

Europe's Second Pillar

BY HANS-JOACHIM DÜBEL

A European deposit insurance system, complementing monetary union, can help to contain the European race to the bottom in financial sector subsidies and regulatory arbitrage.

What do places such as Reykjavik, Edinburgh, Dublin, Brussels, Düsseldorf, Munich, Milan, Vienna, and Stockholm have in common? These regional European financial centers sacrificed basic regulatory and oversight principles over the past decade for the sake of unmitigated growth. They harbored an ambition to quickly join the top-tier European financial capitals of London, Frankfurt, and Paris. Home to banks such as Kaupthing, RBS, HBOS, Depfa, Fortis, KBC, WestLB, IKB and BayernLB, Unicredit, Erste, and Swedbank, these cities are now the hosts of some of the worst casualties of the current financial crisis.

One of the key promoters of the new regional centers was Charles McCreedy, Irish finance minister from 1997–2004, whose biggest coup in 2001 was to lure Depfa, the German public-sector covered bond issuer, from Frankfurt to Dublin by offering its management substantial tax savings and relaxed banking supervision. Once in Ireland, Depfa—stretched by razor-thin margins in public finance—operated under the high asset-to-liability mismatches that German regulators had been eyeing for years and finally ended in 1999. The 2008 financial crisis wrought disaster on Depfa, which had been taken over in 2007 by Munich-based Hypo Real Estate. Alarmed by what it was hearing, German regulators in March asked Ireland for permission to review Depfa's books, which prompted them to instruct Hypo Real Estate in Munich to instruct Depfa in Dublin to close positions. Despite that order, when Hypo Real Estate had to be rescued with a €35 billion German public bailout package in October, Depfa Ireland was still exposed to huge money market roll-over risk and remained the key source of Hypo Real Estate's problems. The supervision chaos was personified by German finance minister Peer

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Steinbrück, who on October 15 mistakenly claimed that German supervisors had no right to inspect a bank located in Ireland.

The example reveals the structural “prisoner’s dilemma” under which European bank regulation and supervision must operate. Absent coordination, individual European countries can adopt moral hazard strategies, hoping to gain individually while the rest of Europe is losing. The super-dilemma is that almost all European states embark on some variant of such strategies, and hence their list keeps growing as the mutual incentives to avoid reforms remain strong. Personal income taxes are low for investors in Switzerland, Liechtenstein, and Monaco, or for bankers in the United Kingdom. Ireland, Luxemburg, Iceland offer corporate income tax havens. Subsidies for specific funding products abound, including French savings passbooks and German Bausparen. Regulatory competition appears in all areas, such as strong subordination of depositors in the German and Spanish covered bond legislations, or special public ownership and intervention privileges still taken for granted throughout most of the continent under the excuse of the property rights guarantee of the EU Treaty (Germany, Spain, Italy, France, Poland, and Hungary exercise this guarantee with regard to public retail banks).

A feature common to all is the lack of incentives to facilitate information exchange about bank safety and soundness across borders and to take joint action by supervisors, a matter that has increasingly attracted attention of internationally active banks that are the main losers from multiple supervision lines, mushrooming regulations, and lack of supervisor co-ordination, and therefore have been pushing for a cross-border framework for years.

When the financial crisis reached its culminating point in 2008 and bank balance sheets, rather than lending operations or locations, became the targets of public intervention, a whole series of new policy coordination failures materialized.

The race to the bottom had begun in late 2007, as central banks globally beginning to lower collateral standards for open market operations in order to stem the growing liquidity crunch. The European Central Bank had acted early by allowing large volumes of mortgage bonds to be repoed, although doubts about their quality had been raised. The U.S. Federal Reserve only followed later.

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After the Benelux rescue of Fortis in early October 2008, Britain reacted with the boldest effort yet to recapitalize the ailing banks that had funded the country’s housing bubble. This prompted Germany and France to come up with their own public rescue plans, although their banking sectors on the whole were doubtlessly in less trouble. In the German case, subscription so far is broadly limited to banks already under other existing public support schemes that face headwind from the EU Commission. A fight is currently raging between member states and the European Union over the minimum interest rate that preferred capital injected by the state should fetch.

The latest race is unfolding in the arena of public guarantees on bank debt. While Britain and the Netherlands have adopted programs that retain proximity of public guarantee pricing to market pricing by using long-term credit default swap rates as a basis and allowing banks facing better conditions to opt out, weeks after the program announcement, specific guarantee conditions in Germany and France have yet to be published. Other terms, such as maturities or cut-off dates for privileged issues, promise to differ strongly. Meanwhile, Ireland and Sweden include covered bonds in

coverage while the German keepers of the Pfandbrief grail do not. The door to politically motivated subsidies, such as in the United States where public guarantee rates are far below market prices for bank debt, is wide open in Europe.

Similar prisoner's dilemmas are looming as a retaliation to individualized rescue strategies, such as the British role in the Icelandic banking crisis and subsequent sovereign default, the Swiss decision to implement a generous "bad bank" for UBS rather than a selective asset purchase program like almost everybody else, and the U.S. decision to let Lehman Brothers—the broker-dealer with the highest exposure to Europe—fail. Each of these steps has the potential to yield socially suboptimal responses.

