSA considers introducing the following limits:

- a monetary limit;
- a time limit.

As far as the **monetary limit** is concerned, the UK authorities are of the opinion that it should be set at the level of **£ 500,000** (i.e. 10 times higher than the current standard coverage limit). The limit of £ 500,000 would apply to all of the above temporary high balances with the exception of the latter, i.e. court awards and out-of-court settlements for personal injury, where should be **no upper limit** (because they may be intended to provide for the whole of an injured person's life). It would apply to the total claim in respect of the original payment irrespective of whether the lump sum was paid into a single bank account, a joint account, or more than one account (but it would not apply to any interest that had accrued since the beneficiary(-ies) received the original payment). The limit would apply both to the balances held in client accounts and in consumers' own accounts. In case of inheritances, it would apply separately to each identified beneficiary (see: Box 5.1).

As far as the **time limit** is concerned, the FSA considers that **6 months** would be appropriate. In their opinion, in the vast majority of cases, it would be a generous period of time that would allow consumers enough (or even more than enough) time to decide what to do with their temporary high balances, including taking advice, etc. But in some cases, such as court awards or out-of-court settlements for personal injury, six months may not be sufficient to assess how the money should be allocated (taking into account that these payments may be intended to provide an income for the rest of the injured person's life, and it may take time for the person's condition to stabilize). Therefore, the FSA is of the opinion that a longer (but not unlimited) period of time seems to be more appropriate, and for that reason, it suggests to extend it up to **18 months** [FSA 2009c].

As argued by the UK authorities, any rules on temporary high balances are ultimately dependent on responses to the public consultation (launched by the FSA in Mach 2009) and discussions at the EU level (expected in the second half of 2009). If a harmonized (fixed) limit is introduced to the EU directive (e.g. € 100,000), the EU member states will not be able to apply higher protection for temporary high balances – unless it is agreed at the EU level that an exception should be permitted for them [FSA 2009c]. Therefore, taking into account the above arguments and conditions, it seems that **there should be higher coverage for temporary high balances (existing and future ones), such balances should be non-interest bearing, and there should be time limit in this regard.** It should be decided what types of temporary high balances would be covered (rather not all suggested by the UK, but only the most important ones, i.e. sale of a house, and perhaps pension lump sum payments). Another problem may be setting a monetary and/or time limit for such balances that would be appropriate for all member states. Taking into account current house prices in the EU (as well as pre-crisis and possible post-crisis prices), it seems that e.g. € 500,000 would be sufficiently high to be relevant for all member states. And a time limit should be rather short but not too short (e.g. a few months) in order to allow depositors relevant managing their funds, e.g. buying a new house, splitting deposits up, etc. In general, it does not seem that such a solution – if properly balanced (i.e. if there are neither too few nor too many circumstances eligible for higher coverage, and all of them are explicitly listed in the directive) – would undermine the standard coverage limit (a common fixed limit for the EU). Therfore, the US and UK solutions related to full/higher coverage for some transaction accounts and temporary high balances could be partially recommended for the EU, but – contrary to the US – it should not be a temporary but rather permanent solution.

**Box 5.1 Examples of the proposed new protection for temporary high balances in the UK**

| | |
|---|---|
| **Example 1 – consumer has £ 60,000 in own account and £ 400,000 in client account following house sale** | |
| Standard deposit limit | covers £ 50,000 of the amount in the consumer's own account |
| Proposed new protection for temporary high balances | covers full £ 400,000 in client account |
| Total amount payable | £ 450,000 |
| **Example 2 – consumer has £ 180,000 in own account following receipt of pension lump sum of £ 100,000 and £ 600,000 in client account as a result of inheritance** | |
| Standard deposit limit | applies to first £ 50,000 of the £ 80,000 in own account that not due to the pension lump sum |

| | |
|---|---|
| Proposed new protection for temporary high balances | covers full £ 100,000 pension lump sum and the first £ 500,000 of the £ 600,000 in client account |
| Total amount payable | £ 650,000 |
| **Example 3 – couple have £ 700,000 in client account following house sale and £ 120,000 in own joint account** | |
| Standard deposit limit | the couple both benefit from protection of £ 50,000, so limit covers £ 100,000 of amount in joint account |
| Proposed new protection for temporary high balances | applies only once to a house sale, irrespective of number of owners, so covers £ 500,000 |
| Total amount payable | £ 600,000 |

Source: FSA 2009c.

Summing up the above considerations, and taking into account the current EU proposals on the coverage level as well as some solutions applied in the US and considered in the UK in recent years, one could suggest the following coverage levels in the EU:

- **€ 100,000 – fixed harmonized level for standard deposits;**
- **€ 200,000 – fixed harmonized level for retirement accounts;**
- **€ 500,000 – fixed harmonized level for temporary high balances.**

The first two coverage levels would mean permanent deposit insurance while the last one – insurance limited to a certain period of time. If implemented uniformly in all member states, it would be a proper solution for the EU – ensuring level playing field for banks, transparent for depositors, etc. It seems that they could be proposed in the EU relatively soon (i.e. during the forthcoming review of the Directive 94/19/EC) or – if the member states are not ready for such rather complex changes – the above proposal could be considered at a later stage (e.g. after a few years following the introduction of the fixed coverage level of € 100,000 as the first step).

The above considerations relate to the nominal coverage limit. And, as mentioned before, the issue of **deposit insurance coverage** should be discussed **in real terms** as well. Therefore, the following issues will be discussed in the last part of this subsection:

- the real coverage limit (or the real scope of coverage);
- harmonizing the scope of coverage (definition of eligible deposits/depositors);
- periodical indexing the guarantee level to the rate of inflation.

With reference to **the real coverage limit** (or **the real scope of coverage**), in the US, it is "*per account per insured bank*" and various types of consumer accounts are insured separately. As a result, in practice, the real coverage level is much higher than the nominal one of $ 100,000 (as it was argued, an average US family could hold insured deposits of even $ 2 million in a single bank). Therefore, one can say that the US approach is really generous for depositors. In the EU, however, there is a different approach in place, i.e. the coverage limit is "*per person per insured bank*". It means that all accounts of the same customer are added and the "*aggregate account*" is insured to a given coverage limit. As stated by the Directive 94/19/EC, the coverage limit "*shall apply to **the aggregate deposits placed with the same credit institution** irrespective of the number of deposits, the currency, and the location within the Community*". At the same time, as far as joint accounts are concerned, the directive stipulates that the share of each depositor in such an account should be taken into account in calculating the coverage limit (usually, if there are no special provisions, a joint account is being divided equally among its co-owners). This

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provision of the directive has not been changed by the recent reform of deposit insurance legislation in the EU. In general, **the EU approach is less costly and less complicated – therefore, of course, it should be maintained**. Perhaps it could be recommended for the US as well, but it is unlikely that it would be possible to put this idea into practice because it would de facto mean decreasing the current scope of deposit insurance in the US (and, as it is known, if people use to something, it is very hard to change it). But for sure, the US approach is not recommendable for the EU as too complex and expensive. Also, the UK suggestion that the coverage limit could be set "*per person per brand*"[43] should not be recommended as less transparent than the current approach ("*per person per bank*") and thereby more confusing for depositors.

The above issue of the optimum coverage level is an important one, but at the same time, it is also important that **more focus and efforts should be put on harmonizing the scope of coverage in the EU member states (definition of eligible deposits/depositors)**. At the moment, on the one hand, the Directive 94/19/EC includes the definition of a deposit,[44] but on the other hand, the EU member states may exclude certain deposits or depositors from guarantee or grant them a lower level of guarantee (those exclusions are listed in the annex to the directive[45]). As a result of those national discretions allowed by the directive, there are significant differences in defining deposits by the member states, which cause that **the coverage levels are not fully comparable within the EU**. The above provisions of the directive – obviously not as urgent as increasing the coverage level in the context of the current financial crisis – have not been changed by the recent reform of deposit insurance legislation in the EU. Nevertheless, this problem should be addressed later, relatively soon after the crisis (it is worth to recall that even before the crisis some stakeholders had suggested streamlining the scope of coverage and making it more coherent across the EU member states by limiting the above national discretions [Commission 2006]). Although it is rather difficult to predict precisely how the scope of coverage should be harmonized, it seems that financial institutions and large companies should be excluded (as even € 100,000 is too low for them), but it should be considered to include micro, small and medium-sized enterprises and local/municipal authorities (since the above coverage level seems to be relevant for them). Such companies and authorities should be subject to the standard (and not higher) coverage level – provided this level is sufficiently high (at least € 100,000). It would be a similar approach to that adopted in the US (see Section 4.3). Anyway, whatever is to be included or excluded, it should be subject to **full harmonization**, i.e. all insured deposits/depositors as well as all exemptions should be explicitly listed in the directive and no national discretion should be allowed in this regard.

Finally, the issue that should be recommended for the EU is **periodical indexing the guarantee level to the rate of inflation** (as it was introduced in the US by the 2005-2007 reform). It would mean an evolutionary rather than revolutionary approach to changing the coverage limit (if needed) and it would avoid ad hoc increases like it was the case in the US in the past. In this context, it should be noted that the Commission – in its recent legislative proposal on amending the Directive 94/19/EC – suggested that it should have the right to adjust the level of coverage, taking into account in particular developments

[43] Although in early 2008, in the consultation paper, the FSA stated that the compensation limit set "*per person per bank*" should continue to apply in the UK, many respondents proposed that it should be set "*per person per brand*", as it was difficult for consumers to understand the difference between a bank and the banking brands (business units, divisions, branches or trade names under which the company operates or markets its products to customers) [Bank of England / HM Treasury / FSA 2008a]

[44] "Deposit" shall mean any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution (Article 1.1 of the Directive 94/19/EC).

[45] The EU member states may exclude e.g. deposits of financial institutions, central, regional and local governments, some enterprises, deposits of a bank's own directors and managers and their close relatives, anonymous accounts, deposits in non-EU currencies, etc. (Annex I of the Directive 94/19/EC).

in the banking sector and the economic and monetary situation in the EU [Commission 2008c]. It was clarified in the new Directive 2009/14/EC that the Commission may adjust the coverage level in accordance with the inflation in the EU on the basis of changes in the **Harmonised Index of Consumer Prices (HICP)**. Since this measure is designed to amend a non-essential element of the directive, it is to be adopted in accordance with the simplified regulatory procedure (the so-called comitology procedure) [EU 2009a].

*5.1.2 Co-insurance*

There is no co-insurance in the United States. In the EU, however, the original Directive 94/19/EC stipulated that the member states may decide that **depositors should bear a certain percentage of losses themselves in case of a bank failure**. According to its provisions, the member states might limit the coverage level to a specified percentage of deposits, which had to be equal to or exceed 90% of aggregate deposits until the amount to be paid under the guarantee reached the minimum coverage limit (i.e. € 20,000). In other words, **the directive allowed for 10% co-insurance**, i.e. the EU member states which had decided to apply 10% co-insurance had to set the minimum coverage limit at € 22,222 in order to reach the minimum required level is € 20,000.

In practice, prior to the emergence of the financial turmoil in 2007, **co-insurance was applied to deposits of individual customers in 12 countries of the EU – mostly in the new member states** (Cyprus, Czech Republic, Estonia, Hungary, Lithuania, Malta, Poland, Slovakia), but in a few old ones as well (Germany, Ireland, Netherlands, United Kingdom). There was mostly 10% co-insurance. In some cases, deposits not exceeding the coverage limit were insured in 90%, while in other cases – in order to protect small depositors – deposits were insured partly in 100% and partly in 90% (e.g. in Poland, it was 100% for amounts up to € 1,000, and 90% for amounts between € 1.000 and € 22,500) (see: Annex 7).

The above provisions, perhaps very clear for professionals, did not seem to be so clear for an average depositor who had regarded that rule as opaque and misleading (from a depositor's point of view, it would have been be more transparent to insure € 20,000 in 100% than to insure € 22,222 in 90%, although in both cases the payout amount was the same). Moreover, **if co-insurance is in place, depositors may have an impression that their money is not fully safe** (indeed, some percentage of money is at risk in such a case). However, it is also argued that the lack of co-insurance may give rise to moral hazard because depositors, keeping in mind that their deposits are fully insured, would choose a bank without any assessing its soundness. But it is also argued (notably by consumer associations) that depositors are not professionals and thereby they should not be expected to assess the soundness of banks. Taking into account the above mixed argumentation and opinions of the EU member states, the European Commission stated that, at the time of reviewing the Directive 94/19/EC (2005-2006), there was insufficient support to introduce any short-term change to co-insurance rules existing in the EU [Commission 2006].

However, a year later, the experience with Northern Rock in the United Kingdom, which forced the UK authorities to abandon co-insurance in October 2007,[46] suggested

[46] In mid-September 2007, a few days after the bank run on Northern Rock, the UK Chancellor of the Exchequer was forced to announce state guarantees for all deposits in that bank in order to stop the run. Two weeks later, the FSA decided to abandon the rule existing before in the UK deposit guarantee scheme (FSCS) and stipulating that compensation was limited to the first £ 2,000 plus 90% of the deposit between £ 2,000 and £ 35,000 (therefore, the maximum payable compensation was £ 31,700, i.e. £ 2,000 + 0.9 x (£ 35,000 – £ 2,000). On 1 October 2007, the old rule with 10% co-insurance was replaced by the new one stipulating that compensation will be paid to eligible depositors on deposits up £ 35,000 equal to 100% of the loss incurred [HM Treasury / FSA / Bank of England 2007]. On 2 October 2008 – after the public consultations in mid-2008 – the FSA decided to increase the compensation limit for protected deposits to £ 50,000 on a "per person per bank" basis – effective on 7 October 2008 [Bank of England / HM Treasury / FSA 2008b; FSA 2008a].

that **the US approach – stipulating no co-insurance – was right**. If people are not convinced that their money deposited at a bank is fully safe, they will be more ready to withdraw this money (to prevent it from losing) at the first whispers of bank troubles – even if they are not necessarily true (or they are just gossips). And a bank run might involve another bank run, and such a contagion effect could threaten the stability of the entire banking system. Therefore, keeping in mind these arguments, **it was obvious that it would be recommended for the EU to abandon the existing rules on co-insurance as soon as possible**. Nevertheless, the EU provision on co-insurance had not been amended (abolished) until the global financial crises escalated spectacularly in fall 2008. Although it should be noted that in mid-2008, the Commission – keeping in mind that only 11 (out of 27) EU member states still had applied co-insurance – stated that it would be useful to assess the current level of support for this provision. And indeed, last year, the member states became much less supportive to co-insurance than during the 2005-2006 review of the Directive 94/19/EC.

The aggravation of the financial crisis in September-October 2008, and potential runs on EU banks that could not have been excluded at that time (as in the case of Northern Rock a year before), prompted making decision on **abandoning co-insurance** in the EU regulations, i.e. **ensuring that depositors' money is guaranteed in full** up to the coverage level. It seems that the EU authorities have been forced to do so like the UK authorities after the run on Northern Rock. In October 2008, the European Commission stated that co-insurance had proven to be counterproductive for the confidence of depositors and might have exacerbated the problems; and for that reason, it should be discontinued [Commission 2008c]. And, indeed, the provision on co-insurance was deleted in the new Directive 2009/14/EC [EU 2009a].



Summing up, **the provision on co-insurance was very unfortunate and it should have never been adopted in the EU legislation**. Unfortunately, it was adopted and survived 14 years. Keeping in mind that it was abandoned as a result of the current financial crisis, one could say that a crisis may have not only negative but also positive aspects.

