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BANK GUARANTEE FUND

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Contents

FROM THE EDITORIAL OFFICE

Dear Readers!

The 15th anniversary of the Polish Bank Guarantee Fund (BFG) concurrs with overcoming the consequences of the global financial crisis as well as with creating a new regulation structure in both normative and subjective interpretation. Unlike quite extensive experiences in overcoming the national banking crisis in the nineties, the global financial crisis at the close of the first decade of the XXI century has not caused the Polish deposit guarantee system any problems connected with issues of the banks operating in Poland. Whether the reasons for such a situation are based in the efficiency of the regulation structure, the level of development of the Polish banking system or in the complex experience of a system transformation of all the participants of the Polish financial market, remains the question of scientific research. While creating space for academic studies within this scope, it is paramount for the safety net links to draw conclusions from foreign and international experiences as well as to shape the architecture of a banking system in a manner that minimizes the risk of occurrence of any crisis phenomena in the future. Driven by this premise, the BFG organs have decided to honor the 15th anniversary of the BFG in a useful way by organizing an international conference entitled “Global Financial Crisis: Lessons for Stability of the Financial Sector” and inviting to participate the representatives of international institutions, central banks, deposit guarantee institutions, as well as prominent scholars and practitioners. The international context of issues raised in the addresses of the conference’s participants has persuaded the editorial office of the Safe Bank, a magazine published by the BFG since 1998, to prepare an issue in English, sharing the presented evaluations, concepts and solutions with an international community interested in the problems of the banking sector's stability.

Many countries are affected by a global infection connected with the financial brokerage, at the same time learning – in a very expensive way – about the meaning of financial stability for the socio-economic systems to work efficiently. The prestige of financiers is dramatically decreasing in the public opinion. Various explanations of the global crisis' reasons are widely propagated. Politicians are attempting to build a political capital by means of new regulations aimed at minimizing the risk of another crisis to occur. These are merely some of the reasons to submit the opinions and directives formulated by representatives of various ways of thinking in economy, as well as various institutions and organizations connected with the financial market, particularly the banking system, for reflection by the financial safety net specialists. By publishing the studies of the conference participants, who have bequeathed their articles, we maintain a certain numerical balance between our guests from abroad and those from Poland.

As W.G. Leibnitz wrote "*the present is big with the future and laden with the past*". The global financial crisis emphasized the significant weaknesses of the financial brokerage, mainly in the credit institutions sector. Apart from short-term restructuring and regulating proceedings, there is a need for a long-term change in the brokerage system which would minimize the risk of another crisis, particularly as a result of neglect. The theoretical reflection ought to be stimulated by searching for a paradigm of the XXI century finance adequate with the level of development of financial markets as well as civilization challenges. In such a reflection it is impossible to omit the changes in the global economy architecture, as a result of reallocation and concentration of manufacture and service centres, mobility of the capital, dangers arising from a wasteful exploitation of natural resources and the degradation of the environment, profound changes of demographic features, uneven access to education, segmentation of the labour markets and dangers arising from an intergeneration redistribution of income in the social security systems. The practical actions ought to take into consideration the ideological motto of the Club of Rome "*In order to survive we must learn from the future, not the past*".

Jan Szambelańczyk
Editor in Chief

BGF Activity

REPORT ON THE OPERATIONS OF THE BANK GUARANTEE FUND IN 2009 (SHORT FORM)

I. LEGAL BASIS, ROLES AND CORPORATE BODIES

The Bank Guarantee Fund, one of the cornerstone institutions ensuring the stability of the Polish banking system, carries out the tasks set out in the Bank Guarantee Fund Act of 14 December 1994, under the supervision of the Finance Minister.

The BGF is a key component of Poland's financial security network, performing its statutory roles that involve guarantee, assistance and analytical activities.

In the mandatory accumulated sum guarantee scheme, these roles include:

- ❖ determining the amount of funds designated in a given year by entities covered by the guarantee scheme, in connection with the obligation to establish the guaranteed sum protection fund;
- ❖ fulfilling obligations resulting from guaranteeing sums on the terms set out in the Act.

The Fund's statutory responsibilities with regard to assisting entities covered by the guarantee scheme include:

- ❖ providing reimbursable financial assistance in accordance with the terms set out in Articles 19 and 20 of the Act, in the event of insolvency risk or for the purpose of purchasing shares of banks;
- ❖ acquiring debts of banks at risk of insolvency;
- ❖ assessing the proper use of the assistance provided;
- ❖ setting mandatory annual fees, as referred to in Articles 13.1 and 14 of the Act, which are paid to the Fund by entities participating in the scheme.

Moreover, pursuant to the Act on the operation of cooperative banks, their mergers and on the acquiring banks of 7 December 2000 (Journal of Laws No. 119, item 1252, as amended), the Fund may provide reimbursable financial assistance to cooperative banks at risk of insolvency from the resources of the cooperative bank restructuring fund (the CBRF).

As regards collecting and analysing information about entities participating in the deposit insurance scheme, the Fund is in particular responsible for preparing analyses and projections for the banking sector.

The statutory corporate bodies of the Bank Guarantee Fund are the Supervisory Board and the Management Board. On 31 December 2009 the BGF Supervisory Board was composed as follows:

Chairman of the Supervisory Board:	*Dariusz Daniluk*
Members of the Supervisory Board:	*Agnieszka Alińska* *Krzysztof Broda* *Alina Gużyńska* *Jerzy Nowakowski* *Krzysztof Pietraszkiewicz* *Piotr Piłat* *Jan Szambelańczyk*

In 2009, pursuant to a decision adopted by the Fund's Supervisory Board, the composition of the Management Board was modified, as a result of which on 31 December 2009, the Fund's Management Board was composed as follows:

President of the Management Board:	*Jerzy Pruski*
Vice-President of the Management Board:	*Anna Trzecińska*
Members of the Management Board:	*Krystyna Majerczyk-Żabówka* *Marek Pyła*

II. GUARANTEE ACTIVITY

The source of financing the Fund's deposit guarantee activity are the resources collected by banks for the protection of guaranteed sums (FPGS). All banks participating in the Polish deposit insurance scheme are obligated to establish these funds. The amount of funds is calculated as the product of the sum of resources collected in the bank, which provide the basis for calculating the amount of mandatory provisions and the interest rate determined every year by the BGF Supervisory Board. The maximum interest rate is 0.4 percent. Taking into account the risks in the banking sector, the Supervisory Board of the BGF determined the interest rate applicable to establishing the FPGS for 2009 at 0.4 percent for the sum of money collected in the bank in all accounts, which serves as the basis for calculating the mandatory provision level. In 2009, the Funds for the Protection of Guaranteed Sums established by all banks and maintained in their assets (updated on 1 July 2009) amounted to PLN 2,611,015.900. These funds were not utilised in 2009 as no bank insolvency occurred.

The method in which banks establish funds for the protection of guaranteed sums does not affect their financial obligations. It only restricts their freedom in administering a small – compared to the balance sheet sum – portion of their financial resources. Resources used to cover these funds are kept in the form of treasury bills, NBP money bills, treasury bonds or participation units of the money market funds, which brings banks income. The participants of the scheme submit to the BGF appropriate amounts for the disbursement of guaranteed sums only after the court declares the insolvency of a bank.

Between the commencement of its operations and the end of 2009, the BGF disbursed guarantee funds to depositors of five commercial banks and eighty-nine cooperative banks.

Bank insolvencies in the years 1995–2009

Year	Commercial banks	Cooperative banks
1995*	2	48
1996	1	30
1997	–	6
1998	–	4
1999	1	–
2000	1	–
2001	–	1
2002–2009	–	–
TOTAL	5	89

* Since 17 February 1995, i.e. from the effective date of the Bank Guarantee Fund Act.

The disbursements of guarantee sums made by the Bank Guarantee Fund in the years 1995–2009 amounted to PLN 814.4 million and were provided to 318,800 eligible depositors.

In 2009, the Bank Guarantee Fund obtained PLN 569,300 on account of receivables admitted to bank bankruptcy estates in connection with providing receivers with funds for depositor disbursements in previous years. These funds were sourced from the distribution of bankruptcy estates of three banks. The overall sum of the funds obtained from bankruptcy estates, as on 31 December 2009, amounted to PLN 53,423,700.

Funds allocated to guarantee disbursements in the years 1995–2009

Year	Funds allocated to guarantee disbursements (in PLN million)				Percentage of utilisation of the FPGS	Number of depositors
	Total	including:				
		from the FPGS	from liquidated bankruptcy estates	from the bankruptcy estate fund		
1995	105.0	85.9	19.1	0	38.1	89.939
1996	50.8	47.3	3.1	0.4	14.9	59.420
1997	6.4	4.7	0.6	1.1	2.3	10.418
1998	8.2	4.1	1.8	2.3	3.2	6.775
1999	4.7	0	2.0	2.7	0	1.572
2000	626.0	484.1	141.9	0	48.4	147.739
2001	12.5	0	4.5	8.0	0	2.658
2002	0.1	0	0.1	0	0	46
2003	0.1	0	0.1	0	0	27
2004	0.4	0	0.4	0	0	124
2005	0.1	0	0.1	0	0	99
2006	0.1	0	0.1	0	0	5
2007	0	0	0	0	0	0
2008	0	0	0	0	0	0
2009	0.004	0	0	0.004	0	1
TOTAL	**814.4**	**626.1**	**173.8**	**14.5**	**6.15**	318.823

In 2009, the Fund was notified of the completion of two bankruptcy proceedings of banks for whom the BGF was a creditor.

As at the end of December 2009, pending were still the bankruptcy proceedings of three banks that were declared bankrupt by the courts during the life of the Fund.

During the reporting period, the Fund provided all interested parties, and in particular customers of banks, with information concerning the terms and conditions of operating the deposit insurance scheme and the involvement of each financial institution in the deposit scheme. Telephone queries and correspondence (letters and emails) addressed to the Fund concerned matters related to possible bank bankruptcy, including the terms of exercising guarantees as well as procedures and options for retrieving sums deposited with banks in the event of bankruptcy. The Fund has also received numerous questions regarding the detailed terms of exercising guarantees, including in particular the terms of guaranteeing joint accounts, branch offices of finance institutions operating in Poland and Spółdzielcze Kasy Oszczędnościowo-Kredytowe (cooperative savings and credit unions). In all cases, the depositors received detailed answers to their respective questions.

III. ASSISTANCE ACTIVITY – THE ASSISTANCE FUND

The fundamental purpose of the Fund's assistance activity is to grant financial assistance to banks at risk of insolvency in order to enable them to undertake restructuring operations, and, indirectly, to protect customers against the loss of funds they entrust with these banks. Pursuant to the Bank Guarantee Fund Act, assistance may be provided in the form of loans, guarantees or sureties, as well as by way of acquiring banks' safe debts, on terms more favourable than generally applicable terms. So far, the assistance provided by the BGF was solely in the form of loans.

The assistance fund out of which loans are extended is created from mandatory annual fees remitted by all participants of the guarantee scheme and the Fund's balance sheet surplus distributions. The fee payable by each bank is calculated as the product of the fee set by the Fund's Supervisory Board and the base set out in the Bank Guarantee Fund Act. The mandatory annual fee payable by banks in 2009 equalled 0.045 percent of the 12.5-fold sum of capital requirements under each risk type and capital requirements with regard to overdraft and breach of other standards defined in the Banking Law.

In 2009, the assistance fund was supplemented with annual fees remitted by banks in the total amount of PLN 308,159,900 and distributions of the Fund's balance sheet surplus of PLN 271,403,400.

The assistance fund is also a source of financing for disbursements of guarantee sums in the event that the resources accumulated in banks as part of the fund for the protection of guarantee sums.

Pursuant to Article 20 of the Act, financial assistance may be granted after specific conditions have been met, including in particular:

- ❖ the Fund's Management Board has approved the results of an audit of the financial statements with regard to the activity of the bank requesting assistance, and in the case of requests for assistance for the purpose of acquiring a bank, bank merger or acquisition of shares in another bank – the results of an audit of the financial statements of both banks,
- ❖ the bank has presented a recovery procedure plan, approved by the Financial Supervision Authority (FSA), and in the case of a bank acquisition or merger or purchase of shares in another bank – the FSA's approval of the validity of these efforts,
- ❖ the bank has demonstrated that the amount of the loan, guarantee or suretyship requested does not exceed the total guaranteed sums deposited with the bank in

depositors' accounts, and in the case of a request for financial assistance for the purpose of acquiring or merging with another bank – that it does not exceed the total guaranteed sums deposited with the target bank in depositors' accounts,

❖ the bank's existing own funds have been used to cover the losses of the bank requesting assistance or the target bank.

In 2009, financial support was offered on the terms and conditions presented in the table below.

Terms and conditions of providing financial support in 2009

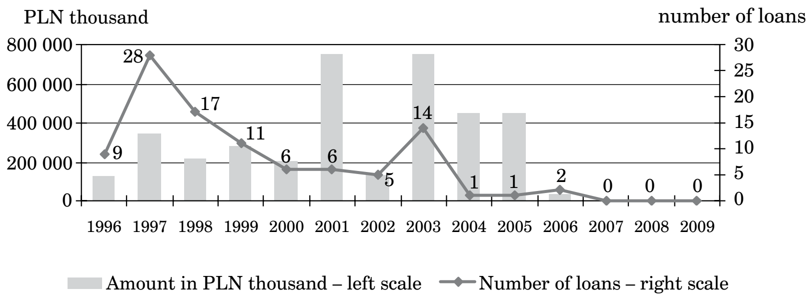
Terms and conditions of providing support:	Purpose of the assistance:	
	elimination of the risk of insolvency	
– annual interest rate on the loan	0.1–0.4 bill rediscount rate determined by the Monetary Policy Council	
– commission	for commercial banks	for commercial banks
	0.3 percent of the loan amount, deducted from the loan amount	0.1 percent of the loan amount, deducted from the loan amount
– loan utilisation period	up to five years*	
– loan disbursement	once-off or in tranches	
– repayment of interest	once per quarter	
– repayment of principal	in quarterly or six-monthly instalments**	

* In reasonably justified cases this period could be extended to ten years.
** In particularly justified cases it was possible to apply a grace period in the repayment of principal.

From its inception until the end of 2009, the BGF granted 100 loans from the assistance fund, of which 44 were extended to commercial banks and 56 to cooperative banks, for a total of PLN 3,746,842,400.The financial assistance granted by the BGF in the years 1995–2009 was allocated towards:

• **banks' self-recovery plans**	**PLN 2,249,050,000**
• acquisitions of banks at risk of insolvency	PLN 1,262,792,400
• purchase by new shareholders of shares in banks at risk of insolvency	PLN 235,000,000

Diagram 1. Disbursement of loans from the assistance fund in the years 1996*–2009



* A loan extended in December 1995 was disbursed in January 1996.

Loans granted from the assistance fund in the years 1995–2009

Type of bank and allocation of assistance:	Loan disbursements	
	Amount in PLN thousand	Share percentage
• **commercial***	**3,427,386.4**	**91.5**
– self-recovery	2,066,000.0	55.1
– commercial bank acquisitions	981,906.4	26.2
– cooperative bank acquisitions	144,480.0	3.9
– share purchase	235,000.0	6.3
• **cooperative**	**319,456.0**	**8.5**
– self-recovery	183,050.0	4.9
– merger processes**	136,406.0	3.6
TOTAL	**3,746,842.4**	**100.0**

* Together with banks that acquired the cooperative banks.

** In 2009, the Fund's Management Board resolved to extend financial assistance in the amount of PLN 43,500,000, but the loan will be disbursed in 2010.

In 2009, no loan was extended out of the assistance fund. Moreover, the Fund administered loans granted in previous years.

IV. ASSISTANCE ACTIVITY – COOPERATIVE BANK RESTRUCTURING FUND

Pursuant to the Act concerning the operation of cooperative banks, their mergers and on the acquiring banks of 7 December 2000, the Bank Guarantee Fund provides financial assistance to cooperative banks from the cooperative bank restructuring fund (the CBRF) established in 2001 to support cooperative bank merger processes.

In accordance with the above act, the Fund received PLN 123,409,700 to be allocated to the above initiatives of cooperative banks and to related investments, in particular towards:

- ❖ unification of IT software and hardware,
- ❖ unification of banking technology,
- ❖ unification of finance and accounting procedures,
- ❖ unification of banking products and services offered,

as well as towards purchasing shares in the acquiring bank.

Financial support is available only to those cooperative banks that are at no risk of insolvency and are fully capable of repaying their outstanding loans.

The amended Act on the Operation of Cooperative Banks broadened the subjective and objective scope of CBRF assistance, in that assistance may now be granted also towards financing planned investments, and the Fund's Supervisory Board defined new forms, procedure and detailed terms and conditions of providing financial assistance from the cooperative bank restructuring fund.

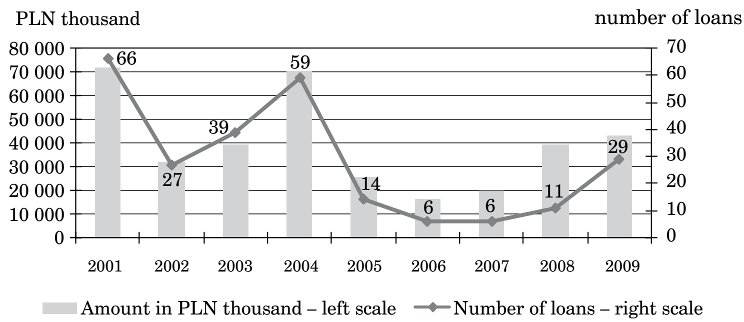
Terms of providing financial assistance from the CBRF for applications received after 13 December 2008

<table>
<tr><th rowspan="2">Terms and conditions of providing support:</th><th colspan="2">Purpose of the assistance:</th></tr>
<tr><th>to support merger processes and non-merger investments</th><th>to purchase the shares in the acquiring bank</th></tr>
<tr><td>– annual interest rate on the loan</td><td>0.1 bill rediscount rate determined by the Monetary Policy Council</td><td>0.05 bill rediscount rate determined by the Monetary Policy Council</td></tr>
<tr><td>– commission</td><td colspan="2">0.1 percent of the loan amount, deducted from the loan amount</td></tr>
<tr><td>– loan utilisation period</td><td colspan="2">up to five years</td></tr>
<tr><td>– grace period in the repayment of principal</td><td colspan="2">up to one year</td></tr>
<tr><td>– loan disbursement</td><td>once-off/tranches</td><td>once-off</td></tr>
<tr><td>– repayment of interest</td><td colspan="2">once per quarter</td></tr>
<tr><td>– repayment of principal</td><td colspan="2">in six-monthly instalments</td></tr>
</table>

The Fund's Supervisory Board adjusted the forms, procedure and terms of granting assistance under the CBRF to the subjective and objective scope of assistance broadened under the amended Act on the Operation of Cooperative Banks (…). The purpose of the adjustments was to accelerate application processing and providing assistance to banks. Compared to previously existing terms, the principal repayment grace period was shortened from two years to one year.

In the years 2001–2009, the Bank Guarantee Fund extended 220 loans from the cooperative bank restructuring fund for a total of PLN 369,830,900. During that time, the amount of loans granted was more than double the size of the cooperative bank restructuring fund as funds obtained from repayments were allocated to new financial relief efforts. None of the cases processed reported any issues with repayment of borrowed funds.

Disbursement of loans from the CBRF in the years 2001–2009



In 2009, the Fund processed 35 requests for financial assistance under the CBRF, for a total of PLN 82,564,100, which included two requests for a total of PLN 2,200,000, submitted before the amended Act on the Operation of Cooperative Banks (...) entered into force, and processed on then-current terms and conditions.

Upon review of the amounts requested by banks before the end of 2009, the Fund's Management Board resolved to:

- ❖ grant 31 loans for a total of PLN 55,053,000, of which:
  - – 27 loans were allocated to support merger processes or non-merger investments – for a total of PLN 51,885,000,
  - – 4 loans were allocated to the purchase of shares in the acquiring bank – for a total of PLN 3,168,000.
- ❖ turn down requests for financial assistance submitted by eight banks due to insufficient amounts in the cooperative bank restructuring fund available at each application stage.

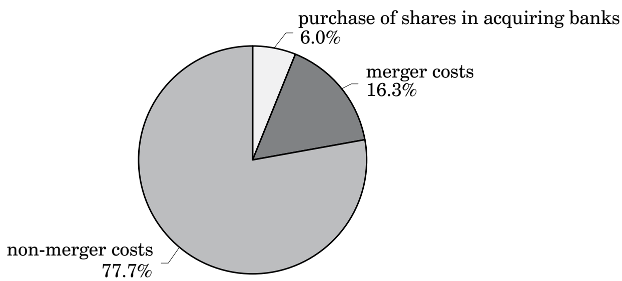
In 2009, twenty-nine loans were disbursed for a total of PLN 43,247,000.[1]

As on 1 January 2009, forty-four banks were utilising fifty-eight loans from the cooperative bank restructuring fund, for a total indebtness thereunder of PLN 85,469,400.