The challenges outlined above clearly warrant responses in several layers of jurisdictions, including global—in the area of regulations—and European beyond the European Union—in the area of tax havens. However, given the scale of the banking market and the existence of a currency union, at the EU level substantial progress can be achieved. This can be done more realistically in the European Union than on other supra-national levels where not only are co-ordination problems larger, but antagonistic attitudes in the financial sector may be more pervasive. Three priority areas stand out where EU action could make a difference.

The first clear case is the fight against intra-EU supervision—the easy moral hazard policies and related arbitrage strategies by banks that have made the transmission of external financial sector shocks to Europe faster and magnified their amplitude. A long-discussed priority here is pan-European supervision of cross-border groups in order to ensure sufficient information flow and a minimum supervision standard. Also, clearly lessons need to be drawn from the failure of many EU member state regulators to implement existing regulations. A striking example here is the contrast between Spanish and German supervisors' responses to banks sponsoring off-balance ABCP conduits and SIVs, which Spain flatly discouraged while Germany tolerated. Addressing the structural weaknesses of national supervisory entities is clearly a priority issue.

Second, the sum of member state fiscal bank crisis resolution costs is likely to exceed the optimal level for the European Union as a whole by far because of the prisoner's dilemmas arising from scope and size of national resolution programs. The European Union can act within its established fiscal discipline mandate under the Treaty to try to minimize those costs, for example by imposing floors on public credit guarantees and preferred equity injection remunerations. On the institutional side, bank crisis resolution is often inadequately organized, as the units are established under central banks or treasury departments rather than where the in-depth supervisory knowledge about banks is located. The European Union can help to rationalize this.

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Third, the race to the bottom in the area of distorting financial sector subsidies is also possible to stop at the EU level, where clear subsidy rules are enshrined in the Treaty. Even banks with capital levels in the range of 7–8 percent now seek public protection as a result of the prisoner dilemma situations described; examples are Germany's Commerzbank and France's BNP Paribas. It is clear that even the best capitalized banks will seek public subsidies, if subsidies are not rationalized.

The financial sector subsidy with undoubtedly the largest distortive potential in that regard is public deposit insurance. The financial crisis has substantially weakened confidence in the financial safety net, and governments have understandably taken short-term action to beef up insurance in order to avoid bank runs.

Yet there is substantial risk that while the distortive recapitalization and public guarantee efforts will be temporary, the subsidies provided through high public deposit insurance coverage will be permanent. The non-cooperative climate within the European Union will lead to an uncapped public guarantee level for retail bank deposits, a level already reached by Germany, Ireland, and Portugal.

Such lavish guarantees would not only eradicate any control function on bank management and deepen the nationalized character of banking—deposits in the Eurozone already provide for around 50 percent of the funding of banks. Private bank capital market instruments, just 16 percent of Eurozone bank funding, and securitization and investment funds—in short all private risk transfer mechanisms—would be threatened in their existence.

In the fall of 2008, covered bonds and investment fund shares are suffering badly as investors seek safety. The jurisdictions that acted by guaranteeing covered bonds argue that subsidizing only public deposit insurance would create an asymmetric subsidy, inducing banks to intensify the use of instruments at the short end of the yield curve. This would exacerbate the problems that caused the crisis in the first place—borrow short, lend long—during the next cycle.

However, the most worrisome impact of a slow death of capital markets through crowding out would be for banking

itself. The already-strong trend towards universal banking, as capital market issuers seek the relative funding stability of deposits, would become a tide. Yet universal banks are information black boxes, structures in which risks are least properly isolated and priced. Translated to the typical European prisoner dilemma situation urging the creation of national champions, the nightmare of a future excessive risk concentration in mega-banks—leading to new Icelands of even larger scale—is within close reach.

A EUROPEAN DEPOSIT INSURANCE SYSTEM

Two of the three areas of action defined above fall within the EU Treaty: fiscal bank resolution costs and financial sector subsidies. The third, coordination of supervision, would require fresh political action. The best approach would be to directly address Europe's structural weakness in this area and combine it with a focus on deposit insurance as the backbone of the financial safety net. The political timing could not be better.

The Council of Ministers should thus announce before the end of 2008 a plan to create a European Deposit Insurance System (EDIS).

This announcement should be coupled with a smarter Deposit Insurance Directive proposal that promotes convergence and realistic and necessary limitations, rather than divergence, of public guarantee coverage in order to minimize distortions. The way to go here is maximum harmonization that includes public deposit guarantee ceilings, excludes non-retail deposits, and defines the interaction with private deposit insurance schemes.

The agreement to create the EDIS of 2008–09 would be seen as the second pillar of the European financial system architecture, with the first being the European Monetary Union begun in 1990. Such a plan could entail three steps:

First, in early 2009 create a pan-European institute supervising cross-border groups. The institute would fulfill two functions: an information clearinghouse for the supervision of cross-border financial groups, which will be taken care of by national lead supervisors; and a formal policy think tank for financial sector restructuring, financial sector subsidies, and regulatory reforms.