*5.1.3 Speed of payout*

With regard to the speed of payout, **there is a substantial difference between the US and EU**. In the US, the reimbursement is near immediate, i.e. maximum a few days after a bank/thrift failure; usually, most depositors are being reimbursed **within 1-2 business days** after the closure of the failed institution (see: Sections 1.2 and 3.2). In the EU, it might have taken a much longer period of time – even **up to 9 or almost 10 months**.[47] In practice, it was **usually about three months**.[48] It still seemed to be too long. A few years ago, several months before the current financial crisis had emerged, the European Commission doubted whether in the 2000s – in an era of rapid technological progress enabling deposit guarantee schemes to trace depositors and calculate payments more easily than in the mid-1990s (when the Directive 94/19/EC was adopted) – a nearly 4-month (or perhaps even 10-month) waiting period for payouts was still appropriate [Commission 2006]. And, in mid-June 2008, keeping in mind the financial turmoil, the Commission regarded **the**

[47] Directive 94/19/EC stipulated that the deposit guarantee schemes in the EU – after making a determination by the competent authorities (within maximum 3 weeks) that a given credit institution had failed to repay deposits which were due and payable – should have been able to pay duly verified claims by depositors in respect of unavailable deposits within 3 months. In exceptional circumstances, a deposit guarantee scheme might apply for an extension of the above time limit. The competent authorities might allow for no more than two further extensions for 3 months each.

[48] According to the results of the recent survey based on experience of bank failures in the EU, over 91% of deposits have been repaid within 3 months, and this means 67% of reimbursed depositors. In the longer period of time, i.e. 9 months, the average figures are 97% and 78% respectively. About 25% of the EU deposit guarantee schemes, which have reimbursed depositors, used the option of extending the 3-month time limit [Commission 2008a].

**slowness of payouts as one of major factors which could contribute to the undermining depositors' confidence** and, in turn, to the possibility of a bank run. Of course, this was true and, moreover, one run might involve another run(s) and – creating a panic in the banking system – it might have systemic implications.

Moreover, in fall 2007 (after the run on Northern Rock), it was argued by the UK authorities that if firms and individuals were not be able to use their money deposited in a bank (possibly for several weeks or even months[49]), it might cause disruption not only to bank customers but also to firms and consumers with whom the customers of the bank interacted [HM Treasury / FSA / Bank of England 2007]. Thus, a bank failure might have negative consequences outside the banking sector, i.e. in the real economy. For that reason, and taking into account that if compensation is to be effective, protected deposits must be paid out promptly, the UK authorities started to advocate in early 2008 for **considerable speeding up payouts to one week**[50] [Bank of England / HM Treasury / FSA 2008a]. A few months later, in mid-2008, the UK authorities confirmed that they remained committed to a target of **7 days for providing the depositors of a failed bank with access to at least a proportion of their funds**, and the balance within the following few days, consistent with the aim of minimizing disruption for depositors. The UK authorities considered developing new payout processes, which might provide depositors with fast access to liquid funds, and the possibility of making **interim payments in advance of a full payout** [Bank of England / HM Treasury / FSA 2008b]. As stated by the FSA in early 2009, the UK deposit guarantee scheme (FSCS) is already able to make interim payments if there is any uncertainty about paying the full amount at a given time; the purpose of the rule is minimizing unnecessary delays by enabling an interim payment where the FSCS is satisfied compensation is payable in principle, but the final amount is unknown [FSA 2009a]. The above is important notably for large banks because, according to the study commissioned jointly by the FSA, FSCS and British Bankers Association (BBA), in case of such institutions only interim payments to the majority of depositors would be feasible within 7 days, and final settlement is likely to fall outside the 7-day target period due to a large number of bank accounts in large banks and many customers who need to be contacted before final payments could be made (in case of smaller and mid-sized banks and credit unions, the majority of depositors should be paid out within 7-10 days) [Ernst & Young 2008].

Therefore, the proposed solution (considerable speeding up payouts – thanks to, *inter alia*, the recently adopted special resolution regime for banks – see: Subsection 5.3.1) would make the UK rules more similar to the US ones in terms of the speed of payout. Although the US speed of reimbursement seems to be unattainable for the EU, the UK approach was a step in the right direction and a good example for the EU as a whole. Although, prior to the financial crisis, it was argued that some progress related to the speed of payouts could have been achieved without the necessity to amend the Directive 94/19/EC – by tackling the existing obstacles (notably, the access to data on deposits)[51] to speed up payouts at the national level, it was obvious that the directive should have not allowed for such a long period of time for payoffs as it had been the case before the crisis. Therefore, **it was recommended for the EU to shorten substantially the directive's maximum deadline for payouts after a bank failure, and especially the number and length of**

[49] According to the consumer research report of September 2008, respondents estimated that they would be able to operate without access to their bank account from a few days up to one or two months [FSA 2009a,b].

[50] Before, the the UK deposit guarantee scheme (FSCS) processed most simple deposit claims within 4 weeks (with hardship cases taking top priority) and complex and/or large cases could be processed within a longer period of time [HM Treasury / FSA / Bank of England 2007].

[51] During the recent survey, the EU deposit guarantee schemes were asked to identify factors influencing the speed of payouts – such us, for example, bilateral/topping up arrangements, access to data on deposits, immediate availability to funds, trained workforce, etc. Around half of the schemes stated that all the above factors can be potentially influential. Nevertheless, the access to data on deposits has been identified as the most important cause influencing the speed of reimbursements [Commission 2008a].

**possible extensions** (it seemed that the 3-month deadline could have potentially been shortened to 1 month). It was particularly important in the context of a potential cross-border banking failure within the EU, which would need payouts by the deposit guarantee schemes in several member states (and all depositors should be paid out in a similarly timely manner). Therefore, **in the light of the financial turmoil, the decisive amendments to the directive's provisions on payoffs seemed to be not only recommendable for the EU but simply inevitable**.

In mid-October 2008 – after the aggravation of the financial crisis – the European Commission stated in its legislative proposal to amend the Directive 94/19/EC that the payout delay of 3 months, which could be extended to 9 months, had been detrimental to the confidence of depositors and had not met their needs. The Commission stated that most depositors – having no access to their deposited money – could be expected to suffer significant financial difficulties already within less than one week. Therefore, **according to the Commission, the payout delay should be reduced to 3 days without a possibility extension**. However, this deadline should commence only when the competent authorities make the determination (within 3 days as well) that a given credit institution appears to be unable to repay deposits[52] [Commission 2008c]. This proposal – similarly like the above-mentioned UK proposal – would have made the EU provisions on the speed of payout more similar to the US ones. However, as one could expect, it proved to be unacceptable for the EU member states, and given the significant time pressure to reach a compromise, **the original Commission's proposal was softened**, i.e. it was finally agreed and included in the new Directive 2009/14/EC [EU 2009a] that eligible deposits will be paid out after a bank failure according to the following rule: **5+20+10 working days**, i.e.:

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- competent authorities shall make the above determination at the latest **5 working days** after first becoming satisfied that a credit institution has failed to repay deposits which are due and payable;

- deposit guarantee schemes shall be in a position to pay duly verified claims by depositors in respect of unavailable deposits within **20 working days** of the date above determination;[53]

- in exceptional circumstances, a deposit guarantee scheme may apply to the competent authorities for an extension of the time limit, which may not exceed **10 working days**.

It should be noted that the Directive 94/19/EC used to set deadlines for payoffs in "days" while the new Directive 2009/14/EC – in "working days". Therefore, the deadline for making determination has not been reduced almost four times (as it could appear on the first glance) but *de facto* three times – from three weeks to one week. Similarly, 20 working days is *de facto* about a month, so this deadline has been reduced three times as well – from three months to one month.

It should also be noted that the new EU provisions on payouts stipulate that guaranteed deposits should be paid out in full within the new (shorter) deadlines, but there are still no relevant provisions that could potentially reduce the payout delay. First, it is still allowed to set off customers' deposits against their loans in the same bank. It seems that **set-off arrangements should be abandoned** – similarly like co-insurance since both provisions

[52] As stated by the Commission, "*the deadline should commence only when either the competent authorities have determined that the credit institution appears to be unable to repay the deposit or a judicial authority has ruled that the claims of depositors are suspended. The decision of the competent authorities may take up to 21 days after first becoming satisfied that a credit institution has failed to repay deposits. In the interest of a rapid payout, this period of 21 days should be reduced to 3 days*." [Commission 2008c].

[53] This time limit includes the collection and transmission of the accurate data on depositors and deposits, which are necessary for the verification of claims [EU 2009a].

were/are unfair for depositors; set-off is even much more harmful as bank customers might lose all deposited money if their loans exceed their deposits in a given bank (and it might cause hardship in some social groups). Set-off is also very complex and time consuming and, in turn, it may contribute to slowing down the payout process. As argued by some authors, set-off becomes more complex where the deposit insurer and the receiver/liquidator of the failed bank are separate entities (like in the EU) than where there is no deposit guarantee scheme or the scheme is also the receiver (like the FDIC in the US) [Garcia 2000]. Moreover, there are **no provisions assuming the above possibility of making interim payments in advance of the full payout** (like proposed by the UK). On the one hand, it seems that the UK approach could be recommended for the EU keeping in mind that – as mentioned above – the Commission shares the view of the UK authorities that most depositors can be expected to suffer significant financial difficulties already within less than one week, and if they are not be able to use their money deposited in a bank for several weeks/months, it may be disruptive not only to them but also to firms and consumers with whom they interact. On the other hand, however, one can argue that the preparation of interim payments may be as time consuming as the preparation of the final payout (and *de facto* it would require deposit guarantee schemes to do practically the same work twice). Even if this is true (at least to some extent – because the claim verification made for interim payments does not need to be repeated; only the reimbursement should be made twice), it should also be taken into account that introducing interim payments – similarly like abandoning set-off – may be an important tool to avoid hardship in some social group.

Of course, the above issues are not the only ones contributing to a rapid payout – it depends on many factors, notably on early access of deposit guarantee schemes to relevant data on deposits (see: Subsection 5.3.1). Anyway, it seems that **the recently adopted payout delay (20 working days) is not the ultimate solution for the EU (although it has made significant progress compared to the past), and therefore, it should be further reduced in the future**. It should be as short as possible, although it is rather impossible to introduce the US standard in the EU (since e.g. the FDIC – contrary to the European schemes – has much broader mandate that contributes to a fast payoff similarly like a long pre-closing period in the US).

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## 5.2 Recommendations on the issues to be discussed in the EU in the nearest future (2009-2010)

Aas mentioned before, the Commission proposal of October 2008 (being a basis for the Directive 2009/14/EC adopted in March 2009) was regarded by the de Larosière group as an important step to improve the protection of depositors and, in general, the existing regime of deposit guarantees (see: Section 5.1). At the same time, however, it was clearly stated that the amended directive still leaved a significant degree of discretion to the member states (notably in such areas as funding arrangements, administrative responsibility, the role of deposit guarantee schemes in crisis management), and leaving these issues unresolved at the EU level would imply that significant weaknesses remained in the EU deposit insurance framework (including, for example, unsustainable funding, limited use in crisis management, negative effects on financial stability, obstacle to efficient crisis management, etc. – see: Annex 10) [de Larosière et al. 2009].

Also, the EU institutions recognized the need to make further reforms of the EU deposit guarantee schemes. In the new Directive 2009/14/EC, they have indicated some further areas to be discussed a little bit later but quite urgently in the EU. In its legislative proposal of mid-October 2008 [Commission 2008c], the Commission committed itself to submit to the European Parliament and the Council, by 31 December 2009 at the latest, a report on:

- potential harmonization of the funding mechanisms of deposit guarantee schemes;

- potential introducing a pan-EU deposit guarantee scheme.

Finally, in the Directive 2009/14/EC, the list of matters to be analyzed by the Commission and reported to the European Parliament and the Council by end-2009 had been substantially extended and included not only the above issues proposed by the Commission, but also a number of additional ones, including, *inter alia*, the following items:

- potential providing full coverage for certain temporarily increased account balances;

- potential models for introducing risk-based contributions.

If necessary, the Commission will prepare appropriate legislative proposals including relevant amendments to the Directive 94/19/EC, which will be discussed by the EU member states in 2010 [EU 2009a].

The issue of full coverage for temporary high account balances has already been discussed in the previous section (see: Subsection 5.1.1). The other issues – potential introducing risk-based premiums, harmonization of the funding mechanisms, and a pan-EU deposit guarantee scheme – will be discussed in this section.

*5.2.1 Risk-based contributions*

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The modification of risk-based premiums/contributions was the key element of the 2005-2007 reform in the United States. As argued before (see: Section 2.2), there are well-built rationale and logic in favor of such premiums to be paid by all banks. And none of them should be exempted from this obligation since every single bank poses some (smaller or bigger) risks which may be dangerous for the banking system as a whole.

According to the Directive 94/19/EC, **the introduction of risk-based contributions is not mandatory but voluntary for the EU member states**. Thus, they are free to introduce (or not) risk-based elements in their deposit guarantee schemes. In November 2006, the European Commission expressed its support for risk-based methods to calculate contributions and recommended that the determination of risk should be based on already available and harmonized tools (such as, for example, those within the Capital Requirements Directive – CRD [EU 2006; 2009b]). The Commission indicated **further harmonization** in this respect as a potential solution for the EU but, at the same time, it noticed that it would clearly require some legislative steps (i.e. amending the Directive 94/19/EC) and, taking into account their complexity, it would not be a short-term project but rather a longer-term one. Moreover, **harmonizing risk-based methods for contributions should follow relevant progress on harmonizing funding mechanisms** [Commission 2006]. Therefore, the Commission's position was mixed. On the one hand, the Commission was in favor of the introduction of risk-based premiums, but on the other hand, it seemed to be rather reluctant to propose concrete legal amendments to the existing provisions at the moment (taking into account mixed results of the public consultation[54]).

In practice, the situation is mixed in the EU. There are just **a few deposit guarantee schemes in the member states that apply risk-based contributions** according to the individual risk of credit institutions (see: Annex 8). Some others use monitoring

[54] The Commission stated that public consultation had revealed differing opinions about whether the existing deposit guarantee arrangements were in need of change. On the one hand, there were opinions that the existing framework should be changed (taking into account existing competitive distortions, potential obstacles for effective cross-border crisis management, etc.). On the other, there were arguments against changing the present stage (mostly due to the high costs entailed) [Commission 2006].

systems to screen their members' activities (by collecting both quantitative and qualitative information on their financial situation and risk profile) in order to recognize the need for intervention and decide on possible preventive measures. According to the European Commission's data (from the 2007 survey), only eight schemes from six member states (Germany, France, Italy, Portugal, Finland, and Sweden) adjusted contributions of all their members, taking into account information on their risk profile. The other two schemes (in Hungary and Romania) make slightly different use of risk-based information, i.e. they do not correct contributions of every member, but may increase just some of them on the basis of the members' risk profile. There is also an example of the scheme (in Poland) that does not adjust contributions using risk-based indicators, but the contribution base includes some risk-related variables (e.g. risk-weighted total balance-sheet assets, guarantees and endorsements, and the remaining risk-weighted off-balance sheet liabilities) [Commission 2008b]. On the one hand, the above data confirm that risk-based contributions are not very popular in the EU, but on the other, it is impossible to say that the EU has no experience in this respect.