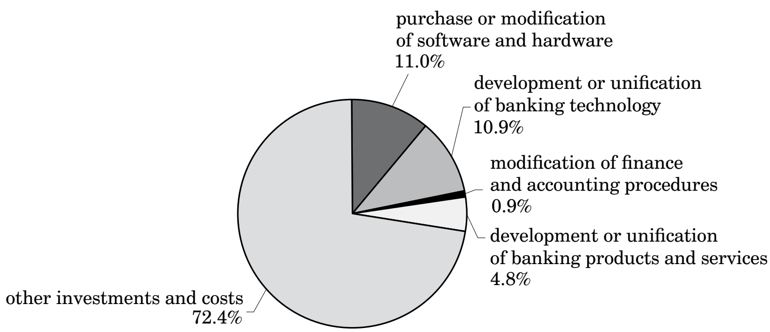
As at the end of 2009, in the collateral structure, the most common form was the freezing of funds on term deposit accounts (37 loans), nine loans were secured using pledges over the rights under securities issued by the State Treasury or the National Bank of Poland, while in eight cases, a bank guarantee issued by the acquiring bank was used.

The allocation of loans from the cooperative bank restructuring fund in 2009 is presented on the diagrams below.

Structure of loans granted in 2009 from the CBRF as on 31 December 2009



Structure of investments carried out under loans obtained in 2009 under the CBRF as on 31 December 2009



[1] Additionally, in 2009, the second tranche of the loan granted in 2008 for a total of PLN 2,707,100 was disbursed. One bank did not sign the loan agreement after assistance was approved, and one loan was disbursed in January 2010. For eleven loans, a total of PLN 6,200,000 remains to be disbursed under subsequent tranches.

A vast majority of the funds obtained by banks under CBRF loans was allocated to other investments and expenses (including construction, renovations and building updates) and the purchase or modification of IT software and hardware. This accounted for 83.4 percent of the loans granted in 2009.

In 2009, banks repaid principal for a total of PLN 24,439,200. Twenty-four banks repaid thirty-one loans in full. Taking into account repayments and disbursements of the loans granted, as at the end of 2009, forty-six banks were taking advantage of cooperative bank restructuring fund loans (utilising a total of fifty-six loans), for a total indebtedness thereunder of PLN 106,984,400.

V. SUPERVISING AND MONITORING UTILISATION OF THE FINANCIAL ASSISTANCE

The scope of the Fund's supervision includes:

With respect to banks using financial aid from the assistance fund	**With respect to banks using loans from the cooperative bank restructuring fund**
verifying whether the financial assistance is being used properly	verifying whether the financial assistance is being used in accordance with its purpose
verifying whether a recovery plan is being implemented	monitoring economic and financial standing and organisational efficiency
monitoring economic and financial standing	verifying the discharge of obligations under loan agreements
monitoring management procedures	

Banks utilising the Fund's financial assistance were supervised and monitored in two forms:

- ❖ in the form of analyses and evaluations carried out on the basis of available financial statements, information obtained from the banks, from the National Bank of Poland and the Financial Supervision Authority and from publicly available sources,
- ❖ in the form of audits carried out at banks utilising the Fund's financial assistance, in accordance with the 2009 audit plan.

In 2009, the Bank Guarantee Fund monitored the economic and financial standing as well as the performance of obligations under loan agreements for forty-eight banks.

In 2009, the Fund monitored twenty-six new banks that had received thirty loans, while the monitoring of twenty-four banks was completed. Upon monitoring the banks taking advantage of financial assistance, it was established that:

- ❖ the banks were not insolvent and that there was no risk of default on their obligations towards the BGF,
- ❖ the banks timely discharged their obligations under loan agreements.

In 2009, the Fund audited eleven banks utilising financial assistance from the BGF.

Upon auditing a bank utilising a loan from the assistance fund, it was established that the recovery plan is being implemented properly, and the financial results earned significantly exceeded the plan projections. Moreover, no objections were raised with regard to the performance of the remaining obligations under the loan agreement concluded with the BGF; the obtained funds were utilised and secured in accordance with the agreement. The audit confirmed that the assistance provided by the BGF has served its purpose, by supporting the acquisition of a bank threatened by insolvency.

As a result of the audit of banks utilising loans provided by the cooperative bank restructuring fund, it was established that:

- ❖ the BGF's financial assistance was utilised in accordance with the goals set out in the Act concerning the operation of cooperative banks, their mergers and on the acquiring banks of 7 December 2000 (as amended),
- ❖ there were no major variations in the performance of the banks' financial projections, with the exception of two cases,
- ❖ as on the date of the audit, the banks' economic and financial situation did not constitute a risk of defaulting on the loans,
- ❖ there were a few instances of failing to conform banks' internal regulations to the applicable laws, as well as irregularities in the internal audit system.

The conclusions from the audits completed, the irregularities identified as a result thereof, and the Fund's position were reflected in post-audit statements provided to the banks' management and supervisory boards and to the respective acquiring banks. In the case of one bank, due to the gravity of the irregularities identified, the Financial Supervision Authority was also notified of the results of the audit.

VI. ANALYTIC ACTIVITY

1. Updating and Developing the Database

The Fund independently analyses the banks' economic and financial standing and evaluated any existing and potential risks for their operations.

The Bank Guarantee Fund sources information about the banks from:

- ❖ the National Bank of Poland,
- ❖ the Financial Supervision Authority,
- ❖ the banks.

In 2009, a SIS reporting information system was implemented and the banks' analytic mechanism was developed using new reporting Technologies, FINREP and COREP; standardised information structures were also developed to allow processing of data for analysis in the form of reports with specified parameters, using BGF-developed utility software known as A*plikacja SIS*.

In 2009, the procedures for providing SIS reporting-based analytic mechanisms were introduced and coincided with the completion of works on establishing an aggregate database and a standard analytic report database. Algorithms were determined for database processing for selected groups of banks, known as collective analytic profiles. The Bank Monitoring System application was modified, allowing component ratings of banks to be calculated and a risk index to be created using new reporting data.

Apart from FINREP, COREP and WEBIS reporting, another important source of information was the data provided to the Fund directly by banks pursuant to the Regulation of the President of the NBP. Banks provided information relevant for the scheme, concerning the amount of debt guaranteed by the Fund and the sums guaranteed by the BGF, as well as on the basis for calculating the mandatory annual fee and the basis for establishing the guaranteed sum protection fund.

Under the Regulation of the President of the NBP, reporting duties were expanded and specified, the frequency of information provided by banks increased, and a requirement was introduced to provide information solely in electronic form, using secure electronic signatures.

Pursuant to the Agreement on cooperation and exchange of information between the Financial Supervisory Authority and the Bank Guarantee Fund, in 2009, the Fund also received supervisory information required to duly identify risks involved in the activity of each bank, as well as the condition of the sector. The agreement sets out the cooperation of the two institutions to perform their statutory duties and to exchange information, in particular with respect to ensuring the stability of the banking sector and the safety of deposits of banking customers.

2. Bank Assessment Methodology

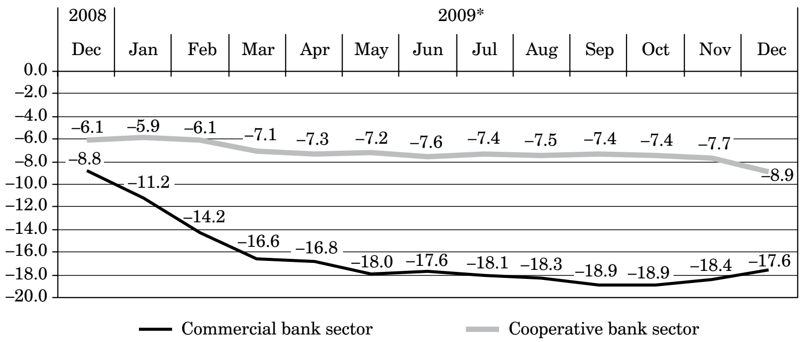
The Bank Guarantee Fund has its own methodology for the assessment of risks in the banking sector. By analysing the reporting and non-reporting factors, it assigns an individual risk rating to each bank. Depending on their ratings, banks are assigned to groups within the risk matrix.

These ratings and risk matrices are the basic source of information concerning each bank's standing. Banks identified as carrying a higher risk undergo more thorough evaluation, aimed at identifying the source of the risk.

The bases for discussing risks in the entire banking sector are the migration matrices and risk indices. A migration matrix is used to observe the position of a bank in relation to the risk index in each reporting period.

The risk index presents a combined, standardised assessment of the effectiveness, solvency, asset quality and the quality of off-balance sheet liabilities granted, weighted by each bank's share in the deposits of the banking sector. The risk index is calculated separately for commercial and cooperative banks. It is presented on a scale of 0 (no risk) to -100 points (highest risk). Variations in index levels reflect changes in the assessment of risk in the sector. The diagram below presents the levels of index risks in the banking sector.

Index of risk in the commercial and cooperative banking sector



* Preliminary data for December 2009.

In 2009, efforts were undertaken to change the methodology of risk assessment for the banking sector using the new SIS reporting mechanism. These efforts were focused on modifying the procedures of assessing reporting and non-reporting factors in the banking assessment system.

3. Analysing the Situation in the Banking Sector and Identifying Risks

The Bank Guarantee Fund's analytic roles are accomplished due to the fact that under the Act, the Fund is authorised to access information about banks, and thus able to make its independent analysis of each bank's economic and financial standing and evaluate existing and potential risks involved in each bank's operations.

The BGF's primary analytic responsibilities include:

- the assessment of risk in the banking sector in order to define the demand for financial resources from the deposit guarantee scheme, accumulated in banks in the form of Funds for the Protection of Guaranteed Sums (the FPGS) in order to cover potential guarantee obligations,
- identifying at an early stage the risk of insolvency for banks and any actions required from the Fund in association with the Financial Supervision Authority and other institutions of the financial security network.

As part of consistent analyses (conducted monthly and quarterly), the economic and financial situation in the banking sector (including the commercial and cooperative banking sector) was evaluated, taking into consideration existing and potential risks. Moreover, basic macroeconomic data and structural and legal changes in the banking sector were analysed, together with information concerning the severity and implications of the crisis on international financial markets in terms of the effect it may have for the stability of the Polish banking system. Particular emphasis was placed on financial institutions investing into banks operating in Poland.

In 2009, projections were prepared concerning the amount and structure of deposits, the overall capital requirements in the banking sector and projections concerning the amount of the BGF's guarantee obligations and demand for assistance. In view of the fact that the amended Directive 94/19/EC allows for increasing the limit of guaranteed sums to EUR 100,000 in 2010, the works concerning both amounts took into consideration two options of the guarantee limit, i.e. EUR 50,000 and EUR 100,000.

The proposed amount of the fee under the fund for the protection of guaranteed sums and the mandatory annual fee for 2010 was presented to the BGF's Supervisory Board, which approved them by way of a resolution on 18 November 2009.

4. Other Analytic Efforts

In response to current problems and changes occurring throughout the banking sector in 2009, a number of analytic works were conducted with respect to:

- the origin and course of the global financial crisis, with particular emphasis on the key changes in both the ownership structure and the capitalisation of international financial institutions, some of which are owned by majority shareholders of banks operating in Poland,
- sources of financing banks operating in Poland and proposed changes thereto in the context of the financial market downturn.

VII. INVESTMENT ACTIVITY

Under the Bank Guarantee Fund Act, the Fund may solely purchase securities issued or guaranteed by the State Treasury or the National Bank of Poland. Furthermore, the Fund may purchase participation units in the money market funds and establish term deposits with the NBP.

In 2009, in the area of the Fund's investment activity, a total of 146 acquisitions were completed, of which:

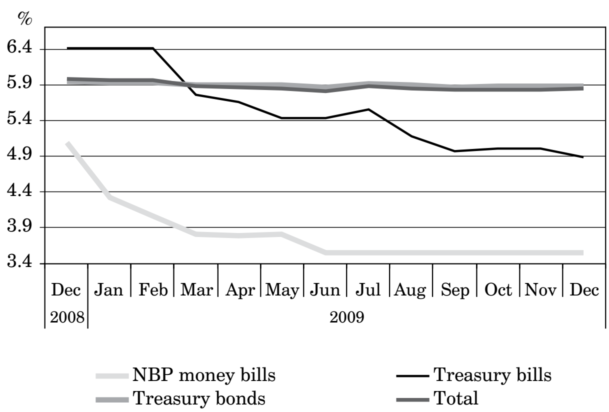
- ❖ 55 involved treasury bonds,
- ❖ 26 involved treasury bills,
- ❖ 65 involved NBP money bills

and 26 buyout transactions, of which:

- ❖ 15 involved treasury bonds,
- ❖ 8 involved treasury bills,
- ❖ 3 involved NBP money bills.

Transactions in the area of investment fund participation units of the money market and allocation of funds in the form of term deposits with the NBP, due to low profitability of the above instruments, were not effected.

Profitability of securities in the Fund's portfolio (on the basis of a 365-day period) as at the end of each month



In 2009, the BGF reported an increase in the share of treasury bonds in the total nominal value of the securities portfolio from 92.6 percent at the end of 2008 to 95.7 percent.

In Q4 2009, the Fund commenced the implementation of a new investment policy, aimed at boosting profitability at an acceptable risk level. Under the policy, the average maturity of treasury bonds was extended and the value of funds invested in NBP money bills, treasury bills and funds deposited on NBP accounts was lowered.

Structure of the Fund's securities portfolio as on 31 December 2008 and 31 December 2009

Items	Structure		
	31 Dec 2008	31 Dec 2009	Change
	%		percentage points
NBP money bills	0.24	0.04	–0.2
Treasury bills	7.16	4.28	–2.9
Treasury bonds	92.60	95.68	+3.1
TOTAL	100.00	100.00	–

VIII. FUNDS AND FINANCIAL MANAGEMENT

The BGF's activity is financed using the following sources:

- the statutory fund,
- the assistance fund,
- sums provided to the Fund by banks from their own guaranteed sum protection funds for the purpose of delivering on depositor guarantees,
- the cooperative bank restructuring fund,
- the reserve fund,
- the bankruptcy estate fund,
- proceeds from the interest on loans extended to banks,
- proceeds from the securities and funds deposited in the Fund's accounts maintained by the NBP,
- sums obtained from non-reimbursable foreign aid,
- subsidies from the public budget on terms set out in public finance legislation, requested by the Fund,
- funds under a short-term loan from the NBP,
- loans from the public budget,
- other proceeds, e.g. from office space lease.

These funds are used by the BGF to finance:

- tasks related to guaranteeing deposits,
- tasks related to extending assistance to participants of the guarantee scheme,

❖ tasks related to extending CBRF loans to support merger processes and the implementation of projects carried out by cooperative banks,
❖ operating costs of the Fund's Office and corporate bodies.

In 2009, the position of the statutory and reserve fund, as well as the cooperative bank restructuring fund, remained unchanged.

The 2008 balance sheet surplus of PLN 271,403,400 was allocated in full towards increasing the assistance fund, taking into account the provisions of the Act[2]. Moreover, the assistance fund was supplemented by a mandatory annual fee of PLN 308,159,900 and amounted to PLN 3,893,601,300.

The following breakdowns illustrate the performance of the 2009 financial plan.

Table 1. Balance sheet

No.	Item	2009 plan (PLN '000)	Performed as on 31 December 2009 (PLN '000)	Plan performance ratio (%)
I.	ASSETS	6,630,044.0	6,703,713.6	101.1
1.	Receivables under loans	2,812,110.0	554,044.0*	19.7
2.	Securities	3,755,607.0	6,086,873.9*	162.1
3.	Tangible fixed assets and intangible assets	61,722.0	62,477.7	101.2
4.	Other assets	605.0	318.0	52.6
II.	LIABILITIES	6,630,044.0	6,703,713.6	101.1
1.	Statutory fund	1,637,026.0	1,637,025.5	100.0
2.	Reserve fund	669,883.0	669,882.7	100.0
3.	Bankruptcy estate fund	51,443.0	53,423.7	103.9
4.	Assistance fund	3,876,987.0	3,893,601.3	100.4
5.	Cooperative bank restructuring fund	123,410.0	123,409.7	100.0
6.	Financial result	267,399.0	325,206.8	121.6
7.	Other liabilities	3,896.0	4,442.2	114.0
8.	Profit/loss from previous years (+/-)	x	–3,278,3	x
III.	CAPITAL EXPENDITURES	1,335.0	1,277.0	95.7
1.	Building	0.0	0.0	x
2.	IT	1,205.0	1,198.8	99.5
3.	Other expenditures	130.0	78.2	60.2

* In accordance with the specific accounting principles for the BGF applicable in the reporting period, receivables under loans and debt securities entered in books of account according to the adjusted purchase take into account the effective interest rate.

2 Article 16.2, 16.2a, 16.2b of the Bank Guarantee Fund Act of 14 December 1994 (as amended).

The balance sheet indicates that a minor increase of the balance sheet sum against the proposed balance sheet sum (by 1.1 percent) significantly affected the proposed asset structure. Due to the stability of the banking sector, no BGF assistance funds were required in the form of loans from the assistance fund. Therefore, the performance of the plan in terms of receivables under loans is at 19.7 percent of the planned value. Unutilised financial assistance funds were allocated into securities, which resulted in a much higher than planned (62.1 percent) securities portfolio.

Table 2. Profit and loss account

No.	Proceeds/expenditures	2009 plan (PLN '000)	Performed as on 31 December 2009 (PLN '000)	Plan performance ratio (%)
I.	Total revenue	290,386.0	344,713.0	118.7
1.	Revenue from interest and commissions on the reimbursable assistance granted to banks	11,292.0	2,473.0	21.9
2.	Revenue from trading in securities	277,624.0	337,968.2	121.7
3.	Other revenue	1,470.0	4,271.8	290.6
II.	Operating costs of the corporate bodies and Office of the Fund	22,987.0	19,506.2	84.9
1.	Salary costs and overheads	12,397.0	11,238.6	90.7
2.	Outsourced services	2,553.0	2,148.6	84.2
3.	Building use and management services of the building	1,462.0	1,532.9	104.9
4.	Depreciation	2,436.0	1,654.1	67.9
5.	Other costs	4,139.0	2,932.0	70.8
III.	Financial result (profit)	267,399.0	325,206.8	121.6

In 2009, the Fund welcomed new regulations concerning:

❖ Chart of Accounts of the Bank Guarantee Fund with a commentary,
❖ Terms and conditions of financial management and handling financial and accounting documents at the Bank Guarantee Fund,
❖ Guidelines for accounting for transactions that involve securities and certain other financial assets at the Bank Guarantee Fund,

and an update of the bylaws concerning the accounting principles applicable to the Bank Guarantee Fund.

IX. ORGANISATION AND STAFF

In performance of its duties set out in the Act and the Statute of the Bank Guarantee Fund, the Supervisory Board held fifteen meetings in 2009, during which it adopted thirty-six resolutions and reviewed motions and information submitted by the Fund's Management Board on the basis of a work schedule, Supervisory Board guidelines or a Management Board request.

As part of its decision-making powers, the BGF's Supervisory Board adopted resolutions including on:

❖ determining:
  – the 2010 percentage rate applicable to the amount of guaranteed sum protection funds established by participants of the mandatory guarantee scheme,
  – the percentage rate for the 2010 mandatory annual fee paid to the Bank Guarantee Fund by participants of the mandatory guarantee scheme, and the date as on which the 12.5-fold capital requirement for each risk type and overdraft and other overage capital requirements, as set out in the Banking Law, will serve as the basis for calculating the annual fee and setting the deadline for its payment,
❖ amending the resolution concerning the principles, conditions and procedure of providing financial assistance to participants of the mandatory scheme for insuring sums deposited in bank accounts,
❖ selecting an entity authorised to audit the 2009 financial statements of the Bank Guarantee Fund,
❖ amending the Management Board Regulations of the Bank Guarantee Fund.

As part of its supervisory duties, the BGF Supervisory Board:

❖ approved the *Directions for Growth of the BGF to 2011*,
❖ adopted the *Plan for Operations and the 2010 BGF Financial Plan*,
❖ reviewed the *Extending the BGF portfolio term and interest rate risk,*
❖ distributed the 2008 balance sheet surplus,
❖ reviewed quarterly reports on the Fund's operations,
❖ evaluated the implementation of the *BGF Plan of Operations for 2009*.

During its ongoing activity, the BGF's Supervisory Board analysed the situation in the banking sector, taking into account the differences between commercial and cooperative banks, as well as the results of supervising and monitoring the financial standing and management systems at banks utilising assistance from the BGF.

The Management Board provided the Supervisory Board with periodic updates on the situation on international markets and on the Polish market, together with outlook for growth, which were used by the Supervisory Board to analyse the mechanisms causing foreign financial institutions to struggle, as well as the causes and directions of change in the Polish banking sector.

The Fund's Supervisory Board also directed its efforts to:

❖ matters related to selecting and implementing a finance and accounting system,
❖ studying the effect of extending the term of securities on interest rate risk,
❖ monitoring amendments to Directive *94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes*,
❖ proposing amendments to legislation implementing into Polish law the amended Directive *94/19/EC on deposit guarantee schemes*.

