Article

Deposit Insurance and Cross-Border Banks

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Deposit insurance is one of the pillars of trust in the banking system. This trust is deeply anchored in the belief that the sovereign stands ready to reimburse depositors in case of a bank failure. What does this mean for banks operating across different countries? Are differences in the design and protection of deposit insurance behind some banks’ reluctance to operate as cross-border banks? Can these differences be explored to attract depositors with heterogeneous risk preferences?

In this article we discuss these issues, focusing especially on the current situation in the European Union. The euro area sovereign debt crisis, with its onset in the early 2010s, paved the way for a strong political consensus on strengthening the financial integration dimension of the European project. Today there is a single banking supervisor and a single resolution mechanism. But the banking union will remain incomplete until a common deposit insurance scheme is launched.

Looking into the current situation in Europe can thus be an important exercise in better understanding what is special about deposit insurance for cross-border banks.

Of course, the implications of this discussion go beyond the European debate. That said, heterogeneous deposit insurance guarantees are possibly even more challenging for banks that operate across other jurisdictions where further legal and financial differences coexist.

DEPOSIT INSURANCE AROUND THE WORLD

For many decades, deposit insurance was seen as an undebatable institution in advanced economies and as a synonym of progress and financial development in emerging markets. Since Diamond and Dybvig (1983) showed how deposit insurance was crucial to prevent bank runs, the need to protect depositors has become a concern of regulators around the world.

Given the heterogeneity in the design of deposit insurance around the world, there are key implications for cross-border banks. When a bank expands across borders, a crucial decision needs to be made: will the bank operate as a branch or as subsidiary? If the bank’s day-to-day operations, that decision does not entail major consequences. The customers of a branch and a subsidiary are usually unaware of the legal status of their bank — unless something goes wrong. In a recent paper, Bonfim and Santos (2019) show that during a crisis, bank depositors seem to be well aware of the differences between a branch and a subsidiary. Indeed, in financial distress, the distinction is not trivial. While a subsidiary is a fully-fledged legal entity in the country where it operates (the host country), a branch does not have legal autonomy from the parent bank. If a subsidiary fails, the host authorities are responsible for dealing with the process. The supervision of a subsidiary is typically the responsibility of the host, even though the home authorities are responsible for supervising the consolidated banking groups. The same is usually true for resolution power and for deposit insurance. In the United European Union, if a subsidiary fails, the host deposit insurance fund is responsible for reimbursing insured depositors. This situation is quite different from branches: host country supervisors have to identify and act with branches, but these are quite limited. Most of the responsibilities fall to the home authorities, including in matters of deposit insurance.

To back this argument up, depositors in a given country may face different levels of protection, depending on the design and credibility of the deposit insurance fund backing the claims. In some cases, host countries of foreign branches might prefer home country regulation and supervision if the host country’s deposit insurance scheme is strong and if the branch is large relative to its banking group. In this case, the home authorities might be more worried about potential spillovers from the branch into the home country’s banking sector. Still, a banking system where large foreign branches are important might be more exposed to fluctuations in financial intermediation that are not easily dealt with by host policymakers. If the home country’s deposit insurance scheme is weak, then exposure to large foreign branches is clearly a material risk for the host authorities. To avoid such risks, supervisors often favor the local market.

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BRANCHES VERSUS SUBSIDIARIES: WHAT DOES IT MEAN FOR DEPOSIT INSURANCE?

Given the heterogeneity in the design of deposit insurance around the world, there are key implications for cross-border banks. When a bank expands across borders, a crucial decision needs to be made: will the bank operate as a branch or as subsidiary? If the bank’s day-to-day operations, that decision does not entail major consequences. The customers of a branch and a subsidiary are usually unaware of the legal status of their bank — unless something goes wrong. In a recent paper, Bonfim and Santos (2019) show that during a crisis, bank depositors seem to be well aware of the differences between a branch and a subsidiary. Indeed, in financial distress, the distinction is not trivial. While a subsidiary is a fully-fledged legal entity in the country where it operates (the host country), a branch does not have legal autonomy from the parent bank. If a subsidiary fails, the host authorities are responsible for dealing with the process. The supervision of a subsidiary is typically the responsibility of the host, even though the home authorities are responsible for supervising the consolidated banking groups. The same is usually true for resolution power and for deposit insurance. In the United European Union, if a subsidiary fails, the host deposit insurance fund is responsible for reimbursing insured depositors. This situation is quite different from branches: host country supervisors have to identify and act with branches, but these are quite limited. Most of the responsibilities fall to the home authorities, including in matters of deposit insurance.