The **risk-based methods and approaches applied by the EU deposit guarantee schemes (to adjust their contributions to risk profiles of banks) are quite diverse**. Some of them are quite simple (e.g. a single solvency/capital indicator is used in Portugal and Finland) while others are much more comprehensive (e.g. in France and Italy several indicators are aggregated applying a weighting system). However, as indicated by the Commission, one can observe **a common principle behind the diverse adjustment procedures**: the contributions are adjusted by decreasing/increasing them by a percentage obtained by classifying a given bank into rating classes, linked to the scores from a set of indicators. Across the EU schemes, **the reduced risk-based contributions range from 75% to 90% of the standard amount while the increased ones vary between 120% and 140% of the standard premium** [Commission 2008b]. It seems that this common principle would serve in the future as a basis for elaborating a common (harmonized) approach to risk-based contributions in the EU. And working on this, the EU institutions and member states should keep in mind some recent international core principles proposed for effective deposit insurance systems, including the rule that the criteria used in the risk-adjusted premium system should be transparent to all participants [BCBS and IADI 2009].

Another issue is related to the question whether actual risk-based contributions imposed on banks should be publicly disclosed or not. For example, the UK authorities are concerned about some potential difficulties in applying risk-based levies, i.e. the necessity to publish regulator/supervisor's view on the relative risks attached to particular financial institutions, which could have adverse consequences for the institution concerned (an increase in the levy – in order to reflect a perceived change in risk – could be regarded by market participants as a signal confirming actual or forthcoming troubles of that institution; and, finally, it could become a self-fulfilling forecast). However, it is argued that a proper balance is necessary between the need to promote transparency, accountability, and discipline through public disclosure and the need to ensure confidentiality. This balance may be achieved by a policy of partial transparency (applied, for example, in the US), which assumes that **the basic framework and criteria for risk-based contributions are disclosed to the public, but the actual ratings or premium categories are confidential**, i.e. they are only disclosed to the board of directors and management of the bank (in such cases, banks are prohibited from disclosing their premium category and any rating on which that classification is based) [IADI 2005]. Also, some other authors agree that risk-based premiums should not be disclosed to the public on an individual-bank basis [Garcia 2000].

In 2008, the authorities of the UK – where there were no risk-based premiums prior to the current financial crisis – stated that they would be seeking views on the **advantages and disadvantages of introducing risk-based levies**. Public consultations showed mixed views of respondents on this issue. On the one hand, some of them indicated advantages in risk-based levies in giving incentives to banks to improve risk management. On the other hand, some others expressed their concerns about maintaining the confidentiality of risk assessments, possible duplication of arrangements for prudential regulation, adverse effects on competition (if risk-based premiums inhibited the ability of smaller banks to compete), etc. Some respondents stated that the introduction of risk-based levies could be facilitated by the introduction of pre-funding (see further part of this subsection) [Bank of England / HM Treasury / FSA 2008a,b]. Although nothing has been decided yet, it is worth to note the UK authorities' interest in the introduction of risk-based premiums. It seems to be a direct result of the current financial turmoil that hit the UK seriously. And keeping in mind that the UK financial supervisory authority (FSA) operates a risk-based approach to supervision, one could state that it seems to be quite logical to apply analogous approach for the UK deposit guarantee scheme (FSCS). If the UK authorities decided to introduce risk-based levies in the future, it would be a similar approach to that in the US where both banking supervision and deposit insurance are risk-based. Of course, taking into account the subprime crisis, the US approach is not ideal, but this is related rather to supervision than deposit insurance which – especially after the 2005-2007 reform – can be recommended for the EU member states as a potential reference.



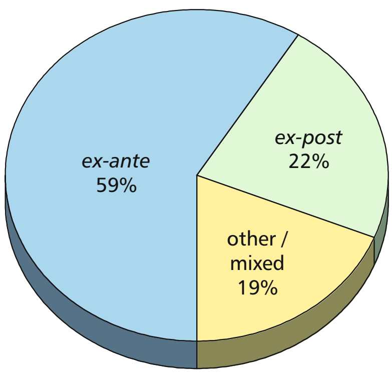
Speaking of supervision, it should be recalled that there are often complaints about paying little or no attention to **the interrelation between deposit guarantees and supervision**. Some authors argue that the closest policy-makers have been to this issue, is considering the need of risk-based contributions to deposit guarantees, but premiums are often based only on the riskiness of individual banks and volume of deposits, without regard to the quality and effectiveness of prudential supervision [Hardy and Nieto 2008]. Therefore, if risk-based contributions are introduced in the EU, it seems that there should not be a separate set of indicators for deposit guarantee schemes to assess risks of banks and then impose premiums based on this assessment. Instead, **deposit guarantee schemes – in order to assess the riskiness of banks and impose risk-based contributions – should mostly or entirely rely on relevant risk measures and indicators used regularly by supervisors** and perhaps on some other additional sources (similarly, like the FDIC relies on the supervisory CAMELS system and assessments of the major rating agencies). However, it would first require to achieve much greater supervisory convergence among EU supervisors than it is the case today (hopefully, it will be achieved relatively soon thanks to the planned establishment of the new EU supervisory framework – the ESFS).

Summing up, it seems that, **in principle, risk-based premiums should be mandatory for all member states in the EU** – notably, taking into account the current global financial crisis. As mentioned before, risk-based premiums make a deposit insurance system fairer by limiting the subsidization of riskier institutions by safer ones (see: Sections 2.2 and 3.3). Nevertheless, risk-based contributions – which can be introduced by the EU member states on a voluntary basis – are not very popular in the EU. However, the EU has some useful experience in applying risk-based premiums since there are about ten deposit guarantee schemes using (fully or to some extent) risk-based adjustments of contributions paid by member banks. Despite the diverse adjustment procedures there is a common principle in this respect. All these factors could potentially serve as a basis to elaborate **a harmonized model for applying risk-based contributions within the EU** (which, however, should be **flexible** enough to be tailored to specific national circumstances). Of course, the experience of some non-EU countries (e.g. the US) may be useful as well and should be taken into account (notably, risk-based contributions should be projected and aimed at **avoiding procyclical effects**). The first step in this direction would be the Commission's report on possible models for introducing risk-based contributions (expected in 2009) and then relevant amendments to the Directive 94/19/EC on risk-based contributions. The legislative action is required if risk-based premiums are to be mandatory in the EU. The present financial crisis proved to be a good trigger that prompted some necessary amendments to the Directive 94/19/EC and the EU institutions should use this opportunity to make further changes to the directive. It seems that the amendments on risk-based contributions should be adopted relatively soon (in order not to lose the reform momentum), but the implementation of the new provisions should not be required immediately but rather gradually (within a few years after the adoption of the amended directive). This would be more acceptable for the EU member states.

### *5.2.2 Funding mechanisms*

There is a pre-funded (or ex-ante funded) scheme in the United States while **the situation in the EU is heterogeneous** (see: Figure 5.2). First, there are ***ex-ante* funded** deposit guarantee schemes where regular contributions are collected (in 16 countries). However, it should be noted that (i) regular contributions do not rule out extraordinary contributions in case the fund is insufficient to cover intervention costs, and (ii) some *ex-ante* schemes in the EU suspend collecting contributions once a specified target for the fund is reached (as this is the case in the US). Next, there are ***ex-post* funded** deposit guarantee schemes with no regular contributions for interventions (in 6 countries).[55] Finally, there are some schemes (in 5 countries) that can be classified neither as pure *ex-ante* nor as *ex-post* ones – so-called **mixed systems**[56] [Commission 2007a]. However, one could regard mixed systems as *de facto ex-ante* ones since they collect at least some contributions in advance.

**Figure 5.2 / Table 5.1**
**Selected data related to the *ex-ante*, *ex-post* and mixed deposit guarantee schemes in the EU (2005)**




27 member states = 100%

| Category | Coverage ratio | Member state | % of EU eligible depositis |
|---|---|---|---|
| Ex-ante and mixed schemes | | | |
| High | > 1.5% | BG, EE, LT | 0.29% |
| Medium | 0.5 - 1.5% | GR, ES, HU, LV, PT, RO, SE | 14.52% |
| Low | 0.1 - 0.5% | BE, CZ, DK, FR, IE, PL, FI | 24.47% |
| Very low | < 0.1% | CY, MT | 0.51% |
| Ex-post schemes | | | |
| Ex-post | – | IT, LU, NL, AT, SI, UK | 33.70% |
| Other | | | |
| Deficit | – | SK | 0.15% |
| N.A. | – | DE | 26.36% |

Source: Commission 2007a (figure); Commission 2008a (table).

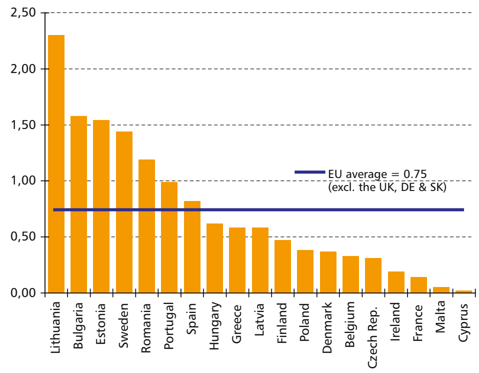
[55] The EU member states with the ex-post schemes are: Italy, Luxembourg, the Netherlands, Austria, Slovenia, and the United Kingdom.

[56] In particular, the Polish scheme can be regarded as a mixed system since *ex-ante* contributions are levied in advance for an assistance fund and *ex-post* contributions are gathered for compensation purposes in case of a bank failure. The other mixed deposit guarantee schemes are in Denmark, Romania, Cyprus, and Malta.

**Table 5.2 / Figure 5.3**

**Coverage ratios in the EU member states with the *ex-ante* and mixed deposit guarantee schemes (2005)**

| Old member states | Coverage ratio (%) | New member states | Coverage ratio (%) |
|---|---|---|---|
| Sweden | 1.44 | Lithuania | 2.30 |
| Portugal | 0.99 | Bulgaria | 1.58 |
| Spain | 0.82 | Estonia | 1.54 |
| Greece | 0.58 | Romania | 1.19 |
| Finland | 0.47 | Hungary | 0.62 |
| Denmark | 0.37 | Latvia | 0.58 |
| Belgium | 0.33 | Poland | 0.38 |
| Ireland | 0.19 | Czech Rep. | 0.31 |
| France | 0.14 | Malta | 0.05 |
| UK* | 0.001 | Cyprus | 0.02 |
| Germany** | n.a. | Slovakia*** | -0.72 |
| Average (excl. UK & DE) | 0.59 | Average (excl. SK) | 0.86 |




* The UK deposit guarantee scheme is classified as an ex-post one, but it holds a small fund inherited by a previous scheme; taking into account this ex-ante fund, the UK ratio is 0.001.
** For Germany the calculation of the coverage ratio was not possible since data on the fund size had been supplied by none of German deposit guarantee schemes for the Commission's survey.
*** The Slovak deposit guarantee scheme had a deficit for the size of the fund in 2004 (minus € 151.902.336).

Source: Commission 2008a (see also: Commission 2007a).

As far as **the size of the fund**[57] is concerned (measured by the so-called coverage ratio[58]), the situation in the EU is **very heterogeneous** as well. The coverage ratios range from very low ones (0.02% and 0.05% in Cyprus and Malta respectively) to very high ones (2.30% in Lithuania). The average coverage ratio for the new member states (0.86%) is higher than the ratio for the old member states (0.59%, or 0.53% when including the UK). The EU average coverage ratio for the *ex-ante* and mixed schemes is about 0.73% (or 0.70% when including the UK) (see: Tables 5.1 and 5.2 and Figure 5.3).

According to the results of the European Commission's consultations, it is argued that considerable (or even fundamental) **differences in funding mechanisms** of the EU deposit guarantee schemes **create competitive distortions within the EU Single Market** (unfair advantages to banks operating under *ex-post* schemes and not paying regular contributions), raise doubts about the ability of the EU schemes to function on a cross-border basis during a EU-wide financial crisis (crisis resolution and burden sharing), create obstacles for banks seeking to consolidate their operations within the EU (using the European Company Statute), etc. [Commission 2006; Commission 2008a]. Another problem is that in case of *ex-ante* funding all banks contribute to the system, while in case of *ex-post* funding failed institutions do not pay anything, which seems to be unfair. Therefore, it seems that **there is a strong need to have funding mechanisms harmonized to a greater extent in the EU**, and – keeping in mind that the majority of the EU deposit guarantee schemes are *ex-ante* ones – a more standardized *ex-ante* funded system in the EU would be a natural approach. But the EU member states with *ex-post* schemes such as, for example, the UK (and its FSCS) argue that the main reason why pre-funding has not been used in this country is the fact that a pre-funded scheme (such as, for example, the FDIC in the

[57] This is related to the *ex-ante* systems only since the *ex-post* systems with zero-size-funds are excluded by definition.
[58] Coverage ratio = size of the fund / total amount of eligible deposits.

US) is less effective because it ties up a considerable amount of resources which would otherwise be used productively in the financial system [HM Treasury / FSA / Bank of England 2007].[59] Moreover, the results from the recent years showed that **a clear majority of the EU member states did not wish to harmonize funding mechanisms** because it would imply a significant financial burden for the banking sectors in the member states operating *ex-post* systems (see: further part of this subsection). And the benefits of a more standardized *ex-ante* funded system in the EU seemed to be more difficult to quantify; it would only become apparent if the EU banking systems were confronted by a cross-border financial crisis within the EU [Commission 2006].

However, the above was stated quite a long time ago – in fall 2006, i.e. before the financial turmoil that emerged in summer 2007 in the US and quickly spread to other parts of the world, including the EU. Currently, the EU has been experiencing the above-mentioned cross-border financial crisis for several months. For that reason, in October 2008, the European Commission committed itself to prepare a **report on the harmonization of the funding mechanisms of the EU deposit guarantee schemes** and submit it to the EU Council and the European Parliament by the end of December 2009 [Commission 2008c]. The Council and the Parliament welcomed this commitment and stated that the Commission's report should address, in particular, the effects of the lack of such harmonization in case of a cross-border financial crisis (with regard to the availability of the compensation payouts of deposits, and with regard to fair competition) as well as the benefits and costs of harmonizing the funding mechanisms [EU 2009a].



In the meantime, after the 2005-2006 review of the directive on deposit guarantee schemes and before the global financial crisis in 2008, the European Commission had published the **report estimating the effects (including costs) of changing the funding mechanisms of the EU deposit guarantee schemes** [Commission 2007a], which was updated in the following year [Commission 2008a]. The Commission – having distributed a survey across the EU member states – investigated in its report potential cost implications of harmonizing the EU deposit guarantee schemes' financing systems (i.e. changes in the contributions of each scheme). The costs were examined for various scenarios.[60] Results of the 2007 report, based on eligible deposits, highlighted that a harmonized funding system representing the old member states with a higher medium coverage ratio (0.84%) would raise the contributions in most of these countries, and that representing the new member states with a lower medium coverage ratio (0.65%) would mainly influence countries with ex-post funding systems. A scenario with a low coverage ratio (0.16%) would have almost no impact on the current ex-ante systems. Finally, results showed that **choosing a harmonized *ex-ante* mechanism with a low coverage ratio would imply a significant financial burden for *ex-post* systems** – in aggregated terms, between € 3.2 and 5.4 billion cumulatively over a period of 10 years[61] (depending on how premiums are defined). And for a higher coverage ratio this cost could be much higher – up to € 25 billion [Com-

[59] It should be noted that the EU schemes which collect *ex-ante* contributions, also use their funds in a relatively productive way. Most of them (about 90%) invest their funds, mainly in government securities, short-term deposits, and other high-rated low-risk instruments [Commission 2008a]. In the US, the FDIC invests its collected contributions in government securities – mostly in US Treasury obligations [see e.g. FDIC 2008j].