In 2009, the Fund's Management Board performed the duties set out in the Bank Guarantee Fund Act, in particular those related to:

❖ ensuring that the Fund is capable of performing its deposit guarantee roles,
❖ remaining prepared to provide assistance in the event of a risk of bank insolvency,
❖ providing assistance to cooperative banks pursuant to the Act on the operation of cooperative banks (…),
❖ collecting and reviewing information about banks participating in the deposit guarantee scheme,
❖ managing the Fund's resources.

In 2009, 64 meetings of the Fund's Management Board were held. The BGF Management Board adopted a total of 172 resolutions. The BGF Management Board President issued 27 decisions.

Table 3. Breakdown of resolutions adopted by the BGF's Management Board in 2009

Area	**Number of resolutions adopted**
Assistance Activity and Deposit Insurance	62
Investment, analytic and reporting activity	23
Assessing the utilisation of assistance and monitoring banks	15
Accounting and finance	23
Organisational matters	49
TOTAL	172

The Bank Guarantee Fund performs its statutory tasks through the following organisational units:

- **Treasury and Analysis Department** – responsible for collecting and analysing information concerning the economy and especially the banking sector, preparing macroeconomic studies and projections as well as assessing the economic and financial standing of entities participating in the guarantee scheme, and conducting investment activity by investing the Fund's available financial resources,
- **Controlling, IT and Administration Department** – responsible for creating databases and disclosing information and reports essential for the Bureau's operations, providing IT and administrative assistance and maintaining the reliability of the technical infrastructure and the Fund's office security system,
- **Assistance Activity and Deposit Guarantee Department** – responsible for performing tasks related to the Fund's duty to ensure disbursement of guaranteed sums to depositors and assisting banks at risk of insolvency, trading in debts acquired from these banks and providing support to banks from the cooperative bank restructuring fund to support their consolidation,
- **Financial Department** – responsible for managing the Fund's finances and accounting,
- **Supervision and Monitoring Department** – responsible for supervising and monitoring the financial and economic standing of banks that have received assistance from the Fund, in terms of proper and suitable use of the financial assistance received and the implementation of corporate recovery or similar schemes as well as for monitoring the standing of the banks taking advantage of the Fund's assistance and serving as the trustee in these banks,
- **The President's Office** – responsible for ensuring support for the Fund's corporate bodies, legal assistance, workflow management and employee matters, as well as cultivating relationships with foreign deposit insurers and financial institutions, and providing public information and promotion of the Fund,
- **Internal Audit Position** – responsible for evaluating the activity of the Fund's organisational units in terms of accuracy and compliance with applicable laws and the Fund's internal regulations.

Moreover, there are two permanent interdepartmental committees at the BGF:

- the Asset Management Committee, which determines the policy for investing the Fund's available financial resources,
- the Committee for the Assessment of Requests for Assistance, responsible for approving or rejecting the banks' requests for financial assistance from the assistance fund and for loans from the cooperative bank restructuring funds, prepared by the Assistance Activity and Deposit Insurance Department.

As at 31 December 2009, Management Board members, in accordance with the responsibilities assigned to them under the BGF Management Board Regulations, were responsible for the following organisational units:

- **Management Board President Jerzy Pruski** – the President's Office, Treasury and Analysis Department, and Internal Audit Position,
- **Vice-President of the Management Board Anna Trzecińska –** Assistance Activity and Deposit Guarantee Department,
- **Management Board Member Krystyna Majerczyk-Żabówka** – Supervision and Monitoring Department and Financial Department,
- **Management Board Member Marek Pyła –** Controlling, IT and Administration Department.

In 2009, the Fund performed tasks related to its day-to-day and long-term IT needs. The key tasks in this area include:

- implementing a new finance and accounting system,
- fully implementing a new reporting system for banks and adapting the methodology for assessing risks to the new reporting database,
- developing the *BGF IT development plan to 2011*, which provides for enhanced infrastructure security and efficiency of IT systems and applications in use, and provides an option to disburse deposits within the deadline set out in *Directive 94/19/EC*, supporting the Fund's analytic efforts and its need to process the ever-growing databases, as well as supporting the increased range of the Fund's activity through greater use of IT solutions in processes and providing users with the requisite tools,
- extensively developing the *BGF IT system operating guidelines* and *BGF IT system security policy*.

Moreover, the Management Board completed tasks that involved:

- software that allows for creating, sending, viewing and receiving NDSR system messages for transactions concluded by the BGF and successful testing of the new settlement system on the NDSR securities market, implemented by the National Depository for Securities,
- software for the Fund's new website; its security was confirmed by a security audit,
- a system for recording and archiving the servicing of the BGF's IT system help desk requests; the application is aimed at streamlining the process of submitting and responding to system issues. It also fully records and reviews help desk requests.

In 2009, as part of its increased security policy, the BGF concluded a new Internet provider agreement with TP SA. Moreover, new contracts were also drafted with another independent telecommunication and internet service provider, using separate telecommunication transmission cables. Additionally, database organisation and administration tasks were performed.

In 2009, various renovation and modernisation works were carried out in order to maintain the technical state of the building, including improving the building's waterproofing, maintaining the air conditioning and completely replacing emergency and evacuation lighting. An inspection of equipment and fixed assets was conducted, followed by the removal or disposal of assets not useful for the Fund's activity. New depreciation rates were implemented on the basis of an evaluation of the life of fixed assets, and orders were given for the Fixed Asset programme to be adapted to the new depreciation rules and for the export of data to the new finance and accounting system to be ensured.

X. WORKING WITH POLISH AND INTERNATIONAL INSTITUTIONS

1. Working with Polish Institutions

1.1. Working with Banks

In 2009, the Fund maintained a close relationship with banks from the Polish banking sector. The Fund notified acquiring banks of, among other things, any changes to the procedures governing granting financial assistance to cooperative banks participating in the association. Members of the BGF's Management Board participated in the meetings of the Advisory Council of the Cooperative Banking Sector.

In November 2009, an advisory meeting was held with the Management Board of the Polish Bank Association regarding the proposed amount of the fee for the establishment by banks of a fund for the protection of guaranteed sums and the amount of the 2010 mandatory annual fee.

On 24 August 2009, the Bank Guarantee Fund and the Credit Score Information Office concluded the Agreement concerning cooperation with regard to the implementation of a research and analysis project involving analysis and projecting credit portfolio quality in the banking sector. The purpose of the project covered by the agreement is to conduct an analysis of the current status and prepare a projection of new lending and credit risk for household and corporate segments.

1.2. Working on Legislative Matters

In 2009, BGF representatives participated in reconciliation conferences concerning financial market legislation drafts. In the course of these works, proposals, opinions and statements concerning required changes and detailed solutions were drafted and submitted. The Fund participated in legislation drafting devoted to widely applicable acts, such as those concerning:

- ❖ the responsibilities of the Bank Guarantee Fund and the operations of its corporate bodies;
- ❖ the operation of the deposit guarantee scheme (changes with regard to notification obligations and international cooperation in connection with Poland implementing Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay),
- ❖ improving the stability of the banking sector,
- ❖ recapitalising certain financial institutions and providing financial institutions with State Treasury support.

Moreover, the Bank Guarantee Fund presented the Ministry of Finance with a position with regard to the changes concerning the investor compensation system in which the BGF's Management Board opted for the acquisition of the system by the BGF.

The Fund participated in the process, coordinated by the Ministry of Finance, of evaluating European Commission documents, including *An EU Framework for Cross-Border Crisis Management in the Banking Sector*. In its evaluation of the document, the Fund opted for placing greater emphasis on the role of deposit insurance schemes in counteracting the crisis and its effects using its assistance responsibility.

The BGF conducted an analysis of the legal grounds for cooperating with entities responsible for deposit insurance schemes in other EU states in the event that a branch of a Polish credit institution asks to join the deposit insurance scheme of the host member state in order to supplement its coverage.

1.3. Participating in Conferences and Seminars

In 2009, Fund representatives participated in numerous conferences, seminars and meetings with representatives of the banking industry, financial institutions and public authorities, including those held by the Polish Bank Association, National Cooperative Bank Association, the Credit Information Bureau and the Gdańsk Institute for Market Economics, as well as several financial and economic academic centres.

On 27 April 2009, the BGF, in association with Linklaters, hosted a seminar entitled *Financial Institutions in Crisis – the Lehman Brothers Case*, attended by more than 100 people.

On 21 May 2009, the Bank Guarantee Fund and the Cooperative Banking Development Foundation held a conference entitled *Cooperative Banks – Challenges* *in the Face of New Regulations*. The Fund's Management Board President outlined the effect of the new legislation concerning the BGF on the cooperative banking sector. The conference brought together about 200 people, among whom were representatives of institutions comprising the financial security network, members of the management boards of acquiring and cooperative banks, and representatives of the media and academia.

2. International Cooperation

2. 1. Working with International Institutions

As a result of a change of President of the Bank Guarantee Fund, the Fund's representative in international insitutions in which the BGF participates, primarily in the International Association of Deposit Insurers (IADI), also changed. The changes were also notified to the office of the European Forum of Deposit Insurers (EFDI).

In 2009, the BGF was represented at international meetings and conferences held by the IADI and the EFDI and devoted to important deposit insurance issues:

- ❖ primary responsibilities of deposit insurers in the event of a bank bankruptcy,
- ❖ insuring deposits during and after systemic crises,
- ❖ principles of effective management of deposit insurance schemes.

Moreover, BGF representatives participated in:

- ❖ *The Eurofi Financial Forum 2009*
- ❖ meeting of a European Commission Working Group concerning deposit insurance schemes
- ❖ at the *Crisis Management at Crossroads* conference, held by the SUERF, CEPS and the Belgian Financial Forum

2.2. Working with International Deposit Insurers

In 2009, the Fund regularly communicated with international deposit insurers and organisations that bring together deposit insurers, exchanging information concerning deposit insurance principles in different countries.

As a result of the amendment of Directive 94/19/EC and the resulting obligation for deposit insurance schemes to work together internationally within the European Union, in May 2009, the Fund once again proposed a cooperation agreement to the Greek deposit insurance scheme. However, the Greek institution was not interested in the agreement.

In 2009, efforts were also made to conclude an agreement with the Slovak guarantee fund, which would govern the increased insurance for customers of a Polish bank branch operating in Slovakia. In November 2009, a meeting was held with the Slovak delegates, during which valid earlier concerns of the Slovak partner, including the disbursement of guaranteed sums in Polish zlotys, were clarified. The issues that remain to be clarified include the expectation on the part of the Slovak Deposit Protection Fund to secure the same position in bankruptcy proceedings as the position of the BGF, to the extent set out in the Bankruptcy and Corporate Recovery Law of 28 February 2003, to be guaranteed a preferred position in the form of satisfaction of its claims and receivables from the insolvent bank first, directly after the payment of court fees for the bankruptcy proceedings and payment for work performed.

Final decisions with regard to the agreement with Slovakia should be made after the Slovaks present their draft wording of the agreement.

Moreover, as part of analysing different deposit insurance schemes, materials were prepared outlining the deposit insurance schemes in Norway, Finland, Slovakia, Ukraine and Greece.

XI. PROMOTIONAL AND INFORMATIONAL EFFORTS

2009 saw a continuation of efforts aimed at promoting in the banking sector the set of best practices, developed by the Fund in the form of two documents, i.e. *Best practices in banking with regard to notifying participation in the mandatory deposit guarantee scheme* and *Best practices in banking with regard to notifying customers of a bank's financial and economic standing*. In 2009, the Fund was notified that fifty-six cooperative banks approved the best practices. By the end of the year, a total of seventy-two banks, including five commercial banks and sixty-seven cooperative banks, notified the Fund of their approval of the best practices. As a result of adoption on 19 September 2009 of *the Act of 16 July 2009 amending the Bank Guarantee Fund Act*, amending the regulations concerning a bank's obligation to notify customers of participation in the deposit guarantee scheme and of its financial and economic standing, the BGF began to consider the purpose of continuing the project.

In 2009, the Fund continued to develop and distribute in Poland complimentary promotional materials for customers of Polish banks, presenting the new rules underlying the deposit insurance scheme. The promotional materials, a total of 900,000 copies, were distributed to commercial and cooperative banks. In late 2009, efforts were undertaken to redesign and update these materials.

Moreover, in response to growing needs reported by the banks, the Fund commissioned and distributed placards confirming a bank's participation in the mandatory deposit insurance scheme. The BGF also prepared a brochure presenting the core activities of the Bank Guarantee Fund in each area of its expertise, taking into account the current legal status of the deposit insurance scheme in Poland.

The Fund distributed new issues of the BGF Newsletter, which contained resolutions of the Fund's Management and Supervisory Boards. The newsletter was distributed to all commercial and cooperative banks as well as selected Polish universities and libraries.

In 2009, the Fund also distributed an issue of the *Secure Banking* magazine issued late in 2008 (2/2008), and published two new issues (1/2009 and 2/2009), with *Safe Banking No. 2/2009* issued in English. The magazine is distributed to banks, selected Polish universities and libraries across Poland, as well as public administration bodies.

In 2009, the Fund completed work on educational materials which, as determined by the Minister of Education, were entered on the list of educational resources recommended for use in schools teaching *Business Basics*. The materials comprised three presentations (*Banks and the Banking System*, *Assessing Banks and the Polish Deposit Guarantee Scheme*) and a transcript. The 5,000 copies of the educational materials were provided free of charge in the form of a CD–ROM to comprehensive secondary schools across Poland.

The Fund undertook informational efforts concerning the new rules of granting financial assistance from the cooperative bank restructuring fund (CBRF). The rules were laid out in the Nowoczesny Bank Spółdzielczy (*Modern Cooperative Banking*) journal. Moreover, a press release concerning the CBRF was prepared and provided to acquiring banks and cooperative banking media.

On 28 February 2009, the Fund once again selected a bachelor's, master's and doctoral dissertation that best covered the issues of the deposit guarantee system, the Fund's operations, and the financial security of the banking industry. Four master's dissertations from the University of Gdańsk and Gdańsk Technical University were submitted of which the judges awarded two. A new edition of the competition was commenced and it will be completed in the next calendar year.

On 17 July 2009, the new BGF website was launched. The website proved popular with the Fund's customers, reporting approximately 60,000 visits by the end of the year.

As part of its promotional and informational activity, the Fund issued the Polish- and English-language *2008 Annual Report of the Bank Guarantee Fund*, which was distributed to banks in Poland, sixty-five deposit guarantee schemes and international institutions in which the Fund participates, i.e. the EFDI and the IADI.

Problems and Opinions

*Jan Winiecki**

GLOBAL FINANCIAL CRISIS. WHERE WE ARE NOW AND WHERE WE ARE HEADING – IF ANYWHERE...

1. INTRODUCTION

This paper observes potent connections between three areas of institutional framework of the U.S. economy and policies pursued within these institutions: monetary policy of the FED, housing regulations and policies toward the housing sector and finance, as well as the piecemeal regulations of the financial sector. It is within this "unholy triangle" and its interactions with the real economy that both extent and pattern of the crisis has largely been determined.

There is often a tendency to look for a primary factor (or factors) of certain important developments and then point to secondary factors, which either add to or subtract from the extent and/or pattern of these developments. In the case of the U.S. – initiated financial crisis, the primary role is difficult to ascertain: all three areas are strongly qualifying to be such factors.

It is the monetary policy that may be seen as a catalyst for crisis, but not the primary factor. For the impact of other factors, that is housing regulations and

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policies, as well as piecemeal regulatory intrusions into the financial sector, would not have been as amplified as they were without the extremely liberal monetary policy of the preceding dozen or so years [see, for example, an empirically reinforced critique by John Taylor in his book of 2009, showing the housing boom and bust under traditional and very liberal monetary policies of the FED].

With respect to the question: "where are we heading?" it is not possible to be optimistic. The diagnostic attempt presented in this paper belongs to a range of minority views, although better established empirically than at the beginning of the crisis. The dominant view is still that of a failure of capitalism (or at best of an "extreme", neo-liberal, or free market version – you name it – of capitalism). The political demand continues to be for more regulation and more interventions in the financial and other markets and these *ad hoc* and regulatory intrusions are duly forthcoming.

I (as do many others) point out however, more regulation and policy interventions are not an efficient answer to the problems at hand. It is stressed that neither piecemeal, fragmented, regulations nor comprehensive regulatory framework (a *constructivist* solution in von Hayek's term) are going to improve the functioning of markets.

The only consolation may be drawn from a sober assessment that the wealth available to be destroyed in such misdiagnosed pursuits is much more severely limited than it was at the time, when most countries of the West entered upon the Keynesian path in macroeconomic management and interventionist regulation. Thus, the period of such experiment may be limited to merely 3–5 years [see my essay: *Keynesian Wars: Episode 2*]. However, there is no guarantee that such sobering process is going to take place. Consequently, institutional and policy changes in the more distant future are not necessarily going to be more sensible than erroneous recommendations we see attempted or imposed now...

2. THE "UNHOLY TRIANGLE" I: FED CREATES A MORAL HAZARD ON A GIGANTIC SCALE

Already in 2002 Robert Barro noted the propensity of the then FED Chairman, Alan Greenspan, to cut, again and again, interest rates: "*The pattern of accelerated rate cuts is worrisome because it might signal that the FED has become less committed to maintaining low inflation and more interested in attempting to forestall any economic downturn*." [Barro, 2002, p.157] and added that "... *it would be better if Greenspan remained focused on his central mission of monetary policy*" [*ibid.*, p.158].

Unfortunately, Chairman, Greenspan did not; neither earlier nor later. The recipe was straightforward: Russian crisis? Let's cut interest rates. *Dot.com*'s bubble? The same. Terrorist attacks on 9/11? The same. No matter what had been the malady, the cure was the same. Deep cut in interest rates was the answer.

Greenspan was not alone. There were many economists, mostly (but not exclusively!) of interventionist beliefs who were delighted by such approach to business cycle. Some of them fervently wished for it to be banished forever. One of the well known American economists said some years ago that inflation in the US will be at the level wished for by Alan Greenspan. The consequences of drowning the economy with money – in Prof. Roubini's terms – in order to forestall any economic downturn were, however, disastrous in the end.

What does it mean for the economy to be drowned with money? It means for businesses and households to have a nearly unlimited access to inexpensive credit. We all remember the basic diagram from the capital theory on investment project selection. The level of interest rate offers a cut-off point, indicating which projects look profitable (at a given risk level) and therefore should be selected for financing and which should not.

But what if the interest rate tends down to near-zero as a result of intermittent deep interest rate cuts made by the central bank? It means that nearly every project looks (artificially!) profitable. Artificially, because interest rates cannot be kept forever so close to the zero level. Alan Greenspan had maintained that "*not only have individual financial institutions became less vulnerable to shocks from underlying risk factors* (sic!!)*, but also the financial system as a whole has become more resilient*" [Krugman, 2008, s. 264]. Such views were not limited to America. The then Chancellor (later Prime Minister) Gordon Brown stressed that under his (interventionist) economic leadership there would be "No Return to Boom and Bust" [Simpson, 2009].

Over a long period of cheap money available, a widespread moral hazard had been emerging. *The Economist* [9.08.2008] stressed the creation of a "*speculative mentality in financial markets ... Why not take risks if you know that central banks will intervene only in falling, not rising, markets?*" [p.12]. Such sentiment was called the *Greenspan Put* on and around Wall Street.

But pretences of being able to banish recessions and, at the same time to eliminate risk could not hold forever. With rising federal interest rates in response to rising inflation, many investments (including residential housing) turned out to be financially unfeasible. The risk, artificially reduced for the time being, returned with a vengeance. It was only a matter of time when and where some bubble would burst. It turned out to be the housing sector and the reasons why add to our evidence of the distorting, moral hazard-generating role of the state in the economy.

3. THE "UNHOLY TRIANGLE" II: FROM AFFORDABLE HOUSING POLICIES TO A COLLAPSE OF THE HOUSE OF CARDS

The most recent housing bubble in the U.S. was supported not only by the monetary policy flooding the economy with money. It would do a lot of damage, but not t h a t much! It was also a consequence of a long trend in regulations and policies by successive American governments, which put pressure on private financial firms, primarily banks, to spend a part of their money on a variety of projects benefiting "disadvantaged members of the community". To offer an example, the famous (or *in*famous) Community Reinvestment Act of 1977 warned banks in no uncertain terms about the negative consequences of not spending a part of their money in that manner. And spending they were at times up to 15–20% of their money on a variety of substandard loans – primarily, but not exclusively, mortgages. The political pressure increased further on in early 1990s.

Consequences were, according to expectations, negative, but some more harmful than others. Clearly, tying a part of the money to low profitability/high risk mortgage loans for low or irregular income customers (sometimes called *ninja*, from: *no income, no job, no assets*) had dual effect. On the one hand, repayment level of the whole mortgage portfolio declined. On the other, banks were forced to search for some projects of above-average profitability – and therefore more risky ones – in order to stay close to long term profitability levels, a classical case of perverse incentives, created step-by-step by the state action, creating moral hazard!

Under the political slogan of "affordable housing", coined during the Clinton era, banks were *de facto* forced to make substandard loans. The softening of mortgage loan standards proceeded under many guises. One was the so-called *subprime mortgage*, that is a loan to the *ninja*, people who according to normal rules of the game could never dream of obtaining a mortgage loan.