Even without ensuing integration steps, the institute would fill important information gaps between the current national supervision entities and facilitate the European reform discussion. With more real-time information exchange, a case like that of Depfa which relies on the timely disclosure of a handful of liquidity indicators could be almost prevented.

Second, create deposit insurance agencies (DIAs) for member states. As both a stabilization measure and a building block of the EDIS, member states would in early 2009 convert their statutory deposit insurance promises into the obligations

of capitalized national deposit insurance agencies (DIAs), following broadly the model of the U.S. Federal Deposit Insurance Corporation.

The key advantage of beefed-up national supervisors would be that existing regulatory and supervisory functions could be combined with financial institution functions—deposit insurance, asset acquisition, and failed bank receivership—under one roof. This creates strong institution with financial “firepower” and a level of autonomy needed to respond at times of crisis. At present, financial institution functions are generally hastily allocated to agencies with little capacity or insight into bank operations, such as finance ministries or central banks.

The private sector's status would remain unaffected as their existing deposit insurance schemes are simply placed under the DIA's supervision and possibly rationalized in order to iron out wide variations in institution and insurance coverage, in line with the EU Deposit Insurance Directive.

Going forward, private schemes would be allocated as first (individual institution level) and second (group level) loss

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buffers under the DIA and EDIS, for the classes of enrolled banks respectively. The private sector would commit member liquidity facilities in proportion to the respective capital bases (for example, at a ratio of 5 to 1). Over time, similar private sector group protection could also be arranged for other bank debt instruments, such as for covered bonds on the national or European level, and similarly backstopped. However, deposit insurance is the priority.

Third, create a European Deposit Insurance System. The EDIS would be constituted in a final step as a politically independent body, much like the European Central Bank. The national DIAs would correspond to EDIS in the

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way eurozone central banks correspond to the European Central Bank, as members of a network. This would shift the regulation-supervision effort ratio of the national DIAs over time to supervision while the EDIS would become more regulation-heavy. However, EDIS would create a supervisor who would focus on cross-border financial groups, as defined by asset/liability structure and risk indicators, or possibly a pan-European bank charter along the lines of the U.S. national bank charter. EDIS would create a catastrophic risk backstop facility for the national DIAs funded by member state credit lines. Those credit lines would replace national lines given initially to the DIAs for the same purpose.

The most important strategic question for the EDIS would be the distribution key for losses potentially arising from financial rescue operations. Surely, the national “deductibles” would remain large to ensure a proper member state supervision discipline. EDIS loss allocation would then follow similar principles to those that have been agreed on for seignorage (inflation tax) profit allocation under the European monetary union; to that end a distribution formula reflecting asset-liability and risk cross-border allocation would have to be developed.

An open question would be the scope of the system, both in terms of membership and scope of supervision. It seems logical that a structure designed to complement the European Central Bank’s repo and lender-of-last-resort functions would operate initially at the eurozone level only. The crisis might present a golden time slot though for warming up so-far-reluctant EU member states to monetary union access, including Denmark, perhaps even the United Kingdom as possible headquarters for an EDIS institute, but also non-EU members such as Iceland. This might address partly the question about extension to the European Economic Area (including Norway and Iceland) as well as Switzerland, all of which should be members at least of a wider policy coordination group in order to capture some

of the strongest regulatory arbitrage outliers. The system should also lead regulation policies in all banking matters, including beyond narrow deposit insurance. Clearly, defining what is a bank, and what not, is one of the hottest topics to be decided beforehand.

As ambitious as the plan for an EDIS may sound, as a decentralized, bottom-up, and phased version that focuses on the strengthening of national systems, it will initially have greater chances for both political and practical success than a comparable effort to create a global financial regulator top-down, as proposed by French President Nicolas Sarkozy in early November 2008. The planned series of G20 summits to discuss responses on the global level is surely necessary, especially with regard to the necessary bank and non-bank regulation reforms, but it cannot be expected to yield deeper supervision coordination mechanisms. Hopes by some in the political arena that the International Monetary Fund could become a global meta-supervisor should be discouraged by even a superficial inspection of the Fund’s past policies; the best hope for the Fund is to perform as a global think tank.

Europe should thus focus on its own strength. The European Union stands at a crossroads, faced with an explosion of member state moral hazard behavior and fiscal irresponsibility in the financial sector. The word “Maastricht” standing for fiscal discipline seems to have become forgotten. The European banking market has only been a secondary cause of the crisis, but it has been hit catastrophically due to the weak structures described. An overdose of subsidies is a sure recipe for the next hit, possibly a bigger one. The priority should not just be to fight the acute crisis, but to vigorously move ahead with overdue institutional and policy reforms. Without those reforms, Europe will continue to perform as weakly as in the past decades when a coalition of U.S. deregulation Rambos and European beggar-my-neighbors created the toxic mix that is currently threatening the entire global financial system. ◆

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