[60] In the 2007 report, the Commission examined four scenarios: three *ex-ante* scenarios and one *ex-post* scenario. Two of these *ex-ante* scenarios referred to the old member states while one referred to the new member states. The *ex-ante* scenarios were characterized by different target levels for the coverage ratio – higher medium (Spain 0.84%), lower medium (Hungary 0.65%), and low (France 0.16%) – and different definitions of the annual premium. In the 2008 update, the scenarios were, in principle, the same; some of them (scenario 1 and 3) were divided into a few sub-scenarios, and the coverage ratios were slightly different (Spain 0.82%, Hungary 0.65%, France 0.14%). In both the report and the update, a comparison was achieved by choosing a funding mechanism applied in one member state and imposing it to all member states.

[61] In November 2006, the Commission estimated that a total financial burden for the member states that operated *ex-post* systems would be between € 2.5 to 4.3 billion during 10 years [Commission 2006].

mission 2007a]. Results of the 2008 update of the report were to some extent similar and to some extent different. In Scenario 1 (higher medium coverage ratio – 0.82%), the contributions would be higher in a few member states with *ex-ante* funding systems (between two to seven times to the actual contributions). Scenario 2 (lower medium coverage ratio – 0.65%) would mainly influence the member states with *ex-post* funding systems (and only five *ex-ante* schemes would slightly increase their values). In Scenario 3 (low coverage ratio – 0.14%), the majority of the member states would not increase their contributions, as their funds were sufficiently high or their current contributions higher than those required in the scenario. In general, as expected, the impact would be particularly high for *ex-post* schemes: the total annual increase for them would range between € 0.3 to 2.4 billion (Scenario 3a and 1b respectively). And considering the entire EU banking system, the impact of choosing a harmonized *ex-ante* mechanism for the EU would vary between € 0.3 to 4.1 billion, depending on the scenario [Commission 2008a]. Although the figures in the report and its update are to some extent different, they confirm the general thesis that **the impact of harmonizing the funding mechanisms (by choosing one of the *ex-ante* scenarios) would be particularly high for *ex-post* schemes**.

In spring 2008, keeping in mind, the EU authorities signed the new Memorandum of Understanding on cross-border financial stability [MoU 2008][62] stipulating some cross-border mechanisms and procedures in case of a serious cross-border financial crisis within the EU, including the division of its potential costs between the EU member states (burden sharing). It is mostly related to competences and responsibilities of supervisory authorities in the home and host member states. And, if there is a harmonized approach to financial supervision authorities in order to ensure their cooperation within the EU in case of a cross-border financial crisis, it seems that an analogous approach should be applied to deposit guarantee schemes as well. Therefore, they should be more harmonized – notably, in terms of funding mechanisms because **significant funds might be required quite rapidly in case of a financial crisis** (taking into account the need to ensure the relevant speed of payment in the EU member states hit by the crisis); and **it might be better ensured by *ex-ante* schemes**. But it should be kept in mind that none of the EU schemes (even the strongest *ex-ante* one) would be able to collect sufficient funds to be able to cope with a large cross-border banking group failure. The same is relating to all the EU *ex-ante* funds; according to the Commission, all these funds together would be able to collect about € 13 billion which is undoubtedly not enough to play an important and active role in such a cross-border crisis situation.

The issue of funding of deposit guarantee schemes had been analysed by the so-called de Larosière group that published its report in February 2009. On the one hand, the members of the group indicated that the **schemes pre-funded by the financial sector should be preferred in the EU because** "***such schemes are better to foster confidence and help avoiding pro-cyclical effects*** *resulting from banks having to pay into the schemes at a time where they are already in difficulty*". On the other hand – keeping in mind that pre-funded mechanisms might not be sufficient for very large and cross border institutions – they were of the opinion that in those cases pre-funded schemes would have to be **topped-up by the member state(s)** [de Larosière et al. 2009]. It seems that, in fact, this means supporting the above recommendation related to the introduction of a mixed (although primarily *ex-ante*) system as a standard model in the EU. And the argument related to avoiding pro-cyclical effects is *de facto* similar or even the same like that raised in the US in the early 2000s – when the FDIC indicated that premiums had been highest at the wrong point of the business cycle (i.e. slowdown or recession) and criticized the requirement that banks had been obliged to pay higher contributions (in order to cover losses of the insurance fund) when they can least afford it (see: Section 2.2).

[62] The MoU 2008 replaced the previous MoU signed in May 2005.

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It is interesting that in mid-2008 – the UK authorities [Bank of England / HM Treasury / FSA 2008b], being traditionally in favor of a post-funded (*ex-post*) deposit guarantee system – stated that there could be some **benefits from introducing pre-funding** (in a proportionate way), including:

- reducing the pro-cyclicality of levy payments (i.e. avoiding the imposition of *ex-post* levies on banks in bad times – when banks may be under financial stress because public confidence is low as a result of failures of other banks);

- reducing the risk of contagion (i.e. the risk that *ex-post* levies could weaken the position of banks to such an extent that the likelihood of their failures was substantially increased);

- allowing a deposit guarantee scheme to pay compensation in case of the failure of a smaller bank without recourse to borrowing from the central bank or government.

Taking into account the above arguments, the UK authorities – being fully aware that the domestic banking sector was opposed to pre-funding – suggested **the introduction of "an element of pre-funding" would be complemented by the provision of liquidity to the deposit guarantee scheme by the public sector in case of a significant bank failure** (by enabling the FSCS to borrow from the National Loans Fund, which would ensure that it has access to substantial amount of immediate liquidity). Pre-funding would allow spreading part of the impact over the period before any failure, while **borrowing from the public sector** would allow the cash flow impact of payout on FSCS levy payers to be spread over a longer period of time following a failure. In this context, it should be noted that the UK authorities do not propose to introduce pre-funding immediately, and the newly enacted UK Banking Act of 2009 includes provisions which could require the FSCS to establish **contingency funds** to meet potential future funding requirements (i.e. pre-funding) [Bank of England / HM Treasury / FSA 2008b; FSA 2009a].

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The above approach is *de facto* **a mixed funding system** which, as mentioned above, could be recommended for the EU. It is worth to note that the UK authorities has proposed **introducing pre-funding not immediately but gradually over time** after careful consideration, including of the cyclical position, i.e. at an appropriate time when banks do not face problems like today. This is *de facto* the US approach that was applied during the 2005-2007 reform of the US deposit insurance system (as mentioned before, the reform was proposed **at a time of very good economic and financial conditions**, such as strong economic growth, wealthy banking system, well capitalized insurance funds, etc.). It seems that the above UK approach – which is similar to the US one – could also be recommended to the other EU member states with *ex-post* systems.

Speaking of funding mechanisms in the EU, and the UK approach in this regard, one should mention **the new FSCS funding model** that was introduced in the United Kingdom last year (from April 2008 onwards). The new arrangements allow explicit **cross-sectoral subsidies** for the first time, requiring **different sectors of the financial system (e.g. banking sector) to contribute to losses incurred in another sectors (e.g. insurance sector)** in the event that any one sector has reached the maximum and it cannot afford to pay more in a given year (see: Annex 9). According to the UK authorities, the new system would provide enhanced levels of consumer protection, help maintaining financial stability, and increase the overall annual financial capacity of the compensation scheme up to a maximum of £ 4 billion [HM Treasury / FSA / Bank of England 2007]. The new funding model in the UK seems to be an interesting and unique solution. It seems to be a logical consequence of the existence of the single financial supervision authority and the single deposit insurance system in this country. And the existence of such single authorities or systems for the whole financial market is justifiable because of more and more blurring borders between different parts of the financial market. Therefore, it seems to be justifiable that in case of a crisis in – for example – the banking sector, the bank deposit guarantee system – after having reached its annual ceiling – could (or should) be supported financially by an analogous scheme (or schemes) of the other sectors (e.g. insurance or capital market).[63] However, such a solution could be recommended, in principle (but not only), for these countries that have the single financial supervision authority (like the FSA) and the single deposit insurance system (like the FSCS).[64] Moreover, **some practical experience related to the new FSCS funding model is needed** before it could be recommended (or not) for the other EU member states.

Summing up, it seems **it could be recommended for the EU to consider a more standardized mixed system (being mostly an *ex-ante* one and to some extent *ex-post* one as well)**. The system would consist of the following elements:

- **mandatory *ex-ante* funding** – the fund would be built on the basis of risk-based contributions paid by all member banks in all member states. There should be a specified target level for the fund size (e.g. a given percentage of insured deposits - being enough to cover a few small or medium bank failures); once this target level is reached, collecting contributions would be suspended – as this is the case in the US. Alternatively, like in the US, there could be a range indicating the required fund size (instead of a single target level). Anyway, if the fund fell below the target level, it would need to be replenished relatively soon (mostly in good times);

- **additional *ex-post* funding** – if needed, e.g. during a crisis situation resulting in bank failures, deposit guarantee schemes should have the right to impose some additional contributions on banks (if *ex-ante* funding is not enough). However, those extraordinary contributions could not be unlimited – otherwise they could deteriorate significantly the overall situation of sound banks (their liquidity, solvency, etc.). Therefore, a limit for maximum additional contributions should be set;

- **contingency funding / borrowing** – if necessary, i.e. when *ex-ante* and *ex-post* funds from the private sector are not sufficient, the EU schemes should have the option to borrow necessary funds from the private or public sector. There are a number of potential sources of contingency funding, including the private sector (loans or bonds, with or without government guarantees), the central bank, the government treasury or another government agency, as well as – in some cases – international organizations (e.g. the IMF or the World Bank) may be asked for help [IADI 2009b]. In fact, most of the EU schemes have such a possibility (similarly like the US FDIC), but in some cases it is not allowed (see: Annex 8 and footnote 63). Therefore, the option of borrowing should be a universal rule in all member states (however, the question is whether it should be limited or unlimited).

If all funds mentioned above are not sufficient (or not available) to cover bank failures, and there are no pan-European deposit guarantee scheme in the EU (see: Subsection 5.2.3), **government intervention** would be inevitable. However, even if it may seem quite obvious that governments should take the ultimate responsibility if deposit guarantee schemes are not able to fulfill their obligations to protect depositors, it seems that – in order to

[63] The EU deposit guarantee schemes have no such possibilities. Instead, as mentioned above, most of them (30 schemes) have the possibility of borrowing funds from the public or private sector. Only in 7 cases, it is not allowed [Commission 2008a].

[64] According to the Commission, more than half of the EU deposit guarantee schemes (20 out of 39) have no links with the investor compensation scheme in a given member state. Only in four cases, the two schemes act as a single legal entity, and in seven cases, they have separate funds managed together [Commission 2008a].

avoid moral hazard – the possibility of such government intervention should rather not be explicitly stated in law (e.g. in the directive). Alternatively, if such an option is stipulated in relevant regulations, it should also be stated that **the amounts used for government intervention in bad times should be repaid** – **in full or at least to some extent** – **by banks in good times** (however, it would require relevant burden sharing arrangements among the member states).

*5.2.3 Pan-European deposit guarantee scheme*

Taking into account that the value of covered deposits in any of the large European financial groups exceeds significantly financial resources of EU deposit guarantee schemes (*ex-ante* ones), these schemes – as they operate today – could not be used as an effective tool to resolve a serious crisis of a large EU banking group (as mentioned before, all these funds would be able to collect only about € 13 billion). Therefore, during the review of the Directive 94/19/EC in 2005-2006, the idea of the establishment of a **European Deposit Guarantee Scheme (complementary to the domestic schemes)** was proposed by the European Commission. However, this idea was rejected by most of the EU member states. But it was prior to the financial crisis when the motivation for reforms is usually rather low. Moreover, it seemed that the idea of a pan-EU deposit guarantee scheme would be feasible and desirable only if a single financial supervisory authority in the EU was introduced. And even after the current financial crisis, there was still no sufficient support for such a pan-EU scheme, but it should be noted that some member states seemed to be open to the idea of **regional deposit guarantee schemes** in countries with similar systems (e.g. funding mechanisms). According to the European Commission, it could bring many advantages, including the transferability of funds [Commission 2008a]. It might be needed during a cross-border crisis in a given region.

In fall 2008, after the aggravation of the global financial crisis, **the European Commission** – having published its legislative proposal for amending the Directive 94/19/EC – **suggested to consider once again the idea of the establishment of a EU deposit guarantee scheme**. As mentioned before, the Commission committed itself to prepare and submit to the EU Council and the European Parliament, by the end of 2009 at the latest, a report on such a pan-EU scheme. Although nothing more about it had been said in the new Directive 2009/14/EC, it is worth to note that some provisions on **cross-border cooperation of the EU deposit guarantee schemes** were introduced. As argued by the Commission, a given deposit guarantee scheme does not cover only deposits in the member state where the insured bank is authorized (home country), but it also covers deposits at the bank's branch in another member state (host country). If the host country's scheme offers a higher coverage level than the home country's one, the branch may also join the host country's scheme to offer the same coverage as the banks that are authorized in the host country. But this is not the most important. It is crucial to ensure that – whether or not the bank has joined the host country's scheme – home and host schemes cooperate with each other to guarantee rapid payouts. To this end, the Directive 2009/14/EC explicitly introduced a general obligation for the EU deposit guarantee schemes to cooperate with each other [Commission 2008c; EU 2009a]. This is in line with the recently proposed principles of the Basel Committee and the IADI that all relevant information should be exchanged between deposit insurers in different jurisdictions provided confidentiality is ensured [BCBS and IADI 2009].

In early 2009, the European Commission suggested a potential solution for addressing problems in large cross-border banking groups through the use of private funds. It was of the opinion that it would be possible by **pooling the resources of all deposit guarantee schemes** and sufficiently strengthening the funding base. It seems, however, that the EU member states are rather reluctant to this idea. Moreover, in February 2009, the so-called de Larosière group did not support this idea as well, indicating generally that setting up and management of such a fund (composed of the national deposit guarantee schemes) would bring various political and practical problems and no clear added-value in comparison with national funds operating under well-harmonized rules [de Larosière *et al*. 2009].

Currently, **after the aggravation of the global financial crisis** that hit seriously not only the US but the EU as well, **the EU member states seem to be less reluctant (although still to some extent hesitant) to the idea of the establishment of a pan-European deposit guarantee scheme**. Although nothing has been decided yet, emerging political will should be regarded as a success and step forward. Nonetheless, if the above idea is to gain enough support to be put in practice, it must be clearly explained to the member states that have to be convinced that it would bring advantages for them. Thus, in the Commission's report (to be submitted by end-2009), **several questions related to a potential pan-EU scheme need to be answered or at least considered**, for example:

- how should the pan-EU scheme be organized (as a new federal or quasi-federal organization for the entire EU or rather as groups of existing schemes, i.e. regional "colleges of deposit insurers")?

- who should be a member of the pan-EU scheme (all member states or home/host member states of a given cross-border banking group (analogously like "colleges of supervisors" in the CRD [EU 2009b])?

- how should relations and cooperation between the pan-EU scheme and national schemes be arranged?

- how should the pan-EU scheme be financed – as *ex-ante*, *ex-post*, or mixed schemes? Who will pay contributions and how high will these premiums be? How should the size (financial capacity) of the pan-EU scheme be?

- what should the level of coverage be offered by the pan-EU scheme (and should it be, in any way, correlated with the coverage limit set in the directive or not)?

Of course, the above questions are only some examples. Undoubtedly, there will be much more questions from the member states after publishing the Commission's report – notably, if the Commission submits a proposal of legislative amendments to the directive in order to establish such a pan-EU deposit guarantee scheme. However, it seems to be rather a longer-term solution, which should be preceded by some important stages in the short and medium term. In general, the process of establishing a pan-EU scheme could look as follows:

- first, harmonization of funding mechanisms in the member states;

- next, much closer cross-border cooperation between deposit guarantee schemes in the EU (notably in relation to cross-border banking groups);

- finally, setting up a pan-EU deposit guarantee scheme for all banks in the EU.