Another, more varied category, were mortgages to people of low-to-moderate, but steady, income, working full time, who simply could not afford standard mortgages. The standards of these mortgages, that is 20–25% downpayment and 20–30 years repayment period, were being progressively weakened. The required downpayment was shrinking over the years and so were other lending standards (as recommended by the government, stressing the need for "*flexible standards*"!!). The process accelerated in the past decade and by 2006, just before the crisis, the share of standard mortgages – according to varying estimates – amounted from one third to one half of the total [see, Sowell, 2009, and Wallison, 2009].

The rapid decline of the quality of mortgages in the most recent period before the bust was also due to intensified activities of *Fannie Mae* and *Freddie Mac*. They were two government-sponsored-enterprises (GSE), created with a mission to maintain a liquid secondary market in mortgage loans. But with a growing political appetite for reaching the ever lower income levels' electorate with "progressive" housing policies, they were encouraged to expand and, apart from insuring mortgages, they were buying subprime and other substandard mortgages from new banks in increased quantities as part of their portfolio. When they became insolvent and were taken over by the government, their prospective losses were estimated to be between 700 billion and 1 trillion $ [see, Wallison and Calomiris, 2008]!

With inflation exceeding 3% *p.a.* interest rates went up (albeit moderately, to 5.25%) and the drama began. With such a share of substandard mortgages the traditional pattern of delinquencies and foreclosures exploded. Foreclosures rarely exceeded 2–4% in recessions; now they went into the stratosphere, increasing to 20–30%!!

One more type of regulation added to the problems as well, namely the *no-recourse* rule introduced in some states by local politicians. They allowed the mortgage holder to give back the keys to his house to the bank and the latter had no claim on the mortgagee anymore. As banks lost up to 30% of the value on the repossessed houses, massive foreclosures undermined financial stability of many new banks. Their losses were estimated to be around 1 trillion $ and were a major cause of the collapse of part of the American financial sector [Sowell, 2009].

Just as in the case of monetary policy propping up the economy in slowdowns, but not restraining it in expansions, governmental regulations and policies were also building up the level of risk in the mortgage sector. The difference was that the level of risk was built more slowly, over a long period, although with the sudden acceleration in the preceding decade. How important was the slow, but accelerating decline in mortgage-related lending standards, may be seen in the comparison between the U.S. and Canada. The latter country also suffered from deep recession, but its regulation of the housing sector was not eroded. The standard mortgage loan is still 20% downpayment and 80% loan-to-value ratio to be repaid in the standard time span of 30 years. There is, moreover, the obligatory insurance to be taken on the loan by the borrower. The outcome (not unpredictable!) was a very much lower foreclosure rate than in America.

American politicians did not learn either from their own experience or from the Canadian one. Recently a Democrat-dominated House of Representatives has rejected the draft that provided for a very modest (barely 5%) compulsory downpayment for mortgages...

4. THE "UNHOLY TRIANGLE" III: REGULATION OF THE FINANCIAL SYSTEM AND THE LAW OF UNINTENDED CONSEQUENCES

Regulation slapped on American multinationals by the government in early 1960s had an intended consequence of controlling the outflow of capital from the U.S., while keeping an eye on the deteriorating balance-of-payment. The intended effect was achieved to a marginal extent. However, unintended consequences were much greater.

Multinationals, in order to be able to use their capital in a timely and flexible manner, decided not to send their dollar revenues back to the U.S., but to keep them on special dollar accounts in the West European banks. At the time of strong controls of capital flows a new international financial market was created as a result. For the European banks decided to use the dollars kept on these accounts for lending purposes. A Eurodollar lending market exceeded very quickly, in terms of the loan volume, the largest Western markets of London and New York!

In 1970s the FED issued Regulation Q, which restricted the level of interest rates that banks and savings societies could pay their depositors. It was a misguided attempt to influence the saving and lending patterns of financial institutions in the face of strong inflationary pressures. It could have done a lot of damage if it had not been for the innovativeness of the regulated sector. Its response was to create money market funds, which circumvented the regulation.

However, we cannot count on too much luck from unintended consequences the whole time. More often than not, unintended consequences of regulatory arrangements upset the regulated market and undermine its efficient operation. The reasons are best summarized by Prof. Meltzer from Carnegie Mellon University. The problem of regulators (and politicians) is that they are good in thinking of restrictions and formulating relevant rules. They are much worse in thinking about the structure of incentives the firms in a regulated sector face. If incentives are strong enough to continue the restricted activity, they are going to try to circumvent the rules, without breaking them. Moreover, regulations are static, while markets are dynamic and sooner or later firms find ways to operate efficiently and profitably in the face of a given regulation [Meltzer, 2008, 2010].

The same *modus operandi* applies to many – undoubtedly well intended – regulations affecting the financial markets [a story is well told by Jeffrey Friedman, 2010]. The Basel I agreement set the level of reserve capital of commercial banks for loans to and bonds from business firms at a rate of 8%. However, the urge to perfect the rules on the basis of differentiated risk of each category of assets moved the regulators to set the reserve capital for mortgage loans at a rate of 4%. On stand alone basis that made sense; after all, the repayment ratio for mortgages have historically been significantly higher than those of loans for businesses. But, as stressed in the preceding section, such repayment ratios were typical in the past, with respect to standard terms' mortgages. With the flood of substandard ones, the old patterns ceased to be valid, which was neither noticed nor predicted in 1991, when the U.S. adopted Basel I standards.

The result of differentiated levels of reserve capital was a shift in proportions of business vs. housing-oriented lending. But even more ominous unintended consequences emerged from the Recourse Rule of 2001, amending Basel I with respect to a new class of financial assets, namely asset-backed securities. A joint regulation (by FED, FDIC, Comptroller of the Currency, and OTS) decided that commercial banks were required to keep only 2% of reserve capital with respect to bonds backed by the stream of repayment installments of one of the three classes of assets: mortgages, car loans, or credit card debt. The only requirement was that such bonds were AAA or AA rated (or were issued by GSEs).

Again, on the surface mortgage-backed securities looked like very safe papers, indeed. After all, in good old times mortgages were being repaid at worst at 98% rate most of the time. But the sub-prime and other substandard mortgages changed the picture materially. And by 2001 the regulators were no longer able to use the excuse of ignorance with respect to an ominous trend of ever lower mortgage standards! Thus, apart from traditional good intentions-reinforced *naivete*, they were guilty also of negligence.

With Recourse Rule 2001 requiring so low level of reserve capital, incentives for banks and other financial institutions overwhelmingly shifted a part of their activities from business loans or buying commercial bonds, all requiring 8% of reserve capital, to those requiring only 2% of reserve capital. In consequence, demand for asset-backed securities increased sharply.

There was, however, yet another issue, which generated unintended consequences. The requirement of high ratings for the new type of instruments – that asset-backed securities (ABS) were required to have – was undermined (if not annulled) by the oligopolistic position of a small number of rating agencies in the U.S.

The 1975 amendment to the SEC regulation turned three agencies (S&P, Moody, and Fitch) into a regulation-preferred oligopoly of sort. As early as in XVIII century Adam Smith was fond of saying that the spirit of a monopolist is characterized, *inter alia*, by laziness. Therefore, unsurprisingly, rating agencies did not do enough homework to recognize the varied characteristics of parties underpinning asset-backed securities and dangers resulting from eroded standards in the case of mortgages. The consequence was a flood of carelessly researched securities: by 2008 almost 81% of all rated mortgage-backed securities held the AAA rating [J. Friedman, 2010, p.6]. A substantial part of these securities later obtained a junk status...

This story of a string of regulations of the financial markets that – in conjunction with various policies – undermined markets' stability and efficiency could be easily continued. None of them would have done very great harm on a stand-alone basis. Taken together, however, they turned out to be devastatingly harmful in their impact upon the financial markets – and the economy at large.

5. WHY DID THE AMERICAN DISEASE SPREAD SO FAST?

This issue is to be dealt with relatively quickly, as these causes are well known, except the one that will be stressed to some length. It is obvious that the sheer size of the American economy influences world economy's developments to a substantial extent. Next, an even larger size of the American financial sector relative to that sector elsewhere amplifies the effects of the American financial developments on the world financial markets. Finally, the U.S., as the largest borrower in the world, influences the world financial markets to an even greater extent. Thus, the supply of the American financial assets is highly important for all buyers.

These are very obvious statements. However, one special aspect of that phenomenon should be pointed out with respect to the most recent business cycle. The very long global economic boom, strongly supported by super-expansionary FED's monetary policy additionally increased the demand for financial assets. Banks throughout the world were hectically looking for suitable securities in order to invest money flowing to them in the form of deposits.

In such a climate of amplified demand for securities two American government-sponsored enterprises (GSEs), *Fannie Mae* and *Freddie Mac,* dramatically increased their presence in the world market for securities. GSEs, considered strange institutional beasts even by welfare state standards, take the capital endowment from the state and are allowed to borrow, that is issue securities, to finance their activities. They were present on financial markets for decades, but only a combination of political pressure on them to support governmental housing policies and the dramatic growth of demand for financial assets created the environment in which such expansion has become possible.

From the last years of the XX century until their insolvency and the takeover by the state in 2008, *Fannie Mae* and *Freddie Mac* issued securities roughly equal in volume to that of the U.S. government!! This expansion is shown diagrammatically in the figure presented by Desmond Lachman [in the *Wall Street Journal*, 2010]. When they went bankrupt in August that year, they held or guaranteed together 1011 bill. $ in unpaid balance of mortgage loans [Wallison and Calomiris, 2008]. A very large part of those were substandard mortgages. And since a large part of mortgages were rolled into packages to back mortgage-backed securities, they created in this manner a very large volume of substandard asset-backed securities issued by both GSEs.

How large? In 2003 *Newsweek*'s economist, R.J.Samuelson signaled that about 3000 banks held *Fannie Mae* and *Freddie Mac* "debt equal to all their capital" [8.09.2003]. Since then, with a huge acceleration in both GSEs' activity, banks' exposure increased accordingly throughout the world. Strangely enough, the disaster took place in spite of earlier assessments that the risk of default and such takeover is "*effectively zero*" [see, first of all, Stiglitz, Orszag, and Orszag, 2002].

The ease with which they tapped the financial markets to finance their (increasingly risky) activities stemmed from their GSE status. Their rating was almost at the level of the U.S. Treasury bonds. Eager buyers perceived the existence of the implicit government guarantee. In that, at least, they turned out to be right – to the dissatisfaction of American taxpayers. Mixing politics with business in yet another way turned out to be as much harmful as more traditional ways of political tinkering.

6. ARE WE HEADING ANYWHERE? DO WE UNDERSTAND WHAT WE PROPOSE?

David Simpson [2009] quotes Lord Keynes assessment of the 1930s: "*We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand*". Having noted that in the foregoing sincere statement Keynes was more Hayekian than Keynesian, the present writer holds little doubt that the present crisis does not seem to be understood much better than that of 1930s. In fact, I suggest that the similarity goes even further than, in turn, suggested by Prof. Simpson. For just as Keynes and his disciples did not understand too well the dynamics of the Great Depression and yet recommended the solutions, so a range of economists of largely interventionist beliefs recommend solutions without understanding too much the dynamics of the present crisis and the Great Recession.

As signaled earlier, the majority of political, public, and also academic opinion seems to be convinced that the crisis has been caused by greedy and reckless bankers – and demand more regulations accordingly. Yet what has been shown in sections 2–5 of this paper leads the present writer to sharply different conclusions. Expansions and recessions, accelerations and decelerations, explosions of exuberant optimism and waves of deep pessimism are part and parcel of the market economy. The risk of failure is also accompanying the developments in the capitalist market economy. Schumpeterian creative destruction is going to be with us all the time as well. But it is due to such developments that capitalism made such an unbelievable progress in creating wealth.

I quoted Prof. Meltzer who stressed that regulations were static, while markets were dynamic. Therefore, the former usually does more harm than good as stressed in particular in sections 3 and 4 of this paper. They try to rectify perceived failures or dangers of a failure in a fraction, or a piece, of the dynamic whole of the market. They inevitably come into conflict with each other – and with a whole, that is with the functioning of financial markets.

Some may – and they do! – suggest comprehensive solutions as a cure. But the cure could have been worse than the malady! The already quoted Nobel Prize winner Friedrich von Hayek warned against juxtaposing naturally evolving and constructivist, man-made systems. For only the former give us an idea of both expected and unexpected consequences of their functioning. Crude intellectual constructs tout only the first best scenarios; unintended consequences are not and cannot be known in the case of constructivist theorizing. Harold Demsetz calls such methodologically faulty comparisons *the Nirvana fallacy* [1989]. When Nirvanas are being tested empirically, as the communist system had been in the 1917–1991 period, the realities of intellectual constructs reveal their ugly – and destructive – features.

7. MARKET-CONFORMING AND, MORE WIDELY, REALITY-CONFORMING APPROACHES

What the present writer stressed in the preceding section does not mean that nothing can – or should – be done. On the contrary. Since, in contrast with many popular beliefs, markets – especially financial markets – have not been left unregulated, which could improve the performance of markets is the substitution of the present, erroneous and internally contradictory, regulations with new ones that conform with the structure of incentives in the market economy in general and in these markets in particular.

Thus, following Alan Meltzer, instead of what he called *regulatory overkill* [2008] reformers should try "*to use regulations to change incentives by making the bankers and their shareholders bear the losses. Beyond some minimum size, Congress should require banks to increase their capital more than in proportion to the increase in their assets*." Then, it is the bankers themselves who would "*choose their* [banks – J.W.] *size and asset composition. Trust stockholders incentives, not regulators' rules*" [Meltzer, 2010]. It is to be expected that the former would choose a risk level, and accordingly a size of the bank, reflecting their risk appetite for investing their own money.

However, certain regulations have already been embedded in particular markets. These regulations have already modified the structure of incentives. An example of such regulations is the governmental deposit insurance scheme. Although such a scheme has its share of pro's and con's, it is here to stay in the fractional banking system of today's world. Here, the reality check should suggest the reduction of certain risks, while taking into account the existence of FDIC and similar schemes around the world.

Since commercial banks as fiduciary institutions take part in the scheme and generally are protected against certain developments in the financial markets, they should not be combined with other types of financial institutions. In the opinion of a number of practitioners and academics a priority regulatory arrangement should be the separation of commercial and investment (merchant) banking.

One hears, *i.a.*, from Paul Volcker, Prof. Mervyn King, Adrian Blundell-Vignal, and Prof. Deepak Lal that much riskier investment banking has been recently "free riding" on the back of deposit-insured commercial banking. Such developments posed a dilemma for central bankers and regulators. If and when risky investments collapse, they present an unpalatable – and dramatically costly – alternative: either to save the commercial/investment as a whole at an enormous cost to the taxpayers or to allow it to go bankrupt at the cost of the panic that may create the systemic risk for the financial market as a whole.

In this as in other similar cases the "Meltzer rule" should prevail. Of course what Prof. Meltzer has been saying of late has been repeated by classical liberal economists since the time of David Hume, Anne-Robert Jacques Turgot, Adam Smith, Adam Ferguson, and others. Detailed arrangements should try to conform to the structure of market incentives. The more they would depart from the conformity to the market rules, the more easily they would be circumvented by market practitioners. The past, including the recent past leading to the financial crisis of our times, suggests us the foregoing recommendation in certain terms.

Finally, as another reality check, I would like to offer a note of warning. There is still quite a high probability for the thrust of regulation to push the regulatory regimes in the U.S., E.U., and elsewhere in the opposite direction to that suggested in this section. The success of traditional interventionist ideas is not going to last long, though. The Keynesian episode lasted from the early 1950s to the late 1970s. But, with the back-breaking load of public debt increasing even more in the years to come, the end of the traditional interventionist road is just a few years from the present. The Western world is going to face difficult choices in the next 3–5 years. I am afraid, however, that choices to be made may not necessarily be reassuring for classical liberals...

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*Leszek Balcerowicz**

HOW TO REDUCE THE RISK OF SERIOUS FINANCIAL CRISES?

I. INTRODUCTION

The subject of this paper is how to reduce – in a cost-efficient way – the incidence of serious financial crises[1], i.e. crises which inflict serious harm to the economy. This subject tackles two basic issues:

- ❖ How to constrain the growth of booms which – having burst – inflict serious losses upon the financial sector.
- ❖ How to limit the "transposition" of these losses into the negative shocks to the real economy.

The former task may be compared to the introduction of driving speed limits, the latter – to the introduction of safety belts and other safety equipment in cars.

The reduction of the incidence of serious financial crises must be achieved in *a cost-efficient way*. This rules out the measures which would reduce the risk of such crises albeit at the cost of suppressing the capacity of the financial sector to finance the growth-enhancing projects (the repressed financial sector), not to mention the sensible steps which – contrary to the intentions – would increase

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1 Financial crisis understood as a banking crisis or a crisis which includes the crisis in the banking sector.

risk-taking in the financial sector, like some of the Basel 1 stipulations (see, e.g. de Larosiere Report, 2009).

It should be pointed out that the impact of the financial crisis on the economy depends not only on the magnitude of the crisis and on the structure of the financial sector but also on the *methods of crisis management*. This is a vast topic which I can only mention here. As has been, amply demonstrated recently, the dominant mode of dealing with the current financial crises was to try to reduce the short-term shocks to the economy at the cost of creating serious risks to its long-term growth. What I have in mind are policies which resulted in a sharply increased public debt, in amplified amount of central banks' money and in increased concentration in the financial sector, which is related to the strengthened belief in the "too big to fail". I will leave aside a huge issue whether, given the initial conditions, the selected inter-temporal trade-off was the best one. However, regardless of how we see this issue, it is not difficult to agree, given the indicated exit problems, that it is worth to search for ways which would limit the incidence of serious financial crises.

In searching for such measures we should go beyond the current global financial crisis and avoid focusing a priori on just one kind of preventing steps, e.g. the financial regulations. Such a narrow approach can eliminate some important causes of the financial crises from the investigation and may, thus, lead to incorrect (i.e. counterproductive, non-productive or cost-ineffective) remedies. Instead, one should take the widest possible view of the incidence of the financial crises and – using the available empirical research – link the variation in their frequency to the likely causes.

II. THE DOMINANT VIEW OF THE FINANCIAL CRISES VERSUS THE EMPIRICAL RESEARCH

The dominant theoretical view of the financial sector stresses:

1. The fragility of banks, resulting from the liquidity transformation they perform, from the insufficient risk monitoring effort by the individual banks, due to the fact that the private benefits from this activity are even less than social ones, and from the information asymmetries between banks' stakeholders and the bank management;
2. The "procyclicality" of the financial sector in the sense of the operation of a positive feedback which amplifies the initial growth of the activity of that sector and, thus, leads to self-amplifying ("endogenous") booms. In the extreme, one concludes that the only stop to this self-amplification is the financial crisis.

This mainstream theoretical view of the banks and of the financial sector is complemented by the widespread interpretation of the influential historical accounts (e.g. Kindleberger, 1978) which stress the recurrence of financial crises for at least the last 300 years of capitalism (if not earlier) and ascribe it to the psychological propensities of the investors ("manias", "animal spirits", etc). Both theoretical and historical analyses, create a widely shared impression that the financial instability is the constant feature of the financial sector due to some interactions of the inherent characteristics of the banks and of the financial sectors (often qualified as "market failures") and of certain psychological propensities of the financial investors. This dominant view crowds out a fundamental empirical question of what were the *differences in the incidence of serious financial crises* and their causes. It also creates the presumption of public intervention (regulation) as the only available means to reduce the risk of financial instability, given the assumed inherent features of the banks and of the financial sector and/or the suggested psychological propensities.

Calamiris who criticized the dominant theoretical and historical views shows in a path-breaking paper (2009a) that the incidence of the banking crises has sharply differed across countries and time. In this situation, just pointing out the invariant recurrence of the serious financial crises and disregarding the differences in their frequency may be compared to emphasizing the "invariant" fact that cars cause accidents regardless of how frequently they occur, depending on the construction of the cars and on the conditions under which they are driven. Furthermore, market failures usually refer to the cases when the real-life situations fall short of a certain ideal (e.g. private costs and benefits equal the social costs and benefits). However, as it is widely known, to identify such a deviation is not enough to demand the public intervention. In addition, it must be shown that there are cost-effective ways of reducing the market failure. And some "deviating" situations classified as "market failures" – may result from certain public interventions. This appears to be the case with respect to the financial crises (see sect. II).

In his review of empirical research on banking crises Calomiris (2009) presents five illuminating comparisons:

1. During the pre World War I period the banking crises were – in general – much less frequent and costly compared with the past 30 years, when 140 episodes were documented in which banking systems experienced losses in excess of 1% of GDP, more than 20 episodes resulted in losses in excess of 10% of GDP, and more than half of which resulted in losses in excess of 20% of GDP (p. 35).
2. During the pre World War I period Argentina, Australia, Norway and Italy suffered exceptionally severe banking crises which resulted in the banking losses between 1 and 10% of GDP. "All of them suffered real estate boom and bust (…), and prior to theses crises all of them had employed unusually large governments subsidies for real estate taking that were designed to thwart market discipline" (p. 97).
3. During the same period the US suffered much more frequent banking crises than Canada even though both had the same monetary system and neither of

them had a central bank. The higher incidence of banking crises in the US is ascribed to the ban on private risk diversification (unit banks) while branching was allowed in Canada (p. 32–34).