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The opinions expressed in the article are those of the authors and do not necessarily reflect those of Banco de Portugal or the Eurosystem. Any errors or omissions are the sole responsibility of the authors.
sovereigns backing up the deposit insurance schemes. This is shown by examining depositor behavior around the periods in which a few foreign subsidiaries operating in Portugal changed their legal status to foreign branches, implying that deposits were no longer guaranteed by a distressed sovereign, but by highly rated European countries. As discussed later, this shows that as long as the banking union is incomplete, the perceived heterogeneity of deposit protection across jurisdictions cannot be overcome.

The strength and credibility of the home countries’ deposit insurance schemes and the absolute and relative size of the banks in each country are key determinants of the effectiveness of regulation and supervision and, ultimately, of financial stability (Eisenbeis and Kaufman 2008; Eisenbat 2004). One key issue behind such a disparity in credibility of deposit insurance is the funding arrangements. Before the Federal Deposit Insurance Corporation (FDIC) was established in the US, there were several attempts to create decentralized deposit insurance schemes.4 Between 1908 and 1917, eight US states created deposit insurance schemes, most of which failed within a very short period. According to Eisenbeis and Kaufman (2008), these schemes had several design flaws in common: (i) the schemes were typically underfunded; (ii) they were undersized, having their risk concentrated in specific regions; and (iii) there was significant exposure to cross-border depositors.

The Directives on Deposit Guarantee Schemes approved in 2005 and 2014 attempts to further harmonize national deposit insurance schemes, guaranteeing deposits up to EUR 100,000 (per credit institution and per account holder). Borrowing/lending between national funds is also envisaged in the Directive, which provides a crude form of risk-sharing, limited to liquidation.笛 still, the degree of heterogeneity across national deposit guarantee schemes permitted by this Directive can be relevant in some dimensions. This may contribute to the differentiation of deposits across national borders and hence to financial frag- ility insurance. This is shown by examining the results of the lessons learned from more than 10,000 bank failures in the US between 1900 and 1913 (Eisenbeis and Kaufman, 2008).

THE EUROPEAN BANKING UNION: WHERE DO WE STAND TODAY AND WHY?

In the European context, and in the euro area in particular, the provision of deposit insurance systems is no longer characterized by a strong home country bias as a result of the crisis. The absence of a European banking union was widely acknowledged as a clear threat to the economic and financial stability of Europe, essentially because it contributes to a strong home country bias in resolution and resolution, and to the lack of clear rules for the resolution or liquidation of banks at the national level. The uncertainty surrounding the ultimate legal status of banks in cross-border banking, the lack of a common backstop and the internalization, at the EU level, of the resolution or liquidation determined by a European decision. Member states thus bear the ultimate responsibility for financial stability, but are clearly constrained by supervisory and resolution (or no resolution) decisions. This means that European authorities might not internalize the costs of determining the potentially disruptive liquidation of a bank by national authorities and the associated activation of public guarantees. Deciding at the European level to apply a resolution measure and, as a consequence, determining the liquidation of banks at the national level, may thus be more likely without a common deposit insurance scheme, possibly leading to local systemic disruptions.

WHAT REMAINS TO BE DONE?