Last but not least, it should be emphasized that the ideas discussed above should be in line with the current works at the EU forum on improving supervision of cross-border banking/financial groups – taking into account that it seems to be logical that **setting up a pan-EU deposit guarantee scheme would only be possible if there is a pan-EU banking/financial supervisory authority in place**. In this context, in particular, one should mention the recent works conducted by the above-mentioned de Larosière group that published in February 2009 its report on financial supervision in the EU. In the report, the group proposed to establish an integrated **European System of Financial Supervision** by 2012[65] [de Larosière *et al*. 2009]. It may be expected even earlier since the European Commission indicated in early March 2009 that the renewed supervisory arrangements – including the ESFS – should be set up and running in the course of 2010 [Commission 2009]. Although the ESFS is not a single EU supervisory authority, it may be a step in this direction.

## 5.3 Other recommendations

### *5.3.1 Early intervention and bank resolution*

Speaking of the recent reform of the US deposit insurance system, it is worth to mention the system itself, i.e. **the FDIC and its main functions compared to the UE deposit guarantee schemes**. As mentioned at the beginning of this paper, the FDIC has three main responsibilities – to act as a deposit insurer, as a supervisor, and as a receiver (see: Chapter 1). It requires that the FDIC plays an active role in resolving failing and failed institutions (which are insured by the FDIC). The FDIC intervenes before a real banking failure (90-day pre-closure period). The above roles – **first, early intervention before a bank failure and, second, acting as a receiver in the liquidation process – are regarded as the most significant differences between the US and the EU** [Commission 2008a]. In the EU, the roles of deposit insurers are, in principle, separated from the roles of supervisors and/or receivers.

As far as **early intervention** is concerned, it is aimed at reducing the payout costs and the impact of failures. In this context, it is necessary to take into account one the fundamental differences between the US and EU deposit insurance legislation. In the US, the FDIC (and the chartering authority) can start intervention when a bank is becoming insolvent, i.e. before it is illiquid. It means that the FDIC has the ability to act earlier than the EU schemes since the Directive 94/19/EC refers to illiquidity without regulating the procedure for insolvent banks [Commission 2008a]. In this context, there is a question **whether (or not) the US approach to early intervention proved to be successful during the current financial crisis and should be recommended for the EU**. Prior to answering this question, a few aspects of this issue should be considered, including the specific situation and needs of the EU.

In the EU – contrary to the US – early intervention is mostly in competences of institutions other than deposit guarantee schemes. Nevertheless – keeping in mind that the Directive 94/19/EC has no provisions on **potential using deposit guarantee schemes in the EU beyond their pure paybox functions** (preventive/liquidity provision), and thereby the directive does not prohibit it – the European Commission is of the opinion that it would be worth considering whether deposit guarantee schemes might be mandated with **providing liquidity to ailing banks and/or even contributing to costs of the resolution**. According to the Commission, it could mobilize significant funds from the private sector (and private sector solutions are always preferred to public sector financing). As a result, it would reduce the need for using public funds at an early stage, leading finally to avoiding unnecessary financial burdens on taxpayers. And it would be in line with the recent recommendations of

[65] The de Larosière group suggested establishing the ESFS in two stages. In the first stage (2009-2010), national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU, and the EU should also develop a more harmonized set of financial regulations, supervisory powers and sanctioning regimes. Moreover, the EU institutions (European Commission, EU Council, European Parliament) should immediately start the necessary legislative work building a consensus to transform the level 3 committees into three European authorities: a European Banking Authority, a European Insurance Authority, and a European Securities Authority. The actual transformation should be completed at the start of the second phase. In the second stage (2011-2012), the EU should establish an integrated ESFS [de Larosière *et al*. 2009].

some international organizations stating that deposit insurance systems should be part of the financial system safety net which provides for the early detection (on the basis of well defined criteria) and timely intervention and resolution of troubled banks [BCBS and IADI 2009].

A very important issue is a **trigger to start early intervention**. In the US, the so-called leverage ratio (see: Box 1.1 and Section 1.2) is being used as a trigger by the FDIC within the PCA procedure (prompt corrective action). This approach, based on the single measure (the amount of regulatory capital), is regarded as too simplistic. According to the European Commission, the current financial crisis has clearly confirmed that "**hard solvency triggers**" (such as those used in the PCA in the US) were not effective means of ensuring common and predictable supervisory responses, and capital ratios could not capture all information necessary to detect problems in a bank at an early stage (e.g. in the case of Fortis Bank, tier 1 capital was 9% – i.e. relatively high according to the US leverage ratios – when the Benelux governments were required to intervene in fall 2008). The current crisis has also shown that triggers based on a bank's solvency proved to be irrelevant during a crisis situation since the key problem for banks had been the lack of liquidity. Moreover, the Commission argues that in the US, the PCA framework was not designed/applied for large banks regarded as "systemic" (like, for example, some large cross-border banking groups in the EU). Therefore, **the US approach based on the leverage ratio does not seem to be useful and thus recommendable for the EU**. Taking into account that no single indicator is able to capture the soundness of a bank, the Commission is of the opinion that not "**a single hard trigger**" but rather "**a set of flexible indicators**" (e.g. CDS spreads, significant drop in share prices, etc.) would be a more appropriate solution for the EU. Such a set of indicators could be used as an "early warning system" and allow for non-automatic but coordinated supervisory responses within the EU (including deposit guarantee schemes when necessary).

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As far as **bank resolution** is concerned, the FDIC plays the central role in this process, after the closure of an insured bank, since it is usually appointed as a receiver. In the EU, in contrast, deposit guarantee schemes usually play the paybox role only, i.e. they are responsible for payouts and do not participte in the bank liquidation process. Of course, it does not seem to be feasible to establish a similar institution to the FDIC (being not only a deposit insurer but also a receiver) in any EU member state, although performing all those functions by a single institution has some advantages (e.g. much faster payouts to depositors after a bank failure). Nonetheless, **even if the EU deposit guarantee schemes have no (or a limited) role in the liquidation process, they should have early access to relevant data on deposits in a failed bank, which are necessary to prepare prompt payouts**. In this context, it is worth mentioning that the UK Banking Act of 2009 enables the FSA to collect from firms (e.g. banks) all information that the FSCS requires, and share this with the FSCS before default (at the first sign of difficulties in a bank). The legislation also allows the FSCS can require and obtain information directly from firms/banks as soon as a firm/bank is declared in default [Bank of England / HM Treasury / FSA 2008a,b].

Moreover, according to the UK authorities, in order to facilitate fast payouts, it was necessary to introduce a special resolution regime for banks, including a modified insolvency process for banks – the so-called bank insolvency procedure[66] [Bank of England / HM Treasury / FSA 2008c; FSA 2009a]. As argued by the UK authorities, the FSCS, which delivers the payment of compensation to eligible depositors, should be involved in the special resolution regime in order to be able to make an assessment of the readiness of a bank for payouts to eligible customers under the bank insolvency procedure [FSA 2008b]. And indeed, in February 2009, **the Banking Act of 2009 created the Special Resolution Regime,**

[66] As explained by the UK authorities in January 2009, the new bank insolvency procedure is essentially a standard insolvency procedure but with the objectives of the insolvency practitioner modified so that they are required to assist the FSCS in delivering fast payouts to depositors (or account transfers) [FSA 2009a].

**which allowed the UK authorities to put a bank into the Bank Insolvency Procedure designed to allow for rapid payments to depositors insured by the FSCS** (see: Box 5.2). It seems that the new UK legislation related to the bank liquidation process could be a source of inspiration for regulators at both the EU and national levels taking into account that faster payouts would be helpful in maintaining depositors' confidence and, in turn, financial stability. And indeed, the European Commission – keeping in mind that the Directive 2001/24/EC on the reorganisation and winding up of credit institutions [EU 2001] was never intended to harmonize insolvency procedures of the member states – has recently started to consult the member states on whether further coordination of insolvency laws (if not harmonization) would be needed in the EU, and whether some special bank reorganisation and winding up procedures would facilitate timely preventive actions, maintaining confidence of depositors (e.g. quick payout of deposit guarantee schemes), etc.

Box 5.2
Special Resolution Regime in the UK

The Banking Act of 2009 created the Special Resolution Regime (SRR) which came into force on 21 February 2009 following the expiry of the emergency legislation in the Banking (Special Provisions) Act. The SRR gave the tripartite authorities in the UK (HM Treasury, Bank of England, Financial Services Authority) a permanent framework providing tools for dealing with distressed banks and building societies. The Act set out five key objectives in choosing which resolution tools to use:

- to protect and enhance the stability of the UK financial system;
- to protect and enhance public confidence in the stability of the UK banking system;
- to protect depositors;
- to protect public funds;
- to avoid interfering with property rights in contravention with the Human Rights Act of 1998.

The SRR powers allowed the UK authorities to:

- transfer all or part of a bank to a private sector purchaser;
- transfer all or part of a bank to a bridge bank (a subsidiary of the Bank of England) pending a future sale;
- place a bank into temporary public ownership (the Treasury's decision);
- apply to put a bank into the Bank Insolvency Procedure (BIP) designed to allow for rapid payments to depositors insured by the Financial Services Compensation Scheme (FSCS);
- apply for the use of the Bank Administration Procedure (BAP) to deal with a part of a bank that was not transferred and was instead put into administration;

The Banking Act created clearly-defined roles for operation of the SRR. The FSA, in consultation with the Bank and the Treasury, makes the decision to put a bank into the SRR. HM Treasury decides whether to put a bank into temporary public ownership, and otherwise, the Bank of England, in consultation with the other authorities decides which of the tools to use. The FSCS has a role in relation to depositors covered by its depositor compensation scheme.

Source: Bank of England 2009.

Summing up, it should be emphasized that **the current financial crisis prompted relevant works on early intervention within the EU, and further work in this respect is undoubtedly desirable in the nearest future**. By mid-2009, the European Commission is going to prepare the White Paper on early intervention. It is to consider all early intervention tools (pre-liquidation stabilization measures aimed at achieving timely solutions for ailing banks) available to various national authorities (notably financial supervisors, central banks, finance ministries, etc.). The Commission is to assess whether the current range of crisis prevention and/or stabilization measures available to these authorities could/should be complemented by additional tools and whether these early intervention tools should be subject to further convergence at the EU level. **Although some US solutions related to early intervention and bank resolution do not seem to be recommendable for the EU (e.g. the PCA triggers), some others – such as a least-cost-resolution rule and the preference for P&A as a resolution method (instead of payoff) – could be potentially useful, at least to some extent**. In this context, it should be noted that the Commission agrees that, in principle, early intervention bank resolution measures should be aimed at achieving outcomes at the lowest possible cost to the public.

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### *5.3.2 Awareness and financial literacy of depositors*

One of the key issues is ensuring **appropriate information for bank customers on deposit insurance**. In fall 2006, the Commission stressed that, according to consumer associations, depositors in the EU were insufficiently informed about deposit insurance and rarely knew which deposits had been covered and up to which amount [Commission 2006]. Currently, the above problem still seems to be unresolved. For example, according to the UK authorities, **consumers do not have sufficient awareness of, or confidence in, the current compensation arrangements**, and the problems faced by Northern Rock in summer/fall 2007 demonstrated the importance of consumer confidence to ensuring financial stability [Bank of England / HM Treasury / FSA 2008b].

As suggested by some international organizations, effective deposit insurance systems should inform the general public on an ongoing basis about the benefits and limitations of a given deposit guarantee system – in order to maintain and strengthen public confidence, build credibility with depositors and stakeholders, etc. [BCBS and IADI 2009; IADI 2009c]. In the EU, the Directives 94/19/EC and 2009/14/EC addressed the above problem of providing customers of deposit guarantee schemes with relevant information in order to maintain their confidence. According to the directives, **the EU member states should ensure that banks make available – to both actual and potential depositors – the information necessary to identify the EU deposit guarantee scheme** of which a given bank and its branches are members (or alternative deposit guarantee arrangements). The depositors should be provided with all necessary information, including the amount/scope of coverage offered by the scheme. Also, if a givern deposit is excluded from guarantee, banks should inform their depositors accordingly. And, last but not least, **all information shall be made available for depositors in a readily comprehensible manner** [EU 1994, 2009]. In this context, it is worth to note that, in the US, it is required that a special sign – providing customers with the most important information (the scheme name/logo and the minimum coverage amount) and indicating a relevant website for more information – must be displayed in all insured banks (see: Figure 2.2 and Section 2.4). Perhaps, such a general design of the sign and the list of required information could be agreed by all member states in the EU – at least, for banks belonging to cross-border groups.

In this context, it is worth mentioning that the UK authorities proposed an interesting approach in early 2009. According to the FSA, the most effective way to provide depositors with information on deposit insurance is **to prescribe the standardised wording to be disclosed to depositors**. Therefore, the FSA proposed to require all domestic banks (and all EEA banks with branches in the UK) to provide – from 1 January 2010 onwards – appropriate prescribed disclosure to their customers on compensation arrangements, including general details of the deposit guarantee scheme (the FSCS or/and a scheme in another member state), its limit(s), and where consumers could go to find more information. The FSA proposed a few potential wordings for general disclosure of information – different for various groups of banks (i.e. UK authorized firms, topped-up EEA branches, non-topped up EEA branches). The above generic disclosure should be provided by banks to their eligible customers through their preferred method of communication (e.g. it could be included on a depositor's account statement, sent by e-mail, etc.) on a regular basis (e.g. quarterly) [FSA 2009a]. However, banks should avoid too frequent providing information to customers as too much emphasis on the compensation arrangements could lead to unnecessary worry or confusion for depositors [Bank of England / HM Treasury / FSA 2008b].

Speaking of the UK authorities, it should be noted that they committed themselves in January and July 2008 to raising bank customers' awareness of deposit insurance and consulting how depositors could be better informed about the FSCS [Bank of England / HM Treasury / FSA 2008a,b]. At the same time, there were two independent surveys – in January 2008 (on the level of consumer awareness of the FSCS and compensation arrangements) and in April 2008 (on people's reactions to specific financial situations, i.e. how long consumers could manage without access to their money). The results of the surveys showed **a distinct lack of awareness of the domestic deposit guarantee scheme** – only 20% of respondents were aware of the existence of the FSCS, but their knowledge of how it worked and confidence in the scheme were low. Most people did not know what to do if a bank went into default and did not understand that they might not be able to access their money in the event of a bank failure. Those findings were confirmed in September 2008 by some further consumer research commissioned jointly by the FSA and FSCS [FSA 2009b], which focused on **what people felt they needed to know about the deposit guarantee scheme and how that information could best be provided to them**. The findings from the above research as well as from the earlier surveys convinced the UK authorities that the most effective way to improve consumer awareness would be a wider **strategic programme of general communications** on the FSCS and its existence. Such a campaign should be led primarily by the FSCS – working closely with the FSA and the banking sector – and conducted with using a range of communication tools, such as, for example, advertising in mass media (e.g. in television and newspapers), displaying the FSCS logo in bank branches (including the full name of the scheme, applicable limits, and where to go for more information – similarly like it is required by the FDIC in the US), displaying leaflets in branches, general disclosure on banks' websites, consistent and appropriately focused messaging and information (e.g. on the FSA / FSCS websites), etc. [FSA 2009a].