4. The US's history shows that some forms of public intervention lead to exceptionally severe banking losses. In the 1830s, states that directed the credit of their banks faired particularly badly (Schweikart, 1987, quoted after Calomiris, 2009b). (The destructive role of political interference in the credit allocation has been also found in modern times). Prior to both the bank failure waves of the 1880s and the 1920s, "some states enacted systems of deposit insurance in which neither entry nor risk taking was effectively constrained. These states experienced far worse banking system failure rate and insolvency severity of failed banks than did other states" (Calomiris, 2009 b, p. 12).
   This suggests that uninsured depositors can act as a source of market discipline, and that generous deposit insurance enhances the propensity of the banks to take risks and can, therefore, contribute to their instability (For more on this see: Kaufman, 1996; Barth et al., 2006). However, such an insurance spread around the world, starting by the US in the 1934.
5. "Britain experienced major panics in 1825, 1836–39, 1847 and 1866, but then the propensity for panics ended for over a century" (Calomiris, 2009b, p. 41). Empirical research, indicates that this transformation was brought about by changes in the Bank of England policies. Prior to 1858 it accepted "a virtually unlimited amount of paper for discount at a uniform rate", both in the bubble phases, which fuelled their growth, and in their aftermath. Starting in 1985 the Bank made its discounting policies much less generous, and during the crisis of 1866 it refrained from assisting major banks which made its no-bail-out policy credible. This example shows that the present discussion on the proper role of the central bank with respect to the financial (in) stability has some interesting antecedents. It also suggests that the primary topic for this debate is not how central banks should prevent the asset bubbles and the resulting financial crises but how to prevent them from occasionally fuelling these bubbles and then from the successive mitigating interventions which accumulate the moral hazard in the financial sector.

These finding as well as the empirical research on the modern financial crises (see e.g. Calomiris, 2009a, Barth at al., 2006) strongly suggest that the differences in the frequency of serious financial instability cannot be credibly linked to some constant features of the banks, the banking sector and of the human nature. Instead one should focus on public policies which shape: 1. the structure of the financial institutions and of the financial sector, 2. the institutional, regulatory and macroeconomic environment within which they operate. One should identify those factors which: 1) enhance the risk-taking in the financial sector by crowding-out the market discipline and/or by subsidizing risk-taking by the decision-makers in that sector and/or by the borrowers; 2) enhance credit and asset booms.

III. POLICIES WHICH CONTRIBUTE TO FINANCIAL CRISES

My reading of the empirical literature on the causes of the financial crises (including that on the recent one) leads me to the following – certainly incomplete – list of policies; which contribute to the financial crises:

1. Politicized (or state-directed) credit allocation: it is usually driven by political considerations which dominate the economic risk assessment and, thus, leads to large banking losses and/or to Sovereign debt distress. The activity of Fannie May and Freddie Mac in the US is the recent example.
2. Persistently expansionary fiscal policy: it contributes to spending booms and may also result in the banking losses and in the public debt problems.
3. Monetary policy which occasionally leans "with the wind", i.e. fuels asset bubbles (Fed's policy in the 2000's being the main recent example). It has been linked to a doctrine of monetary policy which narrows its goal to the short-term CPJ inflation, and excludes from its purview asset price developments and the related factors (e.g. the growth of monetary and credit aggregates).
4. Tax regulations which favour debt finance relative to equity finance.
5. Subsidies to the mortgage borrowing.
6. Financial regulations which encouraged excessive securitization, e.g. the risk-weights contained in Basel 1 and the mandatory use of credit rating by financial investors.
7. Generous deposit insurance which eliminates an important source of market discipline.
8. Regulations which limit the shareholders concentration in large banks and thus increase the agency problems and weaken market discipline (Calomiris, 2009a). This may be an important source of the managers compensation schemes which favour short-term gains and disregard longer – term risks.
9. Policies which have resulted in the "too big to fail" syndrome, i.e. financial markets' subsidization – via reduced risk premiums – of the large financial conglomerates. This is another important instance of public interventions which weaken the market discipline. The resulting concentration, in the face of the financial crisis, exerts an enormous pressure upon the decision-makers to bail-out large financial companies again, thus creating a sort of a vicious circle. The policies in question included an easy acceptance of the mergers of already huge financial companies and an easy-money policy which fuelled the growth of already large financial conglomerates.

As the first best, such distorting policies should be eliminated. Other measures should be considered if the first – best proposals hit the political constrains, or if it can be shown that they are insufficient to ensure a cost-effective reduction in the risk of serious financial crises, and other better remedies are avoidable.

IV. A LOOK AT THE PROPOSED PREVENTIVE MEASURES

A look at the huge literature on how to reduce the risk of another serious financial crisis reveals a long list of the proposed preventive measures. It appears to me that the proposals which are most frequently put forward by various official bodies are the following ones:

1. Increase the required capital in the banks and in some other financial institutions.
2. Reform the risk-weighted capital requirements, e.g. by supplementing them by a limit on the general leverage.
3. Introduce macroprudential regulations in the form of the countercyclical capital charges, dynamic provisioning or contingency capital provisions.
4. Work-out and introduce the prompt corrective action schemes (PCA) and an efficient insolvency procedure for large financial companies which would minimize the negative spillovers resulting from such an insolvency.
5. Introduce the regulations and supervision with respect to the compensation schemes in the financial institutions.
6. Identify the systemically important financial institutions and subject to them the increased capital requirements and other regulatory requirements, depending on their contribution to the systemic risk.
7. Limit the risk which can be taken by the deposit-taking institution by banning them from engaging in more risky activities. This would lead to the restructuring of the present financial conglomerates and to the division of the financial companies into more or less "narrow" banks and firms which are allowed to take more risks.

I am neither in a position to comment here in detail on the respective proposal nor it would be advisable in this stage of the debate. Let me instead offer four general observations:

First, steps which would eliminate the policies that contribute to the financial crises are conspicuously absent on the list. This refers especially to procyclical fiscal and monetary policies, to tax regulations which favour the debt financing and mortgage credit, to the generous deposit insurance, to the mandatory use of credit ratings, to the reforms in corporate governance which would strengthen the shareholders position vis à vis the managers. As a result, the issue of how to strengthen the market discipline is rather neglected. There is a continued presumption of regulation.

Second, some proposals (increased capital requirements, prompt corrective action, efficient insolvency of large banks) may be, however, regarded as intended to mimick the effects of market discipline (see G.G. Kaufman, 1996). The question is whether they can work.

Third, and on the related note: most proposals are still not sufficiently elaborated while the devil is, indeed, in the detail. This obviously makes it very difficult, if not impossible, to evaluate their costs and effects. The story of the unintended effects of some Basel regulations should provide a warning against a hasty introduction of not sufficiently elaborated and tested regulations.

Fourth, the devils is not only in the detail of the respective proposals but also in the relationship between – the sufficiently elaborated – versions of the proposed measures. Which of them are substitutes and which are complements? For example, what is the relationship between the proposal 4 ,5 ,6 and 7? They appear to me to be substitutes but in some reports they are all on the list of the proposed measures. Or, regarding the macroprudential regulations (which I personally consider to be potentially very useful): are countercyclical regulations and contingency capital requirements substitutes, and if yes which is to be preferred? The point is not only to get sufficiently detailed version of the respective proposals but also to be able to say which of them form the best, most cost-efficient combination. We are a long way from that.

V. CONCLUDING COMMENTS

Summing up, much work remains to be done on the way to cost-effective package of measures which would reduce in the cost-effective way the risk of another serious financial crisis. The necessary steps should include the elimination of most important policies which – in the light of empirical research – have contributed to the financial crises. The respective proposal should be elaborated to a much greater detail and the relationships between them should be clarified, so it becomes possible to select the most cost-efficient combination of the preventive steps.

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Jerzy Pruski

CROSS-BORDER STABILITY FRAMEWORK: LESSONS FROM THE GLOBAL FINANCIAL CRISIS

INTRODUCTION

The essence of this subject problem reflects the challenges coming from cross-border activity of big and complex financial institutions, the systemic impact of their failure and the difficulties of cross-border crisis management.

These considerations are focused on two aspects. Firstly, the essential aspects of the cross-border stability framework and secondly the conclusions resulting from the current global financial crisis.

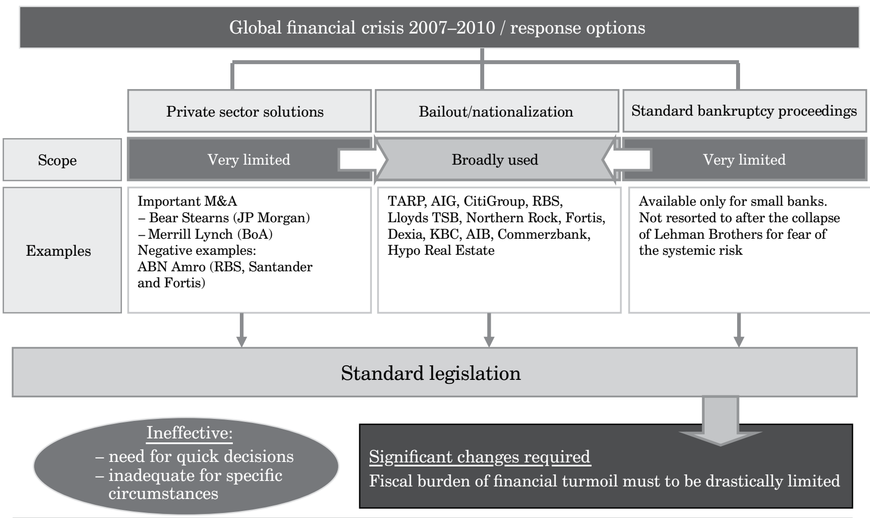
DOMESTIC FINANCIAL STABILITY FRAMEWORK: COMPLETENESS AND EFFICIENCY OF THE SYSTEM

First of all we need to assess the instruments used during the current crisis. It seems to be useful to classify these instruments into three groups, two of which are of very limited usage.

The first consists of private sector solutions. The second: standard bankruptcy proceedings. And, last but not least: bailout or nationalization.

As far as, private sector solutions are concerned, during the current global crisis, they practically haven't been applied. Only in a few cases such an option was discussed or described as private sector solution purchases. Two of them, the purchase of Bear Sterns by JP Morgan and Merill Lynch by the Bank of America, are widely considered as relatively successful. But even in these cases, the acquisitions were supported by financial assistance from the central bank or the government. One can also mention an unsuccessful example of such an acquisition, namely the purchase of ABM Amro by a consortium of the Royal Bank of Scotland (RBS), Santander and Fortis. Two out of three members of the consortium faced extremely serious problems, later on. Fortis disappeared from the market and RBS was almost fully nationalized by the UK government.

Chart 1. Low effectiveness of existing crisis management tools



The second option, which is also of very limited usage during the global financial crisis, was the standard bankruptcy proceedings. Usually, they are applied almost only for small banks, which have no systemic importance. Taking into account the fear of systemic risk, after the collapse of Lehmann Brothers (LB), this option was not resorted to.

So what kind of option was most commonly used during the financial crisis?

With some oversimplification, one may maintain that the most broadly used option was bailout. In practice, this amounted to a form of nationalization. This is the tool by which the government and some regulators started to cope with the negative consequences of the current global financial crisis.

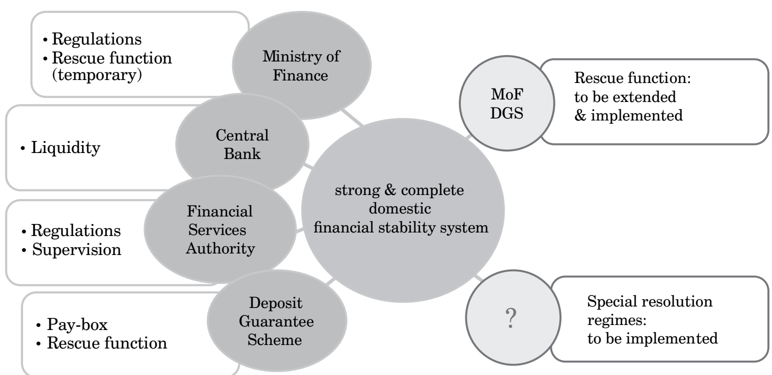
The conclusion which we should draw from the last crisis experiences boils down to saying that:

1) nationalization turned out to be an extremely costly solution,
2) the safety network revealed to be grossly inadequate to the scope and essence of the problem during the global financial crisis.

This assessment originates mainly from a domestic perspective, but if we look at it from a cross-border perspective, it is exponentially worse. Standard legislation also turned out to be ineffective under such specific circumstances as failure of banking institutions operating in cross-border regime and situations demanding a quick and straightforward decision-making process.

Let me briefly discuss what I understand to be a strong and robust domestic stability network. Traditionally, the safety net consists of four institutions, with well-defined functions. The Ministry of Finance, equipped with the authority to impose regulations. In addition to that, endowed with a temporary rescue function and, finally, reluctantly resorted to but in extreme situations broadly used bailout authority. The central bank, providing liquidity assistance with respect to individual credit institutions or the banking sector as a whole. Regulatory or financial services authority responsible for regulations and supervision. And in most countries deposit guarantee scheme equipped with a paybox function and, in limited cases in Europe , with a rescue function.

Chart 2. Robust domestic stability network as prerequisite for effective cross--border safety net

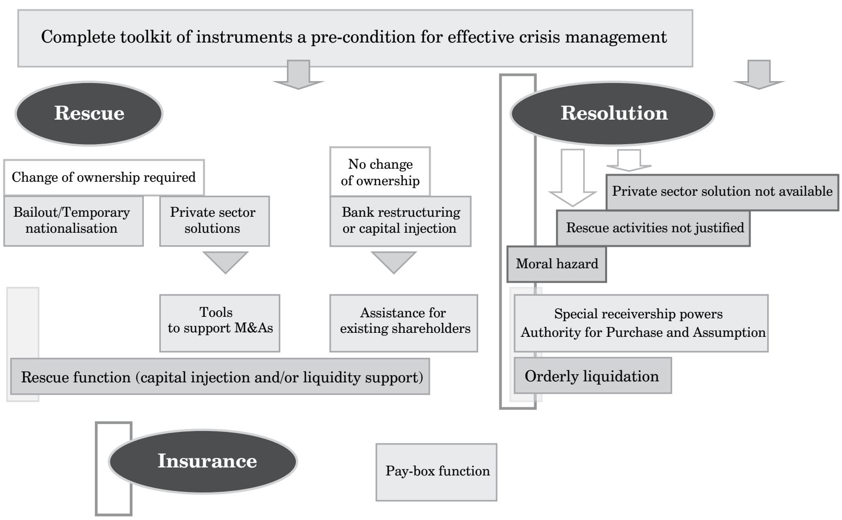


What is missing, especially in Europe? How should the safety network be enlarged?

Firstly, the rescue function should be extended. There are only a few institutions, aside from governments, which are legally established to use rescue instruments. For example in Poland there is the Bank Guarante Fund, the national DGS, designed not only with the pay-box function but under the principle of the least cost, it can serve the rescue function using the so called assistance loan, which may be provided to keep a troubled bank alive and avoid its bankruptcy and reimbursement of claims to its clients. A set of rescue instruments includes alternatively a temporary recapitalization, purchase of assets and guarantee of rights issue or bond issue. Considering the accumulated experiences, there are very strong arguments for the toolkit of rescue instruments to be attached to deposit guarantee schemes, due to its complementarity with the pay-box function, as well as due to possible synergies coming from the usage of this rescue function.

Secondly, what is especially important, there is a lack of special resolution regimes (SSR), special bankruptcy laws dedicated to banks, which allow a bank to be liquidated in an orderly way. SRR can not only mitigate crises but it also stimulates market discipline and reduces moral hazard. Quite recently, after the painful experience of Northern Rock and LB such SRR has been adopted in the UK. Without adequate rescue and resolution instruments, the domestic safety net looks like Swiss Cheese with very large holes and I do hope that there is still some milk left to contain the existing holes. Many countries in Asia, Africa, South America and North America, learning from costly experiences from previous financial crises, have already adopted the necessary regulations and they are much better prepared for the severe consequences of potential banking crises. But even in a country with a very sound and strong domestic safety network established, crises still remain inevitable in a market economy and one should not act under the illusion that any kind of domestic or cross-border stability framework can eliminate financial crises.

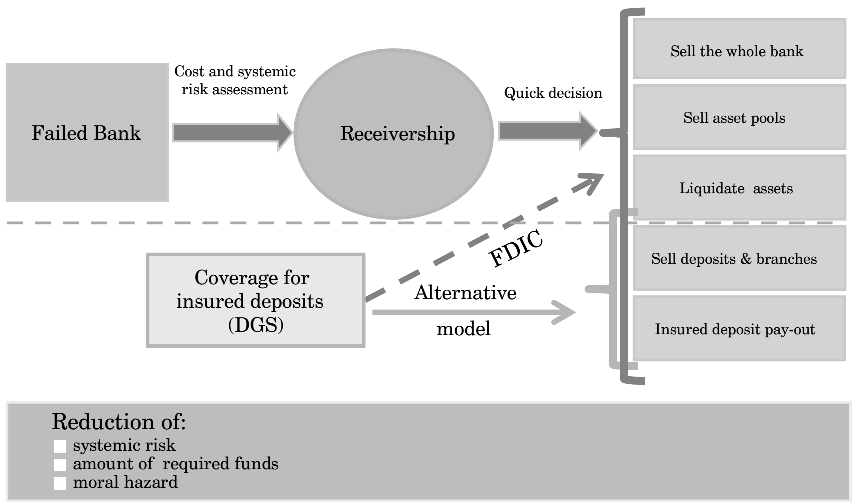
Chart 3. Need for effective rescue and resolution funtions



The rescue function can be executed in many ways, however a capital injection or liquidity support are the most frequently used ones. Rehabilitation of the problem bank with the outside rescue fund may require changing the ownership or be implemented without changing the ownership. There are good arguments to activate the rescue function mainly when a change in ownership is under way.

However, in some cases, when a private sector solution is not available and if rescue operation – using the public funds – can destroy the market discipline stimulating a moral hazard, especially connected with nationalization, there is a need for orderly liquidation of a credit institution. Therefore special receivership powers, special authority for purchase and assumption should be attached to a specific institution or institutions.

Chart 4. Resolution regime

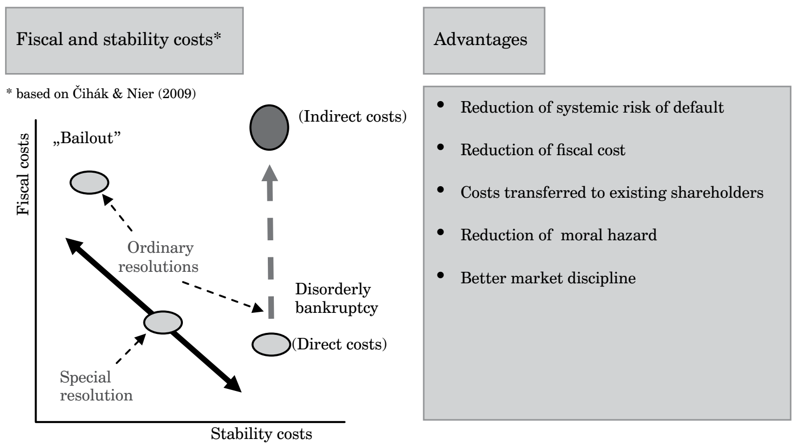


According to the best world practices, resolution instruments are majorly attached to deposit guarantee schemes. The most experienced and the best known is the Federal Deposit Insurance Corporation (FDIC). However, as mentioned before, it is not the only one. We may refer to a few examples. Resolution activities are conducted by deposit guarantee schemes in Canada, countries in Latin America (Chile, Columbia, Mexico); in Asia (Japan, Korea, Malaysia, Philippines, Taiwan, Thailand), in Africa (Nigeria and Tanzania) and some European countries (Russia, Turkey). It would appear that Europeans pretended for a long time that financial crises had been excluded from business cycles in Europe and therefore there were no reasons for implementation of resolution regimes. The current global financial crisis clearly proved that this attitude was totally unfounded. Deep crises and nationalization of the banking institutions in the UK forced politicians to adopt the so called Special Resolution Regime.

Why is this solution so important? Why should the domestic stability network be supplemented by this special resolution regime?

Briefly, we can explain it using slightly a modified, but a well-known diagram of Cihak & Nier.

Chart 5. Significance of special resolution regimes



Source: Autor's concept based on Martin Cihák Erlend W Nier, the need for special resolution regimes for financial institutions. http://www.voxeu.org/index.php?q=node/4446 (09-10-2010)

The modification relies on adding an element incorporating indirect costs.