The mix between centralized supervision and resolution on the one hand, and national deposit insurance and liquidation on the other, creates a clear misalignment of incentives among the various authorities. It is thus necessary to deal with the serious risks related to international expansion. A single bank reso- lution system, demanding coordination among the various resolution authorities, also makes the resolution of cross-border institutions more feasible, while being a first step towards avoiding the involvement of countries (or taxpayers) in the recapitalization of banks and in the activation of deposit guarantees. This can contribute to a more uniform approach of banking systems, and in particular of large pan-European institutions, to the risk management and resolution frameworks. The banking union initiatives that emerged in 2012 represent an important step for the completion of the economic and monetary union. The centralized char- acter of bank supervision ensures proper and consist- ent oversight of multinational banks. It also reduces the capacity of sovereigns and banks to influence each other, in particular as regards strategic decisions related to international expansion. A single bank reso- lution system, demanding coordination among the various resolution authorities, also makes the resolution of cross-border institutions more feasible, while being a first step towards avoiding the involvement of countries (or taxpayers) in the recapitalization of banks and in the activation of deposit guarantees. This can contribute to a more uniform approach of banking systems, and in particular of large pan-European institutions, to the risk management and resolution frameworks.

Despite these evident problems, the ongoing Euro- pean debates concerning the deepening of the banking union (and crucially, a possible common deposit insur- ance system) are marked by a clear cross-border divide. Several groups of member states are calling for urgent risk-sharing solutions and another group calling for the immediate application of decisive risk-reduction measures (reduc- tion of NPLs and of the exposure to the respective sovereigns), ensuring that those insurance mechanisms do not become essentially redistributive at the outset. While efforts to stabilize the banking systems in more vulnerable countries are widely recognized, there seems to be a failure to recognize that facing the next crisis without a complete banking union could jeopard- ize the future of the economic and monetary union.

A DECADE OF CHANGE IN EUROPEAN DEPOSIT INSURANCE

Before the failure of Lehman Brothers, all member states had their own deposit insurance schemes. The existence of deposit insurance initially made a debate over a common deposit insurance scheme nonexistent. Indeed, the overall regulatory landscape was far from integrated. The Second Banking Directive, approved in 1983, was only a first step towards three basic principles: harmonization, mutual recogni- tion, and home country control. Regulatory rules were generally harmonized, ensuring a minimum set of com- mon rules, mostly focused on bank capital. Mutual rec- 4 The FDIC, established in 1913, was one of the first deposit insurance institutions backed by a general government fund. Its creation was a result of the lessons learned from more than 10,000 bank failures in the US between 1900 and 1913 (Eisenbeis and Kaufman, 2008).
the lack of common deposit insurance could potentially outweigh the costs. For example, a shock to the domestic economy that leads to losses in loan portfolios and to potential limitations on the credit supply could be offset by the international operations. But such benefits are perhaps perceived as less significant, since the bias may be reversed (Eisenbeis and Kaufman 2008). As discussed above, there are multiple tensions between home and host authorities that are not easy to address and that raise challenges to cross-border bank operation.

Would completing the banking union fully address these tensions? To entirely eliminate them, the interests of all parties involved in regulation, supervision, and resolution would have to be aligned. Ultimately, this means aligning the interests of all taxpayers represented by these authorities. At its current stage, the banking union anchored on the two pillars of supervision and resolution through branches is insufficient to fully reflect national requests and help create a pan-European banking system that is less dependent on the country of origin. The proposals amount to relaxing liquidity and capital requirements for subsidiaries—providing these requirements are met at the group level—so as to promote the reallocation of resources across jurisdictions. In turn, this could lead to conflicts between host and home authorities, despite the huge step made by the two existing pillars of the banking union: its discussion before, completing the banking union through a common deposit insurance scheme, with a common fiscal backstop, would certainly foster a better alignment of interests. This would avoid the parallel implementation of different systems and might ease the transition of taxpayers. However, it is important to control the potential risk-sharing consequences of these reforms.

IS THE LACK OF COMMON DEPOSIT INSURANCE AND RESOLUTION INCOMPATIBILITY OF THE BANKING UNION A BARRIER TO BANK CONSOLIDATION AND CROSS-BORDER EXPANSION?

There are many benefits associated with cross-border bank expansion. It fosters competition and efficiency, and mitigates risks through geographical and sectoral diversification (Eisenbeis and Kaufman 2008, Hartmann et al. 2017). From a political economy viewpoint, this is a natural step in European integration. Recently, bank expansion. It fosters competition and efficiency, and cross-border expansion?

IS THE LACK OF COMMON DEPOSIT INSURANCE

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REFERENCES