As far as websites of deposit guarantee schemes are concerned, there should be not only basic information (e.g. main features of the scheme), but also – optionally – some useful information on consumer protection and/or financial education programs (as this is the case of the FDIC website – see: Section 2.4). Although websites may be very useful sources of information for depositors, it seems that activities of the EU deposit guarantee schemes should not be limited to this measure only, but – similarly like the FDIC in the US – they could undertake some other **activities to support, encourage, and promote financial**

**awareness and literacy of the society (actual and potential depositors), economic inclusion of some special social groups, etc**. The latter is relating especially to so-called **unbanked and underbanked** who should be brought into the conventional financial system (e.g. by using standard bank products/services, including bank accounts insured by a national deposit guarante scheme). It seems that quite useful tools in this context would be regular (periodical) surveys of insured banks' conducted and published by national deposit guarantee schemes (this activities could be possibly coordinated by the European Forum of Deposit Insurers – EFDI). Therefore, **the EU deposit guarantee schemes should be involved not only in ensuring appropriate information for depositors on deposit insurance, but also – at least to some extent – in their financial education as well**. It would be in line with currently discussed increasing their role beyond the paybox function. And the FDIC seems to be a good example that could be followed by the EU schemes with regard to financial education of the society (consumers/depositors).

In the context of the above, it should be emphasized that **financial education of the society – along with proper regulation and supervision of financial institutions – is one of the key factors which support maintaining stability of the financial system**. The issue of financial education has been explored and developed by the OECD since 2005 (in 2008, the OECD established the International Network of Financial Education consistsing of the EU member states, the US, and a number of other developed and developing countries). The increasing importance of financial education has been recognized in the EU as well. In December 2007, the European Commission regarded **financial education as a complement to some other measures aimed at ensuring the appropriate provision of information, protection and advice to consumers**. Keeping in mind that many international surveys had demonstrated consumers' generally low level of understanding of basic financial/economics matters, the Commission stated that "*education of citizens in financial matters is becoming increasingly important as innovation and globalisation are increasing the range and complexity of financial services on offer*" and indicated that "*the current difficulties in the US subprime mortgage market, where many consumers have taken on mortgages beyond their means owing, in part, to a lack of understanding of product features, serve as a reminder of the magnitude of the problem*" [Commission 2007b]. Also, the EU Commissioner for Internal Market and services emphasized the need for increasing financial capability of EU citizens [McCreevy 2007].

All in all, one could agree **that the lack of financial education (literacy/awareness) was one of quite important factors contributing to the current financial crisis**. Currently, the crisis is still ongoing and even deepening, so there is an urgent need for prompt intervention, supervisory and regulatory actions in the short (or very short) term; and there is practically no time for thinking about more medium- or longer-term issues like financial education. But later, when the crisis is easing or over, all relevant institutions – including the EU deposit guarantee schemes – should play a role in promoting financial education, awareness and literacy of the society in order to do their best to avoid another severe financial crisis like the current one.

# Summary and conclusions

In general, the US system of federal deposit insurance (FDIC) – established in 1933 as a response to massive bank failures in the 1920s and early 1930s (notably during the Great Depression) – proved to be successful. It was apparent, *inter alia*, during the banking crisis in the 1980s and early 1990s in the United States, when bank failures were resolved in a well organized and efficient way and there were no depositor panics and runs on banks (like in the XIX and early XX century). At the same time, however, the banking crisis of the 1980s was a serious reminder that a flawed deposit insurance system could be extremely costly. The crisis prompted the reform of the deposit insurance system in the early 1990s. Nevertheless, despite some important improvements, the US deposit insurance system still exhibited some flaws which undermined its fully effective and fair functioning, such as the existence of two separate insurance funds for banks and thrifts, inadequate pricing of risk, potentially highly volatile premiums, uncertainty for depositors as to the real value of coverage in the future (since it had not been indexed to inflation). Therefore, there was the need to ensure that the deposit insurance system would be operated in a financially, economically, and fiscally responsible way. And it was achieved thanks to the reform of the US deposit insurance system – adopted in 2005 (the Reform Act of 2005) and implemented in 2006 and 2007. It should be noted (or even emphasized) that the reform was proposed and implemented at a time of very good economic and financial conditions (strong economic growth, wealthy banking system, well capitalized insurance funds, etc.).

After the implementation of the 2005-2007 reform of the US deposit insurance system, one could expect that there would be no need for further reforming the system in the coming years, and the next major reform could be expected in a decade or later. But those expectations proved to be wrong very soon. In mid-2007, the financial turmoil (subprime mortgage crisis) emerged in the United States, and – having spread rapidly to other regions of the world, including Europe – evolved into the global financial crisis that is regarded as the most severe and disruptive crisis since the Great Depression (perhaps the "Second Great Depression" or "Great Depression II"). In mid-2008, the situation of the US financial sector started to deteriorate dramatically, and the spectacular aggravation of the crisis took place in fall 2008 – after the sudden collapse of Lehman Brothers Holding, and forced temporary nationalization of American International Group (AIG), both being among the US largest and oldest financial institutions. It proved to be a turning point of the crisis. The above events posed immediate risk to the stability of the US financial system and forced the US authorities to undertake several urgent emergency actions in order to restore public confidence in the financial sector (and notably in FDIC-insured institutions). They included, *inter alia*, some decisive actions related to the deposit insurance system, such as temporary increasing the coverage limit and adopting the restoration plan to replenish the FDIC's insurance fund which experienced a large drop due to added loss reserves for insured institutions (the latter was necessary to meet some obligations stipulated by the Reform Act of 2005). Those actions needed to be adopted immediately after the escalation of the financial crisis in fall 2008 and implemented mainly in 2009. Therefore, once again, the financial crisis prompted the reform of the deposit insurance system – like the crises in the 1920s and early 1930s as well as in the 1980s and early 1990s.

As we can see, there is a sharp contrast between the 2005-2007 reform (proposed and implemented at a time of very good economic and financial conditions) and the 2008-2009 reform (prompted by the serious financial crisis). In this context, as far as the European Union is concerned, it should be noted that the EU member states also had a chance to reform their national deposit guarantee schemes in good times. In 2005-2006 – when the US reformed its deposit insurance system – there was a review of the existing rules on deposit guarantees schemes in the EU (Directive 94/19/EC). The review indicated a number of areas where improvements would be needed. However, there was no political will to amend the directive (although it was almost 12-year-old at that time and out-of-date in several respects) and the member states decided that many improvements could be achieved without amending the legislation. Relatively soon after the above review, the situation in the EU – like in the US – deteriorated markedly due to the global financial crisis that had serious consequences for the EU banking systems and national deposit guarantee schemes, including a bank run in the United Kingdom (Northern Rock in September 2007) that forced the UK authorities to make some important changes to the domestic deposit insurance system (in fall 2007). In fall 2008, when depositors' confidence in the banking system fell dramatically after the aggravation of the financial crisis, it was clear in the EU that – in order to avoid serious problems (including further bank runs that could not have been excluded at that time) – significant changes to deposit guarantee schemes were not only inevitable but extremely urgent as well (especially keeping in mind the flaws in the EU directive that had not been addressed in advance). Therefore, in fall 2008 – when a significant economic slowdown or even recession was foreseen in 2009 in both the US and the EU – the EU member states realized that (contrary to the United States in mid-2000s) they had lost a chance to reform their deposit guarantee schemes at a time of good economic/financial conditions and they would have to do it urgently under stress and time pressure.

The previous papers of the author (who took part in the above review of the EU directive on deposit guarantee schemes) – drafted just a few weeks after the run on Northern Rock [Szeląg 2007b], and also a few months before the aggravation of the financial crisis last fall [Szeląg 2008] – included the following statements that should be reiterated once again: "*it is high time to reform and modernize the EU legislation on deposit guarantee schemes, i.e. amend the Directive 94/19/EC*" and "*it seems that Northern Rock was a sufficient warning for Europe and there is no need to wait for a severe pan-EU financial crisis (…) as a trigger to make relevant changes in the EU legislation and achieve necessary progress in improving European deposit guarantee schemes*". On the one hand, one could regret that the EU member states lost a chance to reform their national deposit guarantee schemes in good times and they waited until the severe financial crisis to make necessary decisions and actions. On the other hand, however, one could state that the crisis – which forced the national authorities to make decisions and actions that otherwise would not have been made – had not only negative but also positive dimensions. Anyway, this is good news that there is emerging political will and motivation in the EU member states for reforming their deposit guarantee schemes ("better late than never"). And the role of the EU institutions – notably the European Commission – is to support and facilitate these efforts in order to keep the current momentum. It seems to be natural that the process of reforming the EU deposit guarantee schemes (including potential pan-EU solutions) should be conducted under the leadership of the Commission, which is to prepare soon relevant reports and, if necessary, legislative proposals. At the moment, the Commission seems to be the only institution being able to propose a decisive and far-reaching reform of deposit guarantee schemes, which is really needed in the EU. But the reform will only be feasible if there is a constructive approach of the member states.

Reforming deposit insurance is an ongoing issue. Of course, it does not mean that there is a need to conduct a major reform every few years, but the US example suggests that even after the recent reforms, there is still some room for further reforming the system (and some potential future changes are being proposed and discussed). It is relating to the EU as well, which has recently addressed fully or partially the most urgent flaws (raising minimum coverage levels, abolishing co-insurance, speeding up payouts), but there are still many problems to be addressed in the relatively near future (potential harmonization of the level/scope of coverage and funding mechanisms, reducing the payout delay, risk-based contributions, the role of deposit guarantee schemes in early intervention and bank resolution, raising awareness and financial literacy of depositors, pan-EU deposit guarantee scheme, etc.). Otherwise, if the above issues were unresolved (e.g. once the crisis is over), the EU deposit guarantee schemes would remain as flawed as today, and could not be comparable to the most advanced deposit insurance systems - like, for example, the US one (notably in relation to large cross-border bank failures). In this context, one can agree with the Commission that "*the costs to the economy and the undermining of confidence in the single financial market could ultimately prove far higher than the level of investment needed to ensure satisfactory functioning of the pan-EU safety net*" [Commission 2006]. It had been stated more than two years ago, and proved to be very true last fall. And it may be true in the future as well, if the necessary reforms are neglected or abandoned.

Although there is an extensive debate and quite many ideas how to reform deposit insurance in the EU, it seems that the US experience on the deposit insurance system and its recent reforms could serve – at least to some extent – as a quite useful source of inspiration and/or recommendations for the EU. The usefulness of such recommendations also stem from the fact that the US has had much longer experience with the deposit insurance system (since 1933) than the EU as a whole (since 1994). Moreover, some recent experience of the United Kingdom (which was the first European victim of the financial crisis) on reforming its domestic deposit guarantee scheme in response to the crisis may be another source of inspiration for the EU. And the future reforms of deposit insurance in the EU (including a pan-EU deposit guarantee scheme) must be in line with the planned reforms of financial supervision in the EU (including a proposal to establish a pan-EU system of financial supervision in the coming years) – since both of them are part of the EU-wide safety net.

# Annex 1

## Primary regulations/supervisors of banks and thrifts and supervisory rating system (CAMELS) in the United States

### a) primary regulators/supervisors of banks and thrifts in the United States

| Institution | Regulator / Supervisor |
|---|---|
| National banks | OCC |
| State banks<br>- members of the Federal Reserve System<br>- non-members of the Federal Reserve System | <br>Federal Reserve<br>FDIC |
| Bank holding companies<br>(including financial holding companies) | <br>Federal Reserve |
| Thrift holding companies | OTS |
| Savings banks | OTS / FDIC / Federal Reserve |
| Savings and loan associations (thrifts) | OTS |
| Foreign banks<br>- state-licensed branches and agencies<br>- federally licensed branches and agencies<br>- representative offices | <br>Federal Reserve / FDIC<br>OCC / Federal Reserve / FDIC<br>Federal Reserve |

Note: the FDIC has some examination authority over all FDIC-insured institutions.

### b) number of institutions under supervision and their assets

| Primary federal supervisor | Number of institutions | Total assets ($ million) |
|---|---|---|
| FDIC | 5,163 | 2,258,527 |
| OCC | 1,585 | 7,924,173 |
| Federal Reserve | 874 | 1,550,883 |
| OTS | 829 | 1,567,216 |
| **Total** | **8,451** | **13,300,800** |

### c) supervisory rating system (CAMELS)

| | Principal evaluation factors |
|---|---|
| **C**apital adequacy | - Level, quality and sources of capital, considering the general financial condition<br>- Balance composition: nature of problem assets, concentration risk and non-traditional activities |
| **A**ssets quality | - Diversification, quality and adequacy of allowance for loan and investment portfolios<br>- Risk identification practices and credit risk exposure arising from off-balance sheet transactions |
| **M**anagement | - Impact on performance, risk profile, collection of information and risk monitoring system<br>- The ability to respond to risks that may arise from changing business conditions |
| **E**arnings | - Exposure to adverse changes in interest rates, foreign exchange rates, commodity prices<br>- Level, quality and sources, including trends and stability |
| **L**iquidity | - The adequacy of sources and the availability of assets convertible to cash without loss<br>- Diversification of funding sources, access to money markets, trend and stability of deposits |
| **S**ensitivity | - Method to identify, measure, monitor and control market risk exposure<br>- Sensitivity of the soundness to market risks and economic risks |

Source: Federal Reserve 2005 (top table); FDIC 2008m (middle table); Commission 2008b (bottom table).

# Annex 2

## Former risk categories in the FDIC risk-based assessment system (until the 2005-2007 reform)

| Capital Groups | | Supervisory Subgroups | |
|---|---|---|---|
| 1 | Well Capitalized<br>Total Risk-Based Capital Ratio equal to or greater than 10 %<br>and<br>Tier 1 Risk-Based Capital Ratio equal to or greater than 6 %<br>and<br>Tier 1 Leverage Capital Ratio equal to or greater than 5 % | A | Financially sound institutions with only a few minor weaknesses.<br>This subgroup generally corresponded to the primary federal regulator's composite rating of "1" or "2" |
| 2 | Adequately Capitalized<br>Not Well Capitalized<br>and<br>Total Risk-Based Capital Ratio equal to or greater than 8 %<br>and<br>Tier 1 Risk-Based Capital Ratio equal to or greater than 4 %<br>and<br>Tier 1 Leverage Capital Ratio equal to or greater than 4 % | B | Institutions that demonstrated weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the BIF or SAIF.<br>This subgroup assignment generally corresponded to the primary federal regulator's composite rating of "3." |
| 3 | Undercapitalized<br>Neither Well Capitalized nor Adequately Capitalized<br>Supervisory subgroup assignments for members of the BIF and the SAIF are made in accordance with section 327.4(a)(2) of the FDIC's Rules and Regulations | C | Institutions that posed a substantial probability of loss to the BIF or the SAIF unless effective corrective action was taken.<br>This subgroup assignment generally corresponded to the primary federal regulator's composite rating of "4" or "5." |

* CAMEL is an acronym for component ratings assigned in a bank examination: Capital, Asset quality, Management, Earnings, and Liquidity. In 1997, an additional component, "S" for Sensitivity to market risk, was added. A composite CAMELS rating combines these component ratings, again with 1 being the best rating and 5 being the worst.

Source: FDIC 2000a.

# Annex 3

## New Risk Categories in the FDIC Risk-Based Assessment System (introduced by the 2005-2007 reform)

| Risk Categories | |
|---|---|
| I | Risk Category I contains all well-capitalized institutions in Supervisory Group A (generally those with CAMELS composite ratings of 1 or 2), i.e., those institutions that would be placed in the former 1A category |
| II | Risk Category II contains all institutions in Supervisory Groups A and B (generally those with CAMELS composite ratings of 1, 2 or 3), except those in Risk Category I and undercapitalized institutions * |
| III | Risk Category III contains all undercapitalized institutions in Supervisory Groups A and B, and institutions in Supervisory Group C (generally those with CAMELS composite ratings of 4 or 5) that are not undercapitalized |
| IV | Risk Category IV contains all undercapitalized institutions in Supervisory Group C, i.e., those institutions that would be placed in the former 3C category ** |

* Under current regulations, bridge banks and institutions for which the FDIC has been appointed or serves as a conservator are charged the assessment rate applicable to the 2A category. The final rule places these institutions in Risk Category I and charges them the minimum rate applicable to that category.