What this diagram suggests is that even if we follow a disorderly bankruptcy, which by definition should not involve large direct fiscal costs, the costs related to the need to calm markets or to offset the negative consequences of disorderly bankruptcy turned out to be very high. It explains why even under disorderly bankruptcy indirect fiscal costs are incredibly high. In short, SRR reduces fiscal costs substantially and mitigates the negative impact on the financial stability.

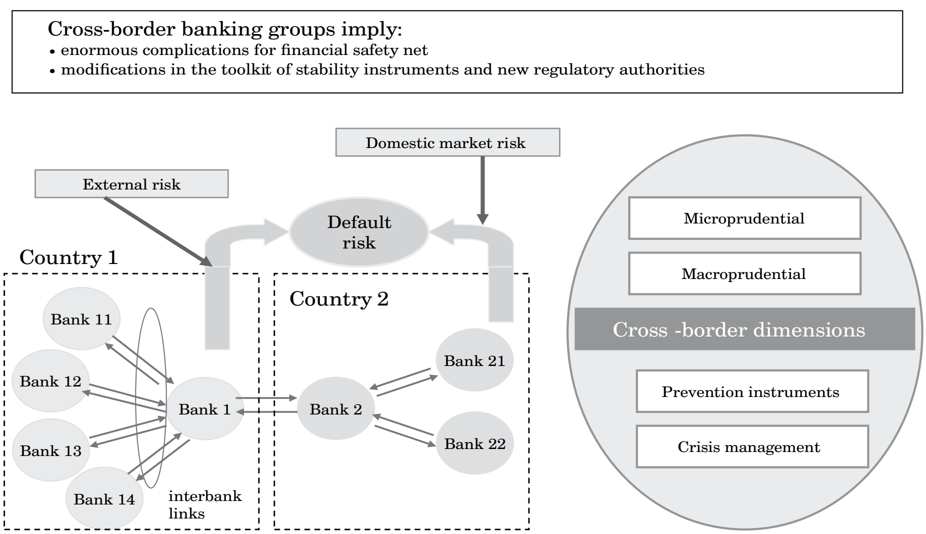
A robust stability framework almost inevitably leads to a negative side effect in the form of increased moral hazard. This problem has to be addressed. We have to diminish the fear of disorderly bankruptcy and under a special regime allow, even big and complex financial institutions, to go bankrupt. Therefore the SRR is an indispensable component of a strong domestic safety net.

The European countries, mainly EU member states, have to quickly make up for the lost time. Some countries have already launched this process. In Poland the SRR concept has been increasingly brought into general use and hopefully the needed decisions should be undertaken fairly soon.

CROSS-BORDER INTERCONNECTEDNESS – ADDITIONAL RISKS AND CHALLENGES

The need for a robust and comprehensive domestic safety net is even more urgent when we move to a global perspective from the financial and economic point of view. The benefits originating from globalization are relatively well known and there is no need to list them. However, globalization also brings some threats. In issues discussed in this paper, there are at least three negative features, resulting from financial globalization should be underlined. Firstly, globalization generates an increased risk of crisis, because cross border and international operations are accompanied by lack of sufficient information. Secondly, interconnectedness incorporates contagion effect. Both inevitably increase the risk of financial crisis which cannot be prevented under existing safety net architecture. Thirdly, crisis management is difficult even from a domestic perspective but in a cross-border environment it turns out to be highly problematic and very challenging. In a cross border perspective a domestic bank is a part of an international system, which immediately raises the question of access to information required for adequate risk assessment. If the cross-border perspective is applied, the available set of methods for macro-prudential oversight, micro-prudential supervision, prevention as well as crisis management instruments should be urgently modified. However, this is truly not an easy task to fulfil.

Chart 6. Cross-border risk management



Let me now turn from a general perspective to the available solutions for mitigation of cross-border risk. My starting point is a robust domestic safety net. I take it as a precondition of any sound cross-border stability framework. Unfortunately, in most of the European countries a robust domestic safety net is still under construction. The specific weaknesses are mainly: lack of a clearly defined and financially prepared rescue and resolution function. But these are merely preconditions.

In order to cope with a very challenging cross-border environment, harmonization and cooperation are of crucial importance. But cooperation is typically based on non-binding agreements, and such a solution could be relatively effective in terms of a fair information exchange and mostly in good times. Under emergency circumstances a non-binding framework is not sufficient and the global financial crisis has proved that such a solution simply does not work effectively.

Chart 7. A selected limitations of cross-border risk monitoring

Systemic risk

Capital surcharge to risk-weighted assets

(in % of initial risk-weighted assets)

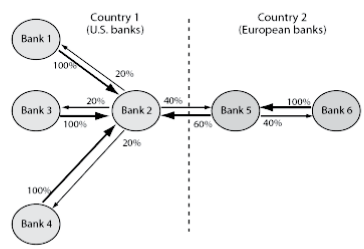
Country	Banks	Network charges	Country 1 charges	Country 2 charges
Country 1	Bank 1	0,74	0,97	
	Bank 2	**1,43**	1,11	?
	Bank 3	0,44	0,54	
	Bank 4	0,41	0,50	
Country 2	Bank 5	**1,56**	?	0,58
	Bank 6	**1,06**		0,34

Source – IMF

Limitations

Identification of systemically important institutions requires access to data on entire cross-border network

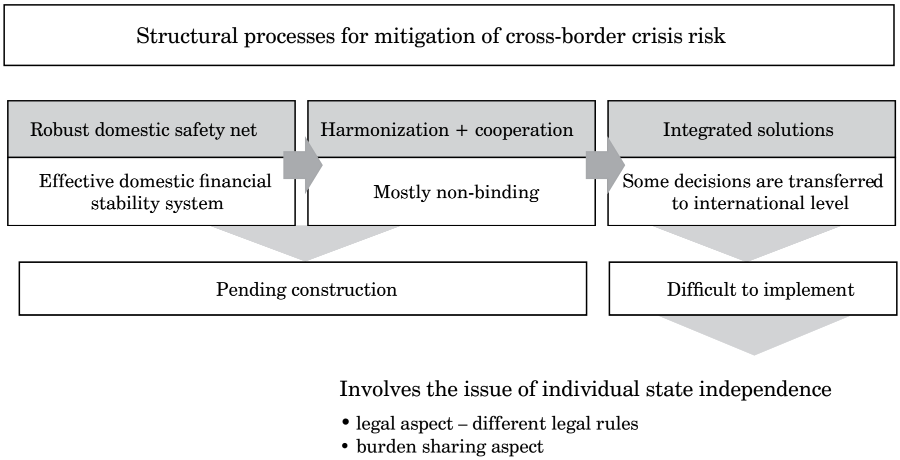
Total picture of the risk is not visible from the perspective of a single country



In addition to a local component, the risk imposed on domestic banks depends on external foreign risk, which is only partially visible

Taking into account not only potential losses, it remains unclear why two basic issues are mentioned, namely: a robust domestic safety net and an effective cross-border cooperation and harmonization which are still pending construction in the EU. On the other hand, it seems very problematic to establish any international body responsible for mitigating financial crisis without adopting adequate domestic safety net in the EU member states effectively cooperating on the basis of harmonized rules.

Chart 8. Process of reducing the risk of cross-border financial crisis



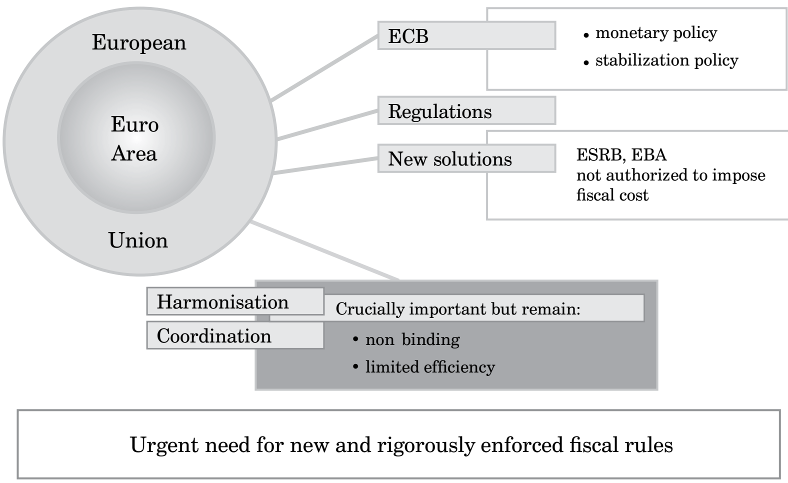
A FEW REMARKS ON THE EUROPEAN FINANCIAL STABILITY NETWORK ENHANCEMENT

First of all the heterogeneity of financial stability network in EU member states should be underlined. The only exception is the European Central Bank and the European system of central banks. The ECB has the exclusive authority to conduct monetary policy and to some extent stabilization policy. The new bodies are some recently established institutions: the European Systemic Risk Board and the European Banking Authority. However, these institutions are not authorized to impose fiscal costs on member states, so the effectiveness of these institutions may be limited. All member states obey the EU regulations; however, they mostly are dedicated to supervision. An oversight and cross border crisis management issues are hardly covered. Therefore, it should be quite clear that harmonization and coordination are of crucial importance in such a stability framework.

Cross border cooperation is not binding and has not been, at least until now, of limited efficiency. The negligible importance of MoUs signed in 2008 by ministries of finance, central bankers and supervisors has been rather evident during the current crisis. This stability network from a macroprudential perspective is supplemented by fiscal rules from the Stability and Growth Pact. And again, the European sovereign debt crisis clearly indicates the urgent need for new and rigorously enforced fiscal rules.

The recent cross border crisis management experience in Europe has revealed that:
– in practice, the European stability safety net has failed to be successful,
– it lags behind domestic standards,
– it is still fragmented,
– it is not binding,
– it lacks funds to intervene at the pan-European level.

Chart 9. Outlook of existing cross-border stability network in the EU



The European stability framework has to be promptly modified and improved. That is why there are many new issues which are currently being discussed, not only Basel 3 with a new set of supervisory indicators, but also the need to establish pan-European institutions like the Stability Fund or the European Resolution Fund, Professor Gross' proposal of a European Monetary Fund, pan-European Deposit Guarantee Scheme or, discussed for many years, the Integrated European Supervisor. What underpins all these institutional proposals is the hope that at a pan-European level the extremely difficult challenges of cross border crisis management may be appropriately addressed. This may be correct. But without a robust domestic stability framework, without efficient cross border cooperation, and without a strong political will to cope with ex ante burden sharing and transfer of additional authority to a European level, all these new initiatives will boil down only to discussion among economists and will never be applied in real life.

Chart 10. Proposed cross-border stability network

European stability framework legs behind domestic standards

Fragmented	Non-binding	Lack of funds

Currently discussed solutions

Basel III	
ESF *European Stability Fund*	Limitations and barriers
ERA *European Resolution Agency*	– lack of ex-ante burden sharing
EDGS *European DGS*	– non-existant legal framework for transfer of assets
IES *Integrated European Supervisor*	– legal differences
EMF *European Monetary Fund*	– lack of common bankruptcy law

CONCLUDING REMARKS

Let me return briefly to the sources of the global financial crisis. Typically they are attached to weaknesses coming from macro-prudential environment, secondly, micro-prudential and thirdly, macroeconomics. We may expect that the extremely difficult problem of macro-prudential weaknesses is to be addressed by the European System Risk Board, the role of which in practice is still to be tested.

With respect to micro-prudential aspects, there are many initiatives. For example, new capital, and liquidity requirements and leverage thresholds, to cite the most widely discussed, or the latest political action to ban the naked short sell. They seem to be adopted on the assumption that the current financial crisis predominantly results from serious faults of the private sector. So the new measures are selective and focus almost exclusively on the banking sector, but their effectiveness has not been fully proved (e.g. lack of full cost-benefit analysis, and impact analysis). However there are serious doubts whether these new supervisory regulations will provide a good balance between the safety and efficiency of the financial system.

Macroeconomics can be a very important source of potential public failure and a deep state, regional or even global crisis (monetary policy, foreign exchange policy and fiscal policy). The most often cited culprit is the monetary policy. The largest central banks kept their interest rates too low for too long, which significantly contributed to building asset bubbles and global over-liquidity. If the famous Taylor rule had been applied by the Fed since 2002, the boom on the real estate market would have been quite well contained. This means that instead of an extended boom in housing industry, financed widely by Ninja credits, and subsequent dramatic bust, the economy would have followed the gently sloping pattern of a normal business cycle. In addition, the monetary policy of many central banks focused almost exclusively on the stability of consumer prices, completely neglecting asset prices, monetary aggregates or credit aggregates.

From a fiscal policy perspective it is clearly evident, especially in Europe, that it has been too expansionary, too generous, and in most countries unsustainable; without paying attention to the size of fiscal burden we are willing to impose on future generations. It should be urgently reformed.

Also foreign exchange policies contributed to global imbalances. Uncoordinated foreign exchange regimes, between countries and even continents build significant deficits in some countries with corresponding surpluses in others.

* * *

The current discussion, on the lessons from the global financial crisis, overemphasizes the importance of the new micro-prudential tools that brings a risk of overregulation in that field. We are doing very little with respect to macroeconomics (mainly expansive monetary policy leading to suboptimal policy mix) and similarly to macro-prudential framework. Attention is focused almost exclusively on micro-prudential regulations without proving that the main sources of global financial crisis are connected with the private sector failure. For many, including myself, many serious failures resulted from the public sector as well.

Fiscal policy, in many countries, especially in Europe, has reached its limits and it is unlikely to expect any serious counter cyclical impact form it. Quite contrary, due to previous mistakes, during the current recession, the fiscal policy has to be restrictive.

Regulatory policy is clearly pro-cyclical and attention is focused mostly on new regulations and with insufficient importance attached to more effective supervision.

Lars E. Nyberg*

CROSS-BORDER STABILITY FRAMEWORKS[1]

CRISIS PREVENTION AND CRISIS MANAGEMENT – TWO SIDES OF THE SAME COIN

In the previous panel, we listened to discussions on the topic of how to avoid another serious global financial crisis. This subject is, in fact, very closely related to the theme of this panel, so you will have to excuse me (or us) for any potential overlaps. Even if our focus (as I interpret the programme) is supposed to be more on crisis management than on crisis prevention, we cannot – and should not – try to separate the two subjects – because, in the end, what happens in a crisis, and the authorities' response to it, has a great impact upon the actions of financial sector participants in normal times, which, in turn, may affect both the frequency and seriousness of future crises. Therefore, I would argue that, when debating how to avoid crises, we must not only focus our efforts on discussing actual prevention tools, we must also dedicate as much – or perhaps even more – thought towards how to establish solid and credible frameworks for dealing with crises. And, most importantly, we need to consider these two subjects in conjunction. For this reason, I will take the liberty of **not** limiting my remarks to the crisis management aspects of cross-border financial stability frameworks.

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1 For the conference "Global Financial Crisis: Lessons for the Stability of the Financial Sector", Warsaw, 21 May 2010. Introductory remarks by Lars Nyberg for the panel discussion on "Cross-Border Stability Frameworks".

Before I start, I have a confession to make. Those of you who have seen (the draft of) the latest Geneva report will notice that the content of this presentation is very similar to that report. In fact, the analytical framework I use in this presentation has been "stolen" from that report. This theft has been carried out not because I lack ideas of my own, but because I think that this framework is very useful to explain and fully understand the challenges related to the regulation and supervision of cross-border banks.

Turning now to the issue at hand, I would like to focus my attention on the EU. As we all know, the recent financial crisis revealed serious weaknesses in the EU framework for financial stability. It is simply enough to mention names like Fortis and Icesave to prove the point. Of course, it would be seriously misleading to put all the blame on the EU for the problems that got us into the mess. In fact, the crisis was almost exclusively triggered by events in the US markets. Still, we cannot escape the fact the EU probably could have coped with the crisis in a much more effective way than it actually did. A fair conclusion is that the framework that the EU had, prior to the crisis, neither helped us to spot the common risks on the internal market, nor helped us to manage them. In some instances, it made problems even worse.

THE LOGICAL INCONSISTENCY OF THE EU FINANCIAL FRAMEWORK

The heart of the EU's problem is conceptually very simple. For quite some time, we have been building a framework based on the logically inconsistent idea of having one single market controlled by 27 sovereign nations. From a financial stability point of view, this is definitely no recipe for success. On the contrary, it is a source of coordination problems and conflicts of interest among the EU countries. Furthermore, since the current framework leaves it highly uncertain who actually will have to carry the costs of failing cross-border institutions, it is potentially also an obstacle to further integration, as countries may become more reluctant to accept the concept of cross-border banking.

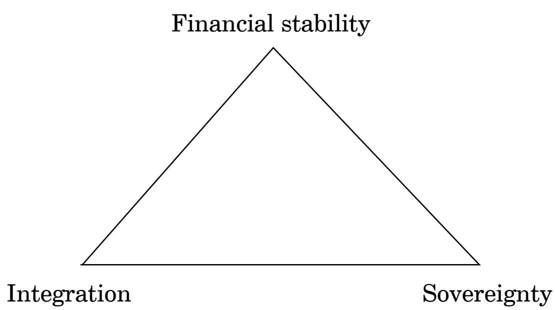
A reasonable question is why on earth the EU has chosen to build a structure that is apparently very ill-suited for delivering financial stability. The answer is simple: financial stability is not the only objective at which the member states are aiming. In the last decade or so, the main focus of the EU financial market agenda has been on integration – establishing an internal market for financial services. Carrying through this ambition, the financial stability aspects of integration were often forgotten or not given priority. Instead, the focus was on achieving a common market while maintaining next to full sovereignty for member states. However, some compromises have been made in the areas of supervision, where the EU has allowed some transfer of powers from the host to home country. As regards crisis management, on the other hand, almost all powers have remained exclusively with each member state. This splitting up of powers in supervision and crisis management has certainly not helped to create optimal conditions for financial stability in the internal market.

In many regards, these flaws came to surface in the crisis, and now, almost everybody agrees that change is needed. And while – as we all know – reform work has already come quite some way, I would say that the final outcome of this reform is still far from certain.

SOMETHING IMPORTANT HAS TO GIVE

Basically, what this reform work is about is choosing the path at a crossroad – a crossroad that has been described by FSA chairman Adair Turner as a choice between more Europe or less Europe. But the choice is not easy, because, whichever road we take, something important has to give. What I am talking about is what has been described by Professor Dirk Schoenmaker as the "financial trilemma of Europe". We have three goals: financial stability, integration, and national sovereignty, but only two of these can be reached simultaneously. This is comparable with the trade-off in monetary policy between a fixed exchange rate, capital mobility and national independency in monetary policy, a trade-off that, in 1998, led 12 EU countries to give up their independent monetary policy to join the Euro project.

The financial trilemma of Europe



As I have already indicated, the pre-crisis approach to dealing with the financial trilemma was to opt for integration without giving up national independency in supervision and crisis management. Of course, all this was at the expense of financial stability. When EU financial integration picked up speed in the mid-90s, the financial stability objective came more into focus. However, the solution was not to centralise powers at the EU level, but to maintain the pace of the harmonisation process and to establish structures for *voluntary* cooperation.

THREE OPTIONS FOR THE FUTURE

Realising now that this has not been enough, the question becomes one of what we should do instead. Broadly, we have three basic options.

- ❖ Firstly, we could go for the **federal approach**, where we allow for a full delegation of powers to the EU level, including regulation, supervision and crisis management.
- ❖ Secondly, we have the option of abandoning the idea of the internal market and returning to a system with **full national control of domestic financial systems**.
- ❖ Thirdly, we could opt for **reforms of the current model,** increasing harmonisation and co-operation to achieve a clearer and more coherent division of powers and responsibilities in supervision and crisis management.

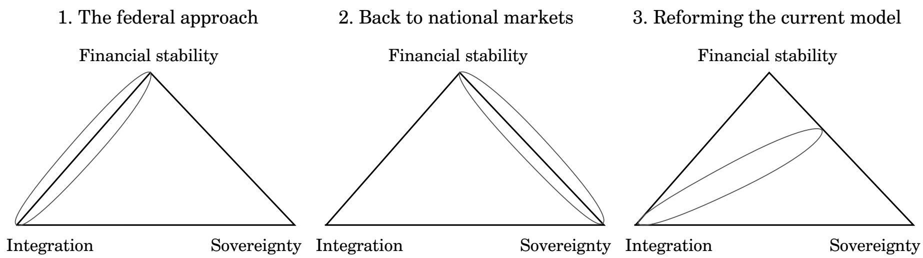
So what does each of these options imply?

The first option, **the federal approach** would mean that risks and problems that are shared by several member states or by the EU as a whole could be managed jointly at a centralised level. The potential co-ordination problems and conflicts of interest resulting from several parties being involved in supervision and crisis management would thereby be mitigated. A necessary condition for this to work would, of course, be the transfer of <u>all</u> powers, including responsibility for crisis management. Otherwise, we risk only aggravating the conflicts of interest that may occur. Following from this transfer of crisis management powers to a centralised level, the EU would have establish some kind of funding mechanism from which resources could be drawn when needed to manage crises. This is where this option gets really problematic. Despite having gone through a major crisis of global proportions, there seems to be little political support behind the idea of establishing supranational authorities equipped with powers to draw on tax-payers' funds.

The second option, a system with **full national control of domestic financial systems**, would imply a roll-back of the integration process that the EU has implemented so successfully over the years. Besides abandoning the principles of home country control and single license, it would be necessary to introduce restrictions on cross-border capital flows in order to prevent contagion. Obviously, in its pure form, this would be a very drastic manoeuvre and not something that is very likely to happen. Still, we see some tendencies in the debate in favour of a more nationally-oriented approach to supervision and crisis management. I find proposals along this line to be very worrying. It would not only be a serious violation of the fundamental idea of the internal market, it would also be highly economically damaging to the European economies. If you ask me, this is not the way to go.

The third option, **reform of the current model**, seems like the only realistic option. In terms of the financial trilemma, what this option basically entails is that we stick to integration and, at the same time, find a reasonable compromise between financial stability and sovereignty. It is all a question of strengthening the EU as the "core" within the EU financial stability framework. How to achieve this and how much of a "core" the EU will be allowed to form are the tricky parts, and the answer varies depending on who you are asking. In concrete terms, the issues at stake are how far we want to go with co-ordination and harmonisation, and what this will imply in terms of the centralisation of powers.

The three options in terms of the financial trilemma



WHAT THE EU IS DOING…

This third option is also the path that the EU has chosen for reform. Before I give you my reflections on the EU's way of tackling the trilemma, let me quickly guide you through the main issues that the European Council has been able to agree on to date.

Firstly, on coordination:

❖ The existing – but loosely formed – European supervisory system will be significantly strengthened. **Three new supervisory authorities will be established** and given certain powers aimed at strengthening coordination. Among other things, they will be able to take certain decisions overriding the powers of national supervisors, for example in the case of a severe crisis situation in the EU or when home and host supervisors cannot reach agreement.

- Working alongside these new authorities, there will be a newly established body responsible for the macroprudential supervision of the EU financial markets, **the European Systemic Risk Board (ESRB)**. This body will not have any binding powers at its disposal, but it will be able to issue risk warnings and make policy recommendations to EU institutions and national authorities on how to address the identified risks.
- The **role of the ECOFIN and EFC in coordinating financial stability policies in an EU-wide systemic crisis will be strengthened** and explicitly integrated into the EU economic policy coordination process.
- The current EU coordination framework for crisis prevention management and resolution between EU and national financial supervisory authorities, central banks and finance ministries will be further enhanced by the establishment of **Cross Border Stability Groups (CBSGs).** These groups will operate on the basis of the procedures set out in formal agreements signed by all the involved parties, **Cross-Border Cooperation agreements (CBAs)**.
- In order to enable effective coordination in a crisis, the CBSGs should develop **operational criteria and principles for ex post burden sharing,** as well as **Recovery and Resolution Plans.**

Secondly, on harmonisation:

- The main issue on the EU's regulatory agenda is the **development of an EU regulatory crisis management framework**, providing harmonised rules for adequate 'early intervention tools' for supervisors, and resolution and accompanying insolvency measures in order to ensure that all Member States have adequate common tools and can coordinate their use, and that actions taken are legally certain.
- To strengthen harmonisation more generally, **the new supervisory authorities will be equipped with powers to develop technical standards** which could be made legally binding after endorsement by the Commission. The authorities will also be assigned with the task of promoting "voluntary" harmonisation, by issuing non-binding guidelines and developing standards for best practice supervisory methodology.

...IS ON THE RIGHT TRACK

Taken together, all these initiatives – if carried through – will significantly improve the financial stability framework of the EU. It will be not be perfect, but it is probably as far as we can get at the moment. In the short run, it is not realistic to aim for a pan-European structure. The political support for such a model simply does not exist. Furthermore, it would require changes to the Treaty, which we know is quite a cumbersome process to go through.

But even if the current agenda looks promising, we are not quite there yet. In the process to come, we need to stay committed to integration. The reason is simple. Financial integration brings more benefits than costs. And to achieve this, we need to address some really complicated and sensitive issues, including, for example, burden sharing and asset transfer.

However, our success in building a better framework is not only measured by how much of their own national interests countries will be willing to give up for the benefit of others or the common good of the EU, but also by how much clarity we can bring to the process of what will happen once a cross-border bank gets into trouble – because simply by bringing more certainty to the crisis management process we will come quite some way towards more efficient cross-border crisis management.

CRISIS MANAGEMENT ARRANGEMENTS ARE THE KEY TO SUCCESS

Basically, what I am trying to get at here is that the key to an efficient stability framework, to a large part lies in crisis management arrangements. Supervision is by all means important, but, to a very large extent, it is the design of the rules of the 'end game' that matters if we want to achieve more prudent risk-taking in the financial industry. In designing such frameworks, which will also be operable in a cross-border setting, four components are particularly important:

- Firstly, all member states must have national crisis management and resolution frameworks in place. However, from a cross-border perspective, it is not only important that such frameworks exist, but also that they are built on a common philosophy of how to tackle problems when they arise. For example, it is important that countries have similar approaches with regard to issues such as the point at which authorities should intervene in a troubled institution, how owners and bondholders are treated in such cases and what responsibility lies with the governments (tax-payers) for supporting distressed institutions financially.
- Secondly, national frameworks need to be compatible. Not only in the sense that they are alike, but also that they allow for cross-border cooperation – in the meaning that the common interest of all involved parties is respected. Issues such as asset transfer and burden sharing come in here.
- Thirdly, on a similar line, responsibilities in crisis management need to be sorted out and aligned. Who does what, when and how are questions that need to be answered. Once again, the crucial aspect here is to find a model that gives

the member state responsible for supervision the correct incentives to also look after the needs and interests of other involved countries. Currently, this is not always the case.

These first three points are basically what the EU is now trying to achieve by developing a harmonised EU crisis management framework.

❖ Fourthly, and not least, effective crisis management requires preparation! As in any other area, the best way to avoid unpleasant surprises, which among other things may erode trust between authorities, is to be prepared. Plan for all types of events and do it together with those who might be involved.

The EU is also doing important work with respect to this point. The previously mentioned initiatives to set up cross-border stability groups and formal procedures for co-operation will most certainly help improve crisis preparedness.

CONCLUDING REMARKS

However, as I said before, it remains to be seen how much of the EU agenda will eventually be delivered. My concern is that a *failure* to deliver would be a huge blow to the integration of the EU financial markets – because, without a robust cross-border stability framework with the ability to provide certain and equitable outcomes for the involved countries in a crisis situation, I am afraid that authorities would be less willing to accept the concept of cross-border banking. And, in my opinion, that would be an outcome that we cannot afford.

*Stanisław Kluza**

THREE PILLARS OF EFFECTIVE CROSS-BORDER FINANCIAL STABILITY FRAMEWORK

I see the global financial stability framework as based on three complementary pillars: one referring to supervision, another to regulation and yet another to responsibility.

PILLAR ONE: COMPETENT FINANCIAL SUPERVISION AT THE COUNTRY LEVEL

During the financial crisis the developed world has learned that market turbulences spread across borders before anyone can react. This shows just how much we need international cooperation before and when something happens. But another lesson we got is that the very origin of crises is local. Problems of large transnational financial groups resulted mainly from inadequate risk management at the parent companies and from lax home supervision.

The greatest attention, then, must be paid to making national supervisors as competent as they can be. European or global bodies will not solve structural ailments of countries that neglected their domestic regulatory systems. In short,

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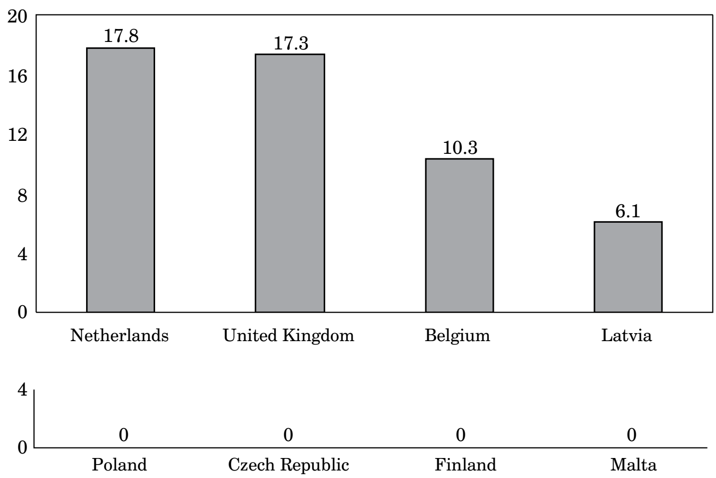
national supervisory authorities must be proactive, independent from any internal or external influences and helped by a prudential regime adjusted specifically for the particular market. If this is the case, the country is able to avoid situations in which taxpayers pay banks in order to make their deposits safe.

Public aid for financial institutions as a percentage of GDP (2008–2009, excl. guarantees on interbank loans)



Source: European Commission

We, as the Polish Financial Supervision Authority (KNF), have learned one more lesson. What made our supervisory policy effective was the ability to independently guard financial institutions' capital and liquidity positions. Any international attempt to transfer this competence from the host country to the domestic or European level should be reconsidered very carefully.

What we lack, of course, is the ability to decisively influence the parent companies of financial institutions based in Poland. Colleges of supervisors have been created in the EU to facilitate control over what is happening in the whole group. We think that one of the main roles of the envisaged European Supervisory Authorities could be to lead these colleges[1].

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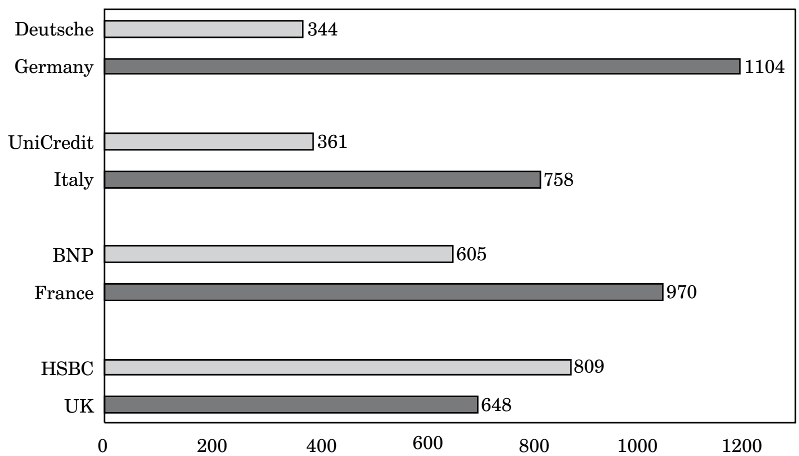
[1] One of the European Parliament's proposals for regulations establishing the European Supervisory Authorities, dated June 2010, included this point, but at the moment of writing of this article it was not clear whether it would be finally accepted.

PILLAR TWO:
REGULATORY REGIME THAT DISCOURAGES CONSOLIDATION

Many financial institutions all over the world have simply grown too large. There are countries in Europe where a single bank has deposits bigger than public budget's expenditures[2]. The same applies to the assets. In 2007, ten European financial institutions had assets larger than GDP of their countries. In 2009 there were already fifteen of them[3].

Deposits held in the largest banks and total state budget expenditures (bln euro, 2009)



Source: Bloomberg

One might say that we have a free market and it is not public authorities' duty to prevent growth of private companies. But the point is that regulations today seem to encourage it. Capital and liquidity requirements applied on the group level, cross-border crisis management, vague regulatory concepts such as "group

[2] HSBC is the most prominent example. At the end of 2009, the bank held deposits worth 809 bln euro. The UK state budget expenditures for the whole 2009 amounted to 648 bln euro. In case of this bank, no public aid was employed nor needed. In case of Belgium, a bank with deposits exceeding state's budget came to the brink of collapse. In Iceland – three such banks did collapse. Source: Bloomberg.

[3] Andrew MacAskill and Jon Menon, European Banks Growing Bigger 'Sowing the Seeds' of Next Crisis, Bloomberg, 2 December 2009, http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=aRDrzOAWRekc

interests" – all those ideas potentially stimulate consolidation[4]. This would create the perverse impact of lowering funding costs of consolidated financial institution giving them incentive to take more risk and simultaneously certainty that they are too big to fail. This is not the goal we should pursue given the amount of risk such large groups generate.

So it is on the level of individual institutions where requirements should be applied – both for the institutions' stability and for the avoidance of consolidation[5].

PILLAR THREE: PROPERLY ADDRESSED RESPONSIBILITY

We, at KNF, propose a simple rule: those who influenced a bank's strategy should be held accountable if it fails. It refers both to supervisory authorities and to parent companies.

Today, all financial institutions in a given country participate in the costs of bankruptcy of one of them, through the deposit guarantee schemes (DGSs), even if they had no influence on the bankrupt's policies. But the guarantee funds are running short of money. In 2008–2009 taxpayers form seventeen European countries had to step in to rescue ailing banks[6].

Against this background, it seems not justified that the parent institutions' financial responsibility for their subsidiaries is limited only to the capital invested. It is the parent who really impacts the subsidiary's strategy, capital allocation, dividends, and composition of the management team. What we propose, then, is to make the parent companies more accountable for the mistakes their daughters commit if these mistakes lead to bankruptcy. In practice, this aim could be achieved by establishing a formal link between home and host deposit guarantee schemes. The former would participate in the costs of bankruptcy borne by the latter. The proposal should be subject to discussion in the context of the new revision of the directive on deposit guarantee schemes.

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4 The level of application of capital and liquidity requirements is currently being discussed once again in the context of the new amendments to the capital requirements directive (CRD 4). The European Commission's approach has been published here: http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf

5 The stance of the KNF on the level-of-application issue is summarized in a comment for the Basel Committee on Banking Supervision's consultation: http://www.bis.org/publ/bcbs165/pfsal.pdf

6 Within the EU only ten states did not resort to direct public aid for banks: Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Lithuania, Malta, Poland, Romania, Slovakia.

The “New Europe” has been very hospitable to foreign financial groups. But this made our financial systems vulnerable to external shocks. The network of DGSs would partly eliminate that.

The functioning of deposit guarantee schemes should also be reviewed in the context of foreign banks operating via branches. We agree with those countries that want to ensure that the Icelandic is case never repeated. Branches of foreign credit institutions do not participate in local deposit guarantee schemes and are supervised by the local authorities only to a limited extent. At the same time they are able to lure many clients, thanks to high interest they can pay.

Transformation of the branches of foreign banks into subsidiaries would subject them to local supervision and make them pay a fee to the local DGS. KNF believes that if they are not willing to convert, they should still pay an additional reinsurance fee to the host DGS. This reinsurance would be activated if the home DGS fails to meet its obligations.

*Per Callesen**

EUROPEAN CROSS-BORDER COOPERATION TO SAFEGUARD STABILITY AND MANAGE CRISES IN THE FINANCIAL SECTOR

For the conference "Global Financial Crisis: Lessons for the Stability of the Financial Sector", Warsaw May 21, 2010. By Per Callesen[1]. Slightly revised August 28, 2010.

This note is devoted to cross-border cooperation for financial stability and crisis management. As illustrated by recent events, financial stability is closely intertwined with macroeconomic stability and fiscal policy. These are fundamental components

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1 All assessments and recommendations are made on a personal basis and do not necessarily represent the positions of institutions where the author has or has had work-relations. The assessments have benefitted from experience and discussions related to the current position as (from January 2010) Executive Director of the Nordic-Baltic constituency in the International Monetary Fund and previous positions as Deputy Permanent Secretary in the Danish Ministry of Finance and the chairing of working groups of the EU Economic and Financial Committee, and previously the Economic Policy Committee on Financial Stability arrangements (2006–2008), examinations of Stability and Convergence programs (EFC-Alternates) 2005–2009, and examinations of structural reform (Lisbon-strategy) 2000–2002. The note has benefitted from much inspiration and comments provided by current and previous colleagues, in particular Nathalie Tuxen from the Danish Ministry of Finance who played a key role in servicing the EFC Ad Hoc Working Group on Financial Stability Management 2006–08.

of the overall framework and also require strong cross-border cooperation. In addition, crisis management is closely linked to and dependent on both the quality of macroeconomic policy management and the built-in stability of the financial system in general. The presentation will therefore be grouped in four parts:

1) Policy-implications of the sovereign debt crisis.
2) The European financial crisis management undertaken in the autumn 2008 from the perspective of the EU 2008 (spring) Memorandum of Understanding (MoU).
3) Revisiting some of the controversies in preparing for the 2008 MoU from the perspective of the subsequent crisis management and policy innovation since then.
4) Selected broader considerations about building a stable financial system, including the need for automatic stabilizers.

The note discusses policy implications of the financial and fiscal crisis 2008–10 in the context of the policy framework until then, and does only fragmentally relate to ongoing work and proposals for financial and fiscal reform in the EU.

1. POLICY – IMPLICATIONS OF THE SOVEREIGN DEBT CRISIS

The sovereign debt crisis in Greece, and broader market concerns for the situation in a number of other high-deficit/high debt countries (in spite of Greece being in a class of its own in terms of fundamentals), has exposed that neither financial institutions nor sovereign states can be left alone to bear the consequences of their historical decisions. Financial markets are strongly intertwined, a lack of transparency on credit and counterparty risk create uncertainty, sovereign debt problems risk spilling over to banks, and financial markets are rightly or wrongly lumping problems in institutions and countries together. Contagion is a major concern. And we cannot have financial stability without sound and credible public finances.

This is not the fault of the euro. On the contrary, in the absence of the euro numerous additional problems would have been added to the current ones, including higher spreads triggered by currency concerns, unpredictable financial implications of currency crisis within the EU, competitive devaluations and continuously high inflation in affected countries.

It is not an economic crisis of the “euro”. It is a crisis of sovereign debt and financial stability in the EU, including the euro-area. Which has triggered a sort of political crisis of policy cooperation in the EU and in particular the euro-area, as well as revealed flaws in the governance and implementation of fiscal policy coordination? Considerations are now[2] given to how cooperation has been

[2] Including by the European Commission in “Reinforcing economic policy making”, May 2010.

undertaken so far. It is rather the political discussions than the economic factors, which have raised concerns about the common currency.

But the stability provided by the euro allowed for large imbalances to build up stronger and for longer periods of time. Otherwise, reactions from financial markets would have enforced policy adjustment at an earlier stage. Why did policy cooperation not prevent this from happening and what kind of reforms are needed in European institutions? One answer is that there is a limit to how much other countries, even members of the EU and the euro area, can do to prevent a sovereign Member State from running unsustainable policies. However much more can be done, including in the following four areas:

a) **The role of the ECOFIN council in EU economic policy making should be strengthened substantially.** Fiscal policy coordination has little chance of success without fundamental changes in the way the Commission, all formations of the Council, and the European Council work. The key coordinating role in the 1990s of Finance Ministers embedded in consistent fiscal concerns has long been replaced by a decoupling between overall fiscal policy and its underlying decisions. On the one hand, fiscal surveillance is undertaken by Finance Ministers. On the other hand, spending decisions with formulation of sectoral and structural policies are made by many others. Inter alia in the context of the Lisbon strategy this has in part been build bottom up by other Council formations, taking into account the civil society and NGO's. In part it has also been build top down by the European Council adopting conclusions with general formulations on the fiscal situation, but specific formulations on sectoral policies, often implying larger spending. A simple unofficial[3] scrutiny of recommendations in the context of the Lisbon strategy revealed 164 objectives of which 66 have fiscal implications. Of those 66, 86 percent required more spending or lower taxes, 8 percent required less spending or higher taxes and 6 percent were fiscally neutral. It is not enough to call in Finance Ministers to manage crises, they need to be continuously in charge of the components which add up to overall fiscal policy. Macroeconomic policy mistakes are very costly, but unfortunately attention to this has eroded over time since the last time mistakes were made.

b) **Macroeconomic crisis management needs stronger sophistication and differentiation.** Few references are any longer made to the "European Economic Recovery Plan" launched in late 2008 with a call for a strong fiscal stimulus from all Member States and without sufficient attention to the significant number of countries vulnerable to financial market risk. The plan

[3] By the Danish Ministry of Finance.

put (as intended) governments under pressure by triggering a competition to get appraisal for providing the largest stimulus. This pressure was backed by the media. In early 2009 the process of fiscal surveillance based on the Stability and Convergence programs had to check if countries expanded fiscal policy enough to comply with the recovery plan. In practice, differentiation between countries turned out better than expected, but not sufficiently strong. While a fiscal stimulus from countries with strong fundamentals was warranted, it is not unexpected that the combination of deep recession and fiscal stimulus in weaker economies would create trouble now.

c) **Fiscal policy surveillance and recommendations has to take current account deficits and inflation differentials into account.** Large current account deficits have – once again and irrespective of participation in the common currency – proven to be fundamental indicators of impending trouble. They reflect lax fiscal policy and/or unhealthy incentives and institutions in the private sector leading to overspending. Countries where the counterpart to government borrowing – directly or indirectly – is not their own private sector but foreign creditors are much more vulnerable. Competitiveness problems are the 2nd round impact of not tuning demand management to potential output for a sustained period rather than the initial cause of problems. High inflation is another strong indicator of an unbalanced economy and imminent trouble. Neither large current account deficits nor high inflation are necessarily driven by lax fiscal policy. But in the absence of other policy adjustments tight fiscal policy can and should in any case work as a backstop policy to contain domestic demand. Building fiscal surpluses in good times would also create the fiscal buffer badly needed when unsustainable economic booms eventually stop. In regards to current account surplus countries with continuous high private financial savings, structural policy recommendations should focus on removing disincentives and barriers towards investment and consumption.

d) **The political follow up has to be stronger by reacting to clearly identified cases of unbalanced economies and unsustainable fiscal policy.** One may argue that more formal, public, and transparent exposure and discussion of such problems would work as political sanctions more effectively than informal discussions. Another issue is how effective peer pressure can be among a large group of countries that simultaneously interact politically in many areas. Also, a strong role should be taken by institutions such as the OECD and the IMF. In addition, economic sanctions, including by implementing already available sanctions, and selected suspension of voting rights should be used and/or considered.