** For clarity, the final rule uses the phrase ''Supervisory Group'' to replace ''Supervisory Subgroup.'' The final rule also designates the capital categories as ''Well Capitalized''.

Source: Final Rule 2006f.

# Annex 4

## Summary characteristic of the US deposit insurance system

| | Description | Date of introduction or reform |
|---|---|---|
| Name and date of creation | Federal Deposit Insurance Corporation | 1933 |
| Nature of the scheme | Public | 1933 |
| Supervisor of the scheme | US Congress | n.a. |
| Coverage limits | $ 100,000 – general (basic) coverage limit / temporarily raised to $ 250,000 until end-2009 and then end-2013<br>$ 250,000 – coverage limit for retirement accounts<br>unlimited coverage for transaction accounts (until end-2009) | 1980<br>2008-2009<br>2005<br>2008-2009 |
| Indexing to inflation | Yes, coverage limits are to be examined every 5 years (beginning on 1 April 2010), and could be increased in $ 10,000 increments by an inflation adjustment | 2005 |
| Co-insurance | No | n.a. |
| Fund name | Deposit Insurance Fund (DIF) | 2005 |
| Fund mechanism | Ex-ante | |
| Fund's finance | Quarterly members contributions and earnings on fund assets | 2005 |
| Investment policy | FDIC invests collected funds in government securities, including short-term US Treasury investments | 1933 |
| Borrowing allowed | Yes, the line of credit with the US Treasury – increased permanently from $ 30 billion to $ 100 billion (+ temporarily unlimited by end-2009 and up to $ 500 billion by end-2010) | 1991<br>2008-2009 |
| Designated reserve ratio (DRR) | The Board must set annually a DRR within a range of 1.15% to 1.50%. The Board may manage the pace at which the reserve ratio achieves the DRR. If the DRR falls below 1.15%, a restoration plan is needed to return it to 1.15% within 5 years. If the DRR exceeds 1.50%, excess amount must be paid back to banks as dividends. | 2005 |
| Risk-based premiums | a) introduction/application of risk-based premiums (risk-based methods through composite indicators)<br>b) eliminating restrictions on assessment rates (premiums) charged to well-managed and well-capitalized institutions | 1991 / 1993<br>2005 |
| Discretion on pricing deposit insurance | FDIC charges premiums to all insured institutions according to actual risk they pose, regardless of the reserve ratio level | 2005 |
| Prompt corrective action | Critically undercapitalized banks (leverage ratio = < 2%) have to be recapitalized within 90 days or closed by the entity that charters the bank and which has the authority to revoke its license | 1991 |
| Competent authority in bank resolution/liquidation | The chartering authority closes the member and appoint a receiver (usually the FDIC) | 1933 |
| Trigger event | Leverage ratio equal to or less than 2% | 1991 |
| Event notification | News in the local newspaper and other media | n.a. |
| Types of intervention | Generally closed bank resolution (also purchase & assumption, and deposit payoff) | 1933 |
| Pre-closing period | The FDIC works on the resolution of members generally for 90 days before the closure | n.a. |
| Least-cost resolution | Minimizing the present value of net losses incurred by the deposit insurer | 1991 |
| The speed of payout | In principle, one business day in most cases | 1933 |

Source: own elaboration based on information from the FDIC and Commission 2008a.

# Annex 5

## FDIC Strategic Plan 2008–2013

The FDIC carries out its mission through three major programs: insurance, supervision, and receivership management. Strategic goals of these programs are the following:

- **Insurance**: Insured depositors are protected from loss without recourse to taxpayer funding;

- **Supervision**: FDIC-insured institutions are safe and sound + Consumers' rights are protected and FDIC-supervised institutions invest in their communities;

- **Receivership Management**: Resolutions are orderly and receiverships are managed effectively.

The table below depicts the strategic goal, strategic objectives, and annual performance goals for the Insurance Program.

| Strategic goal | Strategic objectives | Annual performance goals |
|---|---|---|
| Insured depositors are protected from loss without recourse to taxpayer funding | Customers of failed insured depository institutions have timely access to insured funds and financial services | Respond promptly to all insured financial institution closings and related emerging issues |
| | The FDIC promptly identifies and responds to potential risks to the DIF | Identify and address risks to the DIF |
| | | Disseminate data and analyses on issues and risks affecting the financial services industry to bankers, supervisors, the public and other stakeholders |
| | | Effectively administer temporary financial stability programs |
| | The DIF and the deposit insurance system remain strong and adequately financed | Maintain and improve the deposit insurance system |
| | | Expand and strengthen the FDIC's participation and leadership role in providing technical guidance, training, consulting services and information to international governmental banking and deposit insurance organizations |
| | The FDIC resolves the failure of insured depository institutions in the manner least-costly to the DIF | Market failing institutions to all known qualified and interested potential bidders |
| | The public and FDIC-insured depository institutions have access to accurate and easily understood information about federal deposit insurance coverage | Provide educational information to insured depository institutions and their customers to help them understand the rules for determining the amount of insurance coverage on deposit accounts |

Source: FDIC 2008m, 2009f.

# Annex 6

## Evolution of the quarantee levels in the EU member states since the adoption of the Directive 94/19/EC (in €, 1994-2007)[1]

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|
| Austria | | 18,895 | 18,895 | 18,895 | 18,895 | 20,000 | 20,000 |
| Belgium | | 15,000 | 15,000 | 15,000 | 15,000 | 15,000 | 20,000 |
| Bulgaria | | | | | | | |
| Cyprus | | | | | | | |
| Czech Rep. | | | | | | | |
| Denmark | 33,412 | 41,122 | 40,287 | 39,851 | 40,275 | 40,305 | 40,198 |
| Estonia | | | | | | | |
| Finland | | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 |
| France | | 60,980 | 60,980 | 60,980 | 60,980 | 70,000 | 70,000 |
| Germany | Unlimited[2] | Unlimited[2] | Unlimited[2] | Unlimited[2] | 20,000 /Unlimited[2] | 20,000 /Unlimited[2] | 20,000 /Unlimited[2] |
| Greece | | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Hungary | | | | | | | |
| Ireland | 13,200 | 15,000 | 15,000 | 15,000 | 15,000 | 15,000 | 20,000 |
| Italy | 413,166 | 413,166 | 413,166 | 103,291 | 103,291 | 103,291 | 103,291 |
| Latvia | | | | | | | |
| Lithuania | | | | | | | |
| Luxembourg | 12,395 | 12,395 | 12,395 | 15,000 | 15,000 | 15,000 | 20,000 |
| Malta | | | | | | | |
| Netherlands | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Poland | | | | | | | |
| Portugal | 33,750 | 33,750 | 33,750 | 33,750 | 33,750 | 25,000 | 25,000 |
| Romania | | | | | | | |
| Slovakia | | | | | | | |
| Slovenia | | | | | | | |
| Spain | 9,015 | 14,093 | 14,093 | 14,093 | 14,093 | 15,000 | 20,000 |
| Sweden | | 28,745 | 28,975 | 28,629 | 26,349 | 29,197 | 28,308 |
| United Kingdom | 25,411 | 23,606 | 27,127 | 29,996 | 28,350 | 32,170 | 32,046 |

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| Austria | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Belgium | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Bulgaria | | | | | | | 20,452 |
| Cyprus | | | | 20,000 | 20,000 | 20,000 | 20,000 |
| Czech Rep. | | | | 25,000 | 25,000 | 25,000 | 25,000 |
| Denmark | 40,342 | 40,383 | 40,296 | 40,329 | 40,212 | 40,236 | 40,224 |
| Estonia | | | | 6,391 | 6,391 | 12,782 | 12,782 |
| Finland | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 |
| France | 70,000 | 70,000 | 70,000 | 70,000 | 70,000 | 70,000 | 70,000 |
| Germany | 20,000 / Unlimited[2] | 20,000 / Unlimited[2] | 20,000 / Unlimited[2] | 20,000 / Unlimited[2] | 20,000 / Unlimited[2] | 20,000 / Unlimited[2] | 20,000 / Unlimited[2] |
| Greece | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Hungary | | | | 22,360 | 21,750 | 21,845 | 21,677 |
| Ireland | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Italy | 103,291 | 103,291 | 103,291 | 103,291 | 103,291 | 103,291 | 103,291 |
| Latvia | | | | 8,597 | 10,000 | 15,000 | 15,000 |
| Lithuania | | | | 14,481 | 14,481 | 14,481 | 17,377 |
| Luxembourg | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Malta | | | | 20,000 | 20,000 | 20,000 | 20,000 |
| Netherlands | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 38,000 |
| Poland | | | | 20,350 | 20,350 | 20,350 | 20,350 |
| Portugal | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 |
| Romania | | | | | | | 20,000 |
| Slovakia | | | | 20,000 | 20,000 | 20,000 | 20,000 |
| Slovenia | | | | 21,271 | 21,294 | 21,282 | 21,282 |
| Spain | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Sweden | 26,878 | 27,314 | 27,533 | 27,714 | 26,628 | 27,654 | 26,479 |
| United Kingdom | 52,095 | 48,732 | 44,977 | 44,961 | 46,257 | 47,208 | 43,226 |

[1] The "guarantee level" means: coverage level – for the member states not applying co-insurance; payout limit – for the member states applying co-insurance. For the member states that joined the EU after the adoption of the Directive 94/19/EC, the data are from the date of their accession to the EU onwards. All data are as of end-December each year.

[2] Within the above period of time (1994-2007), protection provided by the statutory deposit protection scheme (Compensation Scheme of German Banks – set up in 1998) was limited to 90% of deposits and the equivalent € 20,000 per depositor. At the same time, however, another scheme (Deposit Protection Fund of the Association of German Banks – established in mid-1970s) fully secured deposits at the private commercial banks up to a ceiling of 30% of bank's equity capital (it meant practically unlimited deposit protection). The Deposit Protection Fund covered deposits to the extent that they had not been covered by the Compensation Scheme of German Banks.

Source: Commission 2005b; data from the member states; own calculations based on the ECB exchange rates.

# Annex 7

## Changes to deposit guarantee schemes in the EU member states as a result of the global financial crisis in 2008 (in €)[1]

| | Coverage level | | Co-insurance | |
|---|---|---|---|---|
| | prior to the crisis [2] | after the crisis [3] | prior to the crisis [2] | after the crisis [3] |
| Austria | 20,000 / 20,000 [4] | Unlimited / 100,000 / 50,000 [5] | No / Yes (10%) [6] | No / Yes (10%) [6] |
| Belgium | 20,000 | 100,000 | No | No |
| Bulgaria | 20,452 | 51,129 | No | No |
| Cyprus | 22,222 / 20,000 [4] | 100,000 [7] | Yes (10%) | To be abolished |
| Czech Rep. | 27,778 / 25,000 [4] | 50,000 | Yes (10%) | Abolished |
| Denmark | 40,229 | Unlimited [8] | No | No |
| Estonia | 22,222 / 20,000 [4] | 50,000 | Yes (10%) | Abolished |
| Finland | 25,000 | 50,000 | No | No |
| France | 70,000 | 70,000 | No | No |
| Germany | Formally 22,222 / 20,000 [4] Practically unlimited [9] | Formally 22,222 / 20,000 [4] Practically unlimited [9] [10] | Formally yes (10%) Practically no [9] | To be abolished |
| Greece | 20,000 | 100,000 / Unlimited [11] | No | No |
| Hungary | 24,905 / 22,829 | 49,430 / Unlimited [12] | Yes (10%) [13] | Abolished |
| Ireland | 22,222 / 20,000 [4] | 100,000 [14] | Yes (10%) | To be abolished |
| Italy | 103,291 | 103,291 | No | No |
| Latvia | 20,000 | 50,000 | No | No |
| Lithuania | 22,000 / 20,100 | 100,000 [15] | Yes (10%) [16] | Abolished |
| Luxembourg | 20,000 | 100,000 | No | No |
| Malta | 22,222 / 20,000 [4] | 100,000 [7] | Yes (10%) | To be abolished |
| Netherlands | 40,000 / 38,000 | 100,000 [17] | Yes (10%) [18] | Abolished |
| Poland | 22,500 / 20,350 | 50,000 | Yes (10%) [19] | Abolished |
| Portugal | 25,000 | 100,000 [20] | No | No |
| Romania | 20,000 | 50,000 [21] | No | No |
| Slovakia | 22,222 / 20,000 [4] | Unlimited [22] | Yes (10%) | Abolished |
| Slovenia | 22,000 | Unlimited [23] | No | No |
| Spain | 20,000 | 100,000 | No | No |
| Sweden | 26,173 | 50,474 [24] | No | No |
| United Kingdom | 44,083 / 39,927 [4] | 64,329 [25] | Yes [26] | Abolished [26] |

[1] In some EU member states, there are more than one deposit guarantee scheme. Data in the table is related to the obligatory scheme (except for Germany). For the EU member states not belonging to the euro area, coverage levels have been converted from their national currencies into the euro (€).
[2] As of mid-September 2008 (or earlier for the UK – see: below footnotes 25 and 26).
[3] In most cases, October-December 2008 (or earlier for the UK – see: below footnotes 25 and 26).
[4] For countries with co-insurance: coverage level / payout amount.
[5] Unlimited – for individuals until 31 December 2009 (from 1 January 2010 - € 100,000); € 50,000 – for non-individuals (according to laws adopted on 1 and 20 October 2008).
[6] No – for individuals; yes – for legal entities.
[7] On 8 October 2008, the Cypriot government declared increased deposit coverage – up to € 100,000 in full. On the same day, the Maltese government announced its intention to do so as well. However, both declarations have not been followed by any legislative action in fall 2008.
[8] The law adopted on 10 October 2008 gave unlimited state guarantee for all domestic and foreign claims by depositors of all scheme member banks for the amounts not covered by the Danish deposit guarantee scheme (a temporary measue until 30 September 2010).

[9] Protection provided by the statutory deposit protection scheme (Compensation Scheme of German Banks) is limited to 90% of deposits and the equivalent € 20,000 per depositor. At the same time, however, another scheme (Deposit Protection Fund of the Association of German Banks) fully secures deposits at the private commercial banks up to a ceiling of 30% of bank's equity capital. The Deposit Protection Fund covers deposits to the extent that are not covered by the Compensation Scheme of German Banks.

[10] On 5 October 2008, the German government declared unlimited deposit guarantees for all retail deposits in German banks.

[11] On 3 October 2008, the Greek government declared full deposit guarantees for all deposits in banks operating in Greece. On 7 November 2008, the level of coverage was increased to € 100,000 (as a temporary measure – until 31 December 2011).

[12] On 8 October 2008, the coverage level was increased from HUF 6 million to HUF 13 million and the Hungarian governmen made a political declaration on full deposit guarantees.

[13] 10% co-insurance for the amount in excess of HUF 1 million – up to maximum of HUF 6 million.

[14] On 20 September 2008, the Irish government declared increased coverage – up to € 100,000 in full (but it has not been followed by any legislative action). The governmental act of 30 September 2008 gave temporary unlimited state guarantees for some major (systemically important) Irish banks – until 29 september 2010.