2. THE EUROPEAN FINANCIAL CRISIS MANAGEMENT PUT INTO PERSPECTIVE

The 2008 MoU[4] was more limited in scope than the broad variety of factors contributing to the crisis and the many factors subsequently identified as weaknesses in the financial system. The focus was to prepare for a cross-border financial crisis, implicitly assuming that such crisis would affect a specific and limited number of institutions and countries. Although acknowledging that the distinction is difficult, it was considered possible to manage liquidity problems, before they develop into solvency problems, far better than it turned out in the crisis. The crisis which came in the second half of 2008 was different. It was global, it affected all countries and financial institutions at the same time, and escalating liquidity problems proved to be a main driving factor as deleveraging set in.

Expectations for the MoU were never that it would set a recipe to be followed in any crisis. The MoU was one of many components of the ongoing work with financial issues in the EU. It was clear when preparing for the MoU, that much work remained to develop appropriate tools for managing both single institutions and cross-border events. One of the most operational ingredients of the MoU was the establishment of cross-border stability groups by each grouping of countries sharing a specific concern. This did not get a chance to be implemented before the crisis unfolded. It was also clear that the MoU as such was hardly the first document to be sought for in a real crisis. Rather, the many discussions and preparations related to both the MoU and cross-border stability groups would help facilitate more efficient management of crisis.

Nevertheless it can be of interest to benchmark the eventual crisis management in the autumn of 2008 against the MoU and the discussions leading up to it. Among the more general conclusions in this context may be that[5]…

- ❖ In the initial phase of the crisis many assumed that it could be managed on a case-by-case basis, implying intervention where specific institutions faced trouble. After the first week of October, however, management of the crisis became systemic, based on general national schemes of extended and wide-ranging guarantees of deposits and wholesale funding as well as a general approach to recapitalization. Intervention in specific institutions became less pronounced as the need for it was overtaken by general measures. EU

[4] "Memorandum of Understanding on Cooperation Between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Crisis Situations", Brussels June 2008.

[5] Inspiration for the assessments in this section comes in part from "EFC-AHWG Report on a European Policy coordination framework for crisis prevention, management and resolution, including burden sharing arrangements", Brussels, March 2010 and "Crisis Management and Resolution for a European Banking System", IMF Working paper WO/10/70, March 2010.

cooperation on the general measures arguably worked fairly well, given the circumstances. However, this followed a short but intense period of unhealthy and uncoordinated launches of extended national guarantees.

- ❖ Protection of creditors and uninsured depositors went far beyond expectations in the MoU and this fact must give rise to more fundamental considerations for crisis prevention and management.
- ❖ Where intervention in specific institutions was undertaken it was not particularly cooperative; countries were fast to protect their isolated national interests and quick to ring-fence. There were, on the other hand, examples of fairly well coordinated bilateral solutions.
- ❖ Competition rules proved, not unexpectedly, to be a major issue and related discussions took up a large share of the time devoted to joint discussions of crisis management in the economic EU-institutions. The positive aspect of this was that competition policy prevented a much worse outcome of crisis management in terms of discrimination and negative spill-over. The difficult part was how time-consuming specific decisions were. Problems were by and large handled by the Commission increasing its flexibility on the issue.
- ❖ Contagion became an issue clearly beyond what was expected in the preparations for the MoU giving rise to concerns for wider sectors and smaller institutions. One implication of this contagion environment effect might have been an alleviation of the risk that large cross-border institutions would sell off or abandon subsidiaries, limit their funding, or close branches in host countries. That did not happen even in severely affected countries, probably in part due to reputational risk.

More specifically, it can be of interest to test the extent to which the main objectives of the 9 principles adopted as part of the MoU was adhered to:

Principle 1. The objective is to protect the stability ... in all countries involved and the EU as a whole ... The objective is not to prevent bank failures. *Yes*. This objective was clearly adhered to. However, crisis management went clearly beyond that as very few banks were allowed to fail, no doubt partly due to the fears for contagion and partly due to the sheer number of banks facing trouble at the same time.

Principle 2. ... Primacy will always be given to private sector solutions ... shareholders will not be bailed out and creditors and uninsured depositors should expect to face losses. *No*. Solutions were overwhelmingly public, or at least publically supported or facilitated, as few private institutions were in a position to take over others. Shareholders lost their investment in most cases of failed banks. But few banks were allowed to fail and, in particular, creditors and uninsured depositors were protected almost in full across the board.

Principle 3. The use of public money to resolve a crisis can never be taken for granted...Strict and uniform conditions shall be applied to any use of public money. ***Mainly yes***. The problem with this principle was that while it was sought to be applied, pretty often it was also shortly afterwards overtaken by events. It can be argued that the attempt to apply this principle – also called "constructive ambiguity" – in the crisis created disruptive uncertainty which illustrates a key dilemma in crisis resolution. Strict conditions were generally applied. Clearly, fundamental reform is needed to prevent such use of public money in future financial crises.

Principle 4. Managing a cross-border crisis is a matter of common concern for all Member States affected... authorities ... will carefully cooperate and prepare in normal times as much as possible for sharing a potential fiscal burden. ***Yes and no***. The crisis was treated as a matter of common concern when it came to the general measures, although with a difficult beginning. However national interests prevailed in a number of cases and there had been no careful preparations for burden sharing, although also examples of fairly cooperative solutions.

Principle 5. Arrangements and tools for cross-border management will be designed flexibly... Authorities should be in a position to promptly assess the systemic nature of the crisis. ***Mainly yes***. Almost all possible remedies were used to address the crisis. A prompt assessment was difficult due to the special nature and global panic in the crisis. It might have been overestimated how much and how quickly guarantees would loosen up frozen liquidity markets. This freeze was probably as much due to a mutual deleveraging effect as concerns for counterparty risk.

Principle 6. Arrangements for crisis management and crisis resolution should be consistent with arrangements for supervision and crisis prevention. ***Yes***. Rescue operations seemed to strictly follow national responsibilities – possibly too much, since cooperation could have been better.

Principle 7. Full participation in management and resolution of a crisis will be ensured at an early stage for those Member States that may be affected. ***Probably not***. Many countries and authorities no doubt would have wished for better information and participation during the crisis, although it is not clear to what extent that would have been feasible.

Principle 8. Policy action ... will preserve a level playing field... comply with EU competition and state aid rules. ***Mainly yes, but problematic***.

There were examples of discriminatory action taken, some were corrected later, and in general there was much confusion about the implication of state aid rules. However, the application of state aid rules was a key coordination factor for guarantees, capital injections and the purchase of bad assets. In its absence large distortion and destructive competition for aid could have taken place with negative spill-over.

Principle 9. The global dimension will be taken into account. ***Yes***. The crisis was global and this fact was taken into account. There was much global cooperation in practice, although not enough.

The 9 principles are sufficiently overarching to serve also in part as a benchmark for management of the big 2008 crisis, although it was very different from the events perceived at the time of the MoU. The assessment is broadly positive but in particular any attempt to hold back public money to spur private sector solution and induce responsible behavior failed entirely and proved impossible.

3. REVISITING CONTROVERSIAL ISSUES FROM THE PREPARATION OF THE 2008 MOU

Work in the 2008 MoU was initiated in late 2006 with the establishment of an EFC Ad Hoc Working Group (AHWG) on financial stability management. Following intensive work throughout 2007 the report[6] was the basis for an ECOFIN discussion in September 2007 (the same weekend where the UK bank Northern Rock fell into trouble). The report dealt with a broad range of cross-border financial issues. It was in part analytical, and in part it provided recommendations for the road ahead. It included a roadmap for further work and proposed to extend the 2005 MoU. Work on the MoU was undertaken in the spring of 2008 and the MoU was signed by 118 authorities in 27 Member States in June 2008. It concentrated on practical cooperation arrangements.

Only in part due to their wide range and complexity many issues were controversial throughout the entire process of the AHWG. Members were extremely knowledgeable and came from different institutions (Ministries, Central Banks, supervisors and the Commission) and different countries. They had in many instances well argued opposing views – which were helpful to explore the full range of concerns and ways forward.

Among the three most contentious issues were:

6 "Developing EU Financial Stability Arrangements – Final report", Economic and Financial Committee, Bruxelles, September 2007.

How to manage moral hazard. It is a serious concern if financial institutions and their shareholders operate in the expectation that public intervention will cover or in part cover the loss of risky investments while they keep the gains if investments succeed. This may lead some to believe that preparations for crisis management should be done without even mentioning the possibility of public intervention. However, expectations for public intervention are rather formed on the basis of the perception of the financial stability framework and the occurrence of past intervention.

The AHWG took the view that it was better to specify strict circumstances for public intervention than to neglect the fact that such intervention takes place. Such strict circumstances were specified in the principles, cf. above, but as regards to their practical implementation much remained to be developed. Subsequently, the 2008 crisis has overtaken this discussion with massive public intervention at all levels of bank activities and, as mentioned, on the basis of a broad interpretation of what implies contagion-risks.

In addition to better prevention, focus has therefore rightly shifted to how public intervention takes place in practice and towards how dysfunctional financial institutions can be allowed to fail without triggering large contagion and financial crisis. Probably the two basic options to follow are a contribution system, where the sector in aggregate contributes financially ex ante to cover trouble from failed institutions, and a much better and comprehensive resolution regime with living wills to ensure an orderly transmission of activities from a failed institution to others. Such measures in addition to offering a fairer distribution of costs and smoother crisis management may also help reduce moral hazard to some extent.

Preparing for burden sharing. The need to prepare for burden sharing relates to the risk that timely intervention fails to achieve full effectiveness because authorities from different countries cannot agree on how to share the public sector costs or outlays. It may, for example, imply that an important branch in a host country disrupts the system. This could happen if home country authorities are not willing to sponsor the full burden of a bank rescue, or do not find host country contributions appropriate, as offered.

The unfolding of the crisis during 2008 and 2009 seems to indicate a lower than expected risk of disregarded institutions (very few were allowed to fail), possibly due to the perceived risk of reputation and contagion. However, burden sharing continues to be contentious. Initial discussion on burden sharing was at first related to the moral hazard problem, as the concept of burden sharing automatically implies that there is a possible public sector intervention. While the relevance of such fear of signaling has been overtaken by events, there is still strong resistance to any ex ante agreements on cost sharing; not to mention ideas of creating a fund at the EU-level to assist troubled cross-border institutions.

As agreed already in the principle 4 of the MoU, budgetary net costs are to be shared on the basis of the economic impact and supervisory powers. What is interesting is that this principle states that burdens actually are to be shared. On the other hand, the concept of supervisory powers is an effective caveat. Essentially, burden sharing is the issue following a longer chain of decisions such as regulation and supervision, a form of intervention and resolution strategy. The basic problem with ex ante burden sharing is that while lending money (providing liquidity) is less of a concern, countries or authorities are very reluctant to commit to co-share a real fiscal burden which eventually may turn out to be due to failures by authorities in another country. In particular, a rescue fund at the EU level would imply contributions from countries which do not bear any relation to a specific crisis involving possibly only a few Member States. In other words, there is a very high perceived "exchange rate" between money spent on behalf of taxpayers in their own country and money spent for other countries. Such decisions easily move to the highest political level.

One reading of the debate in Europe about both burden sharing in the financial sector – and in the fiscal sphere – is the strong wish to keep up the pressure for as much and as long as possible on authorities to bear the full responsibility of their actions. It can be rightfully argued that the absence of such pressure would create a moral hazard for authorities. While this is right and necessary, the implication is almost by definition that rescue operations are bound to happen quickly, late, and in a fairly chaotic environment.

The solution appears in European discussions to have advanced a bit since the MoU was signed, but the ideas are basically the same. Authorities should cooperate as much in advance in relation to any systemically important cross-border bank by exchanging information, taking preventive measures and discuss how burden sharing – should the need arise – can be managed in practice, including on which criteria. The most operational ideas center on indicators for the weight of the institution in countries affected and a qualitative assessment of responsibility of which the latter can probably not be settled in advance.

Setting up cross-border stability groups. The original controversies surrounding this issue can almost be detected from the labeling undertaken in 2008-drafting: "voluntary specific cooperation agreement", and the fact that the more in-depth practicalities of such possible groups were relocated to the annexes. One concern was to avoid a prescriptive arrangement, which would not match the need between specific countries or would run counter to their priorities. Another concern was to avoid heavy procedures and workload, including overlap with existing supervisory colleges, and – in part related to this – an institutional wish not to have other authorities (read Finance Ministries) interfering too much.

It is, however, clear that the need to prepare for burden sharing makes the participation of Finance Ministries necessary. They will shoulder the preparation for budgetary decisions in an actual crisis. In order to do that, they need the insight they can only get by cooperating in advance not only with other Finance Ministries on the possible issues, but also by working closely with supervisors and central banks who have in-depth knowledge about specific institutions and markets.

It is overall positive that work on setting up cross-border stability groups is proceeding[7]. Although preparations may appear well founded from the perspective of single countries, no authority should underestimate the institutional, cultural, and political differences arising from interacting with authorities in other countries in the absence of continuous dialogue and specific cooperation. Work in cross-border stability groups can ensure that authorities get to know the mindset of their counterparts much better in advance, provided they are based on formulating specific joint work in writing[8].

4. CONCLUDING REMARKS ON STABILITY IN THE FINANCIAL SYSTEM

Insufficient cross-border co-operation about specific financial institutions was arguable not the main problem in managing the 2008 financial crisis. That does not make further work and preparations to that end less important.

Much effort is also made in Europe and globally to improve supervision and the supervisory structure, including the establishment of the European Systemic Risk Board and the system of European Supervisors. This is important, and can no doubt help improve the prevention of future crises. There are however inherent problems in relying heavily on the capacity to undertake discretionary action towards the financial system (as there is in fiscal policy management).

The political system hardly ever accepts the notion of having good times – until such times are over. It is difficult politically to acknowledge the existence of good times, as it implies that even more progress cannot be expected in the near future. Often such a stance is supported by selected economists, and in particular the media, inventing terms such as "the new economy" to push a perception of "the end of the business cycle". Supervisors will have to operate in that environment

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7 "EFC-AHWG Report on a European Policy coordination framework for crisis prevention, management and resolution, including burden sharing arrangements", Economic and Financial Committee, March 2010.

8 The 8 Nordic and Baltic countries have signed a joint Memorandum of Understanding , which is probably the first of its kind in terms of establishing a cross-border stability group and providing specific criteria and procedures in preparing for possibly burden sharing, see http://www.danmarksnationalbank.dk/C1256BE9004F74D0/side/_Memorandum_of_Understanding_uk

and they will in good times be under pressure from the political system and the financial sector not to take away the punch-bowl. Also, supervisors may have their own doubts in a long recovery as one can never be sure about the future.

This is a strong argument for much better built-in automatic stabilizers in the financial system, such as countercyclical provisioning and capital buffers and adjusting accounting standards accordingly. In reality, risks are at their highest at the peak of the business cycle, where accounting standards and provisioning rules have traditionally suggested that they are at their lowest – as no problems have been detected yet. Such an approach is not only bad for financial stability, but it also does not inform investors about the underlying profitability and risk undertaken by investments.

The 2008 crisis has also exposed the harsh dilemma between increasing competition in the financial sector and safeguarding financial stability. Rather than regulation, stronger competition and transparency are the optimal answer to a sector having wages – and in good times – profitability at levels which one would expect only in protected monopolies. But strong competition increases the risk of having failed institutions. Establishing a system which can allow such failure to happen is therefore important.

One should not forget that the 2008 crisis was only in part due to failures of the financial system. The crisis was in major part due to failure in macroeconomic management of the boom and bubbles which preceded it. Monetary policy was too lax and, not least, fiscal policy was very lax as many countries ran fairly high deficits even at the peak of the boom, where budgets should have been in substantial surplus to dampen activity and establish buffers towards future downturns.

The 2008-2010 real economic crisis has indeed been deep, but benchmarking the slow-down against a continued path of the preceding decade exaggerates the output loss. Rather, economies took an unhealthy sudden shift from a position much above trend to one clearly below trend. A shift in that direction was unavoidable, but it could have been much smoother had macroeconomic policies been driven better in good times and had the financial sector not proven to embed so many deficiencies.

Finally, there is a strong real economic need to bring the financial sector back in a position of good shape. Arguably bringing back a bit of the features driving the previous bubble is needed, especially in countries with large private sector financial savings, and of course, provided it can be managed well. Almost every country now needs a long period of large fiscal consolidation. Including necessary pension reform, typical advanced countries will have to take discretionary fiscal action in the order of 5 to 15 percent of GDP.

While the slump on private investment and consumption is no doubt in part due to a psychological overreaction, a strong impulse from the financial sector is also needed to bring back private spending as the necessary driver of recovery.

Economies will not be rebalanced or grow appropriately if the private sector in advanced countries continues to strive for large financial savings surpluses, while the public sector has to reduce its deficits very substantially. In addition to bringing back a financial sector in good shape, this is a challenge for monetary policy in general. While countries with high fiscal deficits should be in the frontline making strong fiscal consolidation, countries with high private sector savings surpluses should assess and reform incentives and institutions which hold back private spending, such as barriers in the financial system, in the tax system, in welfare systems and in housing markets.

Assessment	**Primary Principle**	**Secondary Principle**
1. Yes, but	Protect stability in all countries	Not prevent bank failures
2. No	Primacy to private sector solutions	Creditors to expect losses
3. Mainly Yes	Public money, never taken for granted	Only used strictly
4. Yes and No	Common concerns for all MS	Coop. in normal times
5. Mainly Yes	Arrangements & tools designed flexibly	Shared assessments
6. Yes	Consistent with supervision & prevention	
7. Probably No	Full participation ensured for affected MS	
8. Mainly Yes	Preserve level playing field/state aid rules	
9. Yes	Global dimension taken into account	

*Paul Wright**

THE CONCEPT OF TOO BIG TO FAIL: ISSUES FOR CONSIDERATION[1]

INTRODUCTION

A great deal of international debate is currently focused on the treatment of firms that are judged to be systemically important. The recent crisis has reminded us that large and complex firms can fail and that such failures can have very serious consequences for financial stability.

Because the consequences of failure can be so serious, there has been a temptation in the past for governments to rescue such firms, typically using public money to take capital stakes in them. But this cannot be a sustainable policy in the long term. In the first place it is prohibitively expensive. The Bank of England has estimated that official support to the banking systems of the UK and US in the period 2007–09 accounted for around three quarters of GDP[2]. These are staggering figures even if (as has already been the case to a considerable degree) much of the cost is eventually recovered. Closely linked to this is the fact that such rescues are highly unpopular politically. And less visible, but no less important, is the pernicious effect that the expectation of such actions has on markets and market discipline. If creditors and market counterparties believe that the firm they

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1 This article is an expanded version of a presentation made at a conference held by the Bank Guarantee Fund in Warsaw on May 21 2010. The views expressed should be taken as those of the author and not necessarily those of the IIF.

2 Bank of England Financial Stability Report, June 2009.

are dealing with will be rescued in the event of failure, they will not undertake proper due diligence and they will not price risk correctly. That creates moral hazard which stops markets from working as they should and is highly corrosive.

Policy makers are therefore faced with a dilemma. Firms will fail and exit the market from time to time. They should not be rescued using public money. But the systemic consequences of disorderly failure are often judged to be unacceptable. How can policy makers respond to this?

PRELIMINARY CONSIDERATIONS

Before turning to possible solutions, it is worth setting out some preliminary considerations which need to be borne in mind as we face up to this dilemma.

The first important point is that systemic risk – which lies at the heart of this debate – is a very elusive concept that is hard to pin down. One official report recently described it as follows:

'A risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy. Fundamental to the definition is the notion of negative externalities from a disruption or failure in a financial institution, market or instrument. All types of financial intermediaries, markets and infrastructure can potentially be systemically important to some degree'[3].

This definition highlights a number of important features of systemic risk.

- It is varied in form. It can arise from the failure of a single large bank (or non-bank financial institution); the simultaneous failure of a number of small banks or the failure of key element of market wide infrastructure. One particularly lively debate which is currently under way is whether insurance firms can be a source of systemic risk[4].
- It can mutate and spread quickly