[15] The law adopted on 14 October 2008 introduced the coverage level of € 100,000 as a temporary 1-year measure and abolished co-insurance (both from 1 November 2008).

[16] 10% co-insurance for the amounts in LTL equivalent to more than € 3,000 up to maximum of € 20,000.

[17] On 7 Oct 2008, the coverage level of € 100,000 was introduced as a temporary 1-year measure and co-insurance was abolished.

[18] 10% co-insurance for the amount in excess of € 20,000 up to maximum of € 40,000.

[19] 10% co-insurance for the amounts in PLN equivalent to more than € 1,000 up to maximum of € 22,500.

[20] The law adopted on 3 November 2008 retroactively (from 12 October 2008) and temporarily (until 31 December 2011) increased the level of coverage to € 100,000.

[21] For individuals only.

[22] The law adopted on 24 October 2008 introduced unlimited coverage and abolished co-insurance (from 1 November 2008).

[23] Unlimited state guarantee for bank deposits in banks having their head office in Slovenia (for the amounts not covered by the Slovenian deposit guarantee scheme) – introduced on 20 November 2008 as a temporary measure (until 31 December 2010).

[24] On 31 October 2008, the level of coverage was increased from SEK 250,000 to SEK 500,000.

[25] On 2 October 2008, the FSA decided to increase the compensation limit for protected deposits to £ 50,000 – effective on 7 October 2008.

[26] 10% co-insurance for the amount in excess of £ 2,000 – up to maximum of £ 35,000. The UK authorities abolished co-insurance on 1 October 2007 (after the run on Northern Rock in mid-September 2007).

Source: Own elaboration based on the data from the EU member states / Commission / OECD.

# Annex 8

## Key features of the EU deposit guarantee schemes[1] (including changes introduced by the Directive 2009/14/EC)

| | Coverage level (€) [2] | | | | | |
|---|---|---|---|---|---|---|
| | Current level (as of mid-May 2009) | Planned/expected changes | Co-insurance | Risk-based premiums | Funding mechanism | Borrowing allowed |
| Austria | Unlimited / 100,000 / 50,000 [3] | 100,000 [4] | No/To be abolished[4] | No | Ex-post | Yes |
| Belgium | 100,000 | – | No | No | Ex-ante | No |
| Bulgaria | 51,129 | – | No | No | Ex-ante | Yes |
| Cyprus | 100,000 [3] | 100,000 [5] | To be abolished | No | Mixed | Yes |
| Czech Rep. | 50,000 | – | No | No | Ex-ante | Yes |
| Denmark | Unlimited | 50,000 / 100,000 [6] | No | No | Mixed | Yes |
| Estonia | 50,000 | – | No | No | Ex-ante | Yes |
| Finland | 50,000 | – | No | Yes | Ex-ante | Yes |
| France | 70,000 | – | No | Yes | Ex-ante | Yes |
| Germany | Formally 22,222 / 20,000; Practically unlimited [3] | 50,000 / 100,000 [7] | No | Yes | Ex-ante | Yes |
| Greece | 100,000 | – | No | No | Ex-ante | Yes |
| Hungary | 44,921 | 50,000 [8] | No | No | Ex-ante | Yes |
| Ireland | 100,000 [3] | 100,000 [5] | To be abolished | No | Ex-ante | No |
| Italy | 103,291 | – | No | Yes | Ex-post | No |
| Latvia | 50,000 | – | No | No | Ex-ante | No |
| Lithuania | 100,000 | 100,000 [9] | No | No | Ex-ante | Yes |
| Luxembourg | 100,000 | – | No | No | Ex-post | Yes |
| Malta | 100,000 [3] | 100,000 [5] | To be abolished | No | Mixed | Yes |
| Netherlands | 100,000 | 100,000 [9] | No | No | Ex-post | No |
| Poland | 50,000 | – | No | Partly [10] | Mixed | Yes |
| Portugal | 100,000 | – | No | Yes | Ex-ante | Yes |
| Romania | 50,000 | 50,000 [11] | No | No | Mixed | Yes |
| Slovakia | Unlimited [3] | – | No | No | Ex-ante | Yes |
| Slovenia | Unlimited [3] | 100,000 [12] | No | No | Ex-post | No |
| Spain | 100,000 | – | No | No | Ex-ante | Yes |
| Sweden | 47,005 | 50,000 or more [13] | No | Yes | Ex-ante | Yes |
| United Kingdom | 56,148 | 50,000 or more [13] | No | No | Ex-post [14] | Yes |

| | Minimum / target size of the fund | Supervisor of the scheme | Nature of the scheme | Year of funding |
|---|---|---|---|---|
| Austria | N.a. | Financial Markets Authority | Private | 1988 |
| Belgium | No | Ministry of Finance | Public | 1999 |
| Bulgaria | No / Yes | Central Bank, Council of Ministers, National Audit Office | Other | 1999 |
| Cyprus | Yes | Auditor General of the Republic | Other | 2000 |
| Czech Rep. | No | Ministry of Finance | Other | 1994 |
| Denmark | Yes / No | Danish Financial Supervisory Authority | Private | 1987 |
| Estonia | No / Yes | Supervisory Board of the Fund | Other | 1998 |
| Finland | No / Yes | Financial Service Regulatory Authority | Private | 1998 |
| France | No / Yes | Ministry of Finance (regulator) | Private | 1999 |
| Germany | No | Financial Service Regulatory Authority | Private | 1998 |
| Greece | No | Ministry of Finance | Other | 1995 |
| Hungary | No / Confidential | State Audit Office (periodically) | Public | 1993 |
| Ireland | No / Yes | Irish Financial Services Regulatory Authority | Public | 1989 |
| Italy | Yes | Central Bank | Private | 1987 |
| Latvia | No | Financial service regulatory authority | Public | 1998 |
| Lithuania | No / Yes | Ministry of Finance | Public | 1996 |
| Luxembourg | N.a. | Financial Supervisory Authority | Private | 1989 |
| Malta | Yes | Malta Financial Services Authority | Public | 2003 |
| Netherlands | N.a. | Central Bank | Other | 1978 |
| Poland | No | Ministry of Finance and Fund's Council | Other | 1994 |
| Portugal | No | Central Bank and Minister of Finance | Public | 1992 |
| Romania | No / Yes | Central Bank | Other | 1996 |
| Slovakia | Yes / No | Central Bank, Supervisory Board of the Fund | Public | 1996 |
| Slovenia | N.a. | Central Bank | Other | 2001 |
| Spain | No / Yes | Court of Auditors | Public | 1977 |
| Sweden | No | Ministry of Finance | Public | 1996 |
| United Kingdom | No | Financial Services Authority | Private | 2001 |

1 In some EU member states, there are more than one deposit guarantee scheme. In the above table, there are data related to the obligatory scheme in a given country.
2 For the EU member states not belonging to the euro area, coverage levels have been converted from their national currencies into the euro (€) – using the ECB exchange rates.
3 See: Annex 7.
4 Unlimited deposit guarantees for individuals will expire on 31 December 2009; possible introduction of the same coverage level (€ 100,000) for both individuals and non-individuals. Also, co-insurance for non-individuals is expected to be abolished.
5 Afther the declaration of the Dutch government on 10 march 2009, it is expected that relevant legislation will be adopted to confirm the political declarations made in fall 2008.
6 The law adopted on 1 May 2009 increased the coverage level to € 50,000 (from 30 June 2009) and to € 100,000 (from 1 October 2010).
7 The law adopted on 14 May 2009 increased the coverage level to € 50,000 (from 30 June 2009) and to € 100,000 (from 31 December 2010), and discontinued co-insurance on the former date.
8 As required by the Directive 2009/14/EC, the minimum coverage level of € 50,000 must be implemented by 30 June 2009.
9 It is expected that a temporarily increased coverage level of € 100,000 (until October 2009) will be adopted as a permanent measure.
10 Poland does not adjust contributions using risk-based indicators, but the contribution base includes some risk-related variables (see: Section 5.2.1).
11 The coverage level of € 50,000 for individuals is expected to be extended to non-individuals as well (by 30 June 2009 at the latest – in line with the Directive 2009/14/EC).
12 Unlimited deposit guarantees will expire on 31 December 2010; possible introduction of the € 100,000 coverage level afterwards.
13 From 30 June 2009 onwards (at the latest), the coverage level (or its equivalent in €) must not be lower than € 50,000 – in line with the Directive 2009/14/EC.
14 The UK government considers introducing into legislation powers which would allow it to introduce some elements of pre-funding of the FSCS. It, however, does not propose to introduce pre-funding immediately.

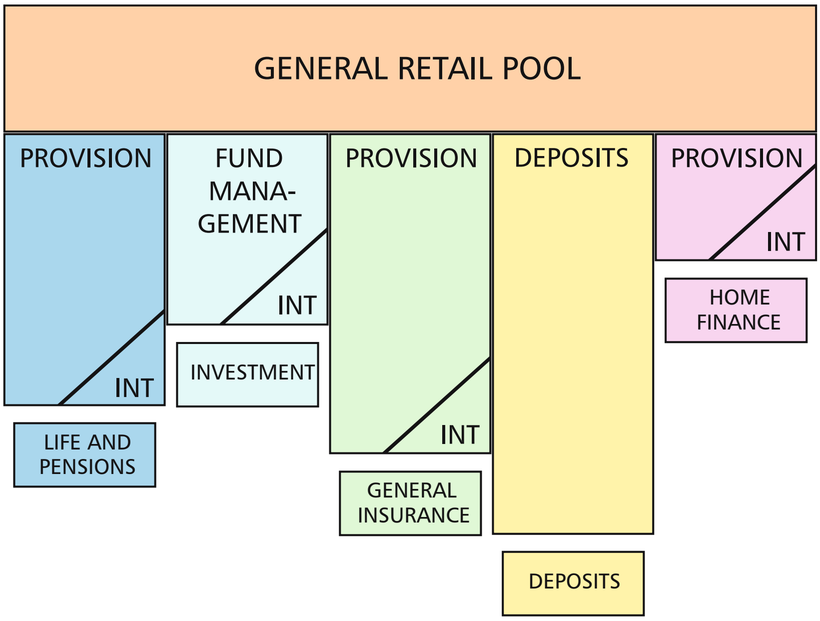
Source: Own elaboration based on the data from the EU member states / Commission / OECD.

# Annex 9

## The new ESCS funding model in the UK (introduced on 1 April 2008)

The funding model consists of five broad classes: life and pensions; deposits; investment; general insurance and home finance. With the exception of the deposits class, each broad class is divided into two sub-classes based on provider/intermediation activities.

The model operates on the basis that a sub-class will meet the compensation claims from defaults in that class up to its threshold. Once a sub-class reaches its annual threshold the other sub-class in their broad class will be required to contribute to any further compensation costs. A final layer of cross-subsidy is then available from the general retail pool, through which the other broad classes support any broad class which has reached its overall threshold, up to the overall limit.




Note: Diagram not to scale; INT = intermediation.

Source: FSA 2007.

# Annex 10

## Report on financial supervision in the EU (so-called de Larosière Report of 25 February 2009) – issues related to deposit quarantee schemes

*Recommendation 14:* Deposit Guarantee Schemes

*Deposit Guarantee Schemes (DGS) in the EU should be harmonised and preferably be pre-funded by the private sector (in exceptional cases topped up by the State) and provide high, equal protection to all bank customers throughout the EU.*

*The principle of high, equal protection of all customers should also be implemented in the insurance and investment sectors.*

*The Group recognises that the present arrangements for safeguarding the interests of depositors in host countries have not proved robust in all cases, and recommends that the existing powers of host countries in respect of branches be reviewed to deal with the problems which have occurred in this context.*

• The crisis has demonstrated that the current organisation of DGSs in the Member States was a major weakness in the EU banking regulatory framework.* The Commission recent proposal is an important step to improve the current regime, as it will improve the protection of depositors.

• A critical element of this proposal is the requirement that all Member States apply the same amount of DGS protection for each depositor. The EU cannot indeed continue to rely on the principle of a minimum coverage level, which can be topped-up at national level. This principle presents two major flaws: first, in a situation where a national banking sector is perceived as becoming fragile, there is the 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. As the crisis has shown, this cannot be reconciled with the notion of a well-functioning Single Market.

• Another important element to be taken into account is the way in which the DGSs are funded. In this respect, the Group is of the view that preference should be given to schemes which 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 the schemes at a time where they are already in difficulty.

• Normally, pre-funded DGSs should take care in the future of losses incurred by depositors. Nonetheless, it is probable that for very large and cross border institutions, pre-funded mechanisms might not be sufficient to cover these guarantees. In order to preserve trust in the system, it should be made clear that in those cases pre-funded schemes would have to be topped-up by the State.

• The idea of a pooled EU fund, composed of the national deposit guarantee funds, has been discussed by the Group, but has not been supported. The setting-up and management of such a fund would raise numerous political and practical problems. Furthermore, one fails to see the added-value that such a fund would have in comparison to national funds operating under well harmonised rules (notably for coverage levels and the triggering of the scheme). EU harmonization should not go as far either as laying down rules on the possible use of DGSs in the management of a crisis. It should not prohibit additional roles beyond the base task for a DGS to act ex post, in the crisis resolution phase, as a pay box by reimbursing the guaranteed amount to depositors in a defaulted bank. Most member countries limit their national DGS to this pay box function. Some countries, however, extend the activities by giving their DGS also a rescue function. The Group did not see any need for EU harmonization in this respect.

• There is a specific case (of the Icelandic type) when a supervisory authority allows some of its banks to mushroom large branches in other EU countries, whilst the home Member State is not able to honour the deposit guarantee schemes which are inadequate for such exposures. The guarantee responsibilities then de facto fall into the jurisdiction of the host country. This is not acceptable and should at least be addressed, for example, in the following way: the host Member State should have the right to inquire whether the funds available in the DGS of the home Member State are indeed sufficient to protect fully the depositors in the host Member State. Should the host Member State not have sufficient guarantees that this is indeed the case, the only way to address this kind of problem is to give sufficient powers to the host supervisory authorities to take measures that would at the very beginning curtail the expansive trends observed.

• The Group has not entered into the specifics of the protection of policy-holders and investors. It nevertheless considers that the above general principles, and in particular the equal protection of all customers in the Single Market, should also be implemented in the insurance and investment sectors.

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* The Commission's recent proposal is an important step to improve the current DGS-regime, as it strengthens harmonization and improves the protection of depositors. However, the directive still leaves a large degree of discretion to member states, particularly in relation to funding arrangements, administrative responsibility and the role of DGS in the overall crisis management framework. Leaving these issues unresolved at EU-level implies that significant weaknesses remain in the DGS framework, including *inter alia*:

- *Unsustainable funding* – the current lack of sophisticated and risk sensitive funding arrangements involves a significant risk that governments will have to carry the financial burden indented for the banks, or worse, that the DGS fails on their commitments (both of which illustrated by the Icelandic case). In particular, in relation to the any of the 43 European LFCIs identified earlier in the chapter, no current scheme can be expected to have the capacity to make reimbursements without involving public funds.
- *Limited use in crisis management* – Even if DGS' had that capacity, the pay box nature of most schemes makes it unlikely that they ever will be utilised for LFCIs, because of the large externalities associated with letting such institutions fail.
- *Negative effects on financial stability* – reliance on *ex-post* funding and lack of risk sensitive premiums weakens market discipline (moral hazard), distort the efficient allocation of deposits, as well as it may be a source of pro-cyclicality.
- *Obstacle to efficient crisis management* – due to incompatible schemes (trigger points, early intervention powers etc.) and diverging incentives among member.

Source: de Larosière et al. 2009.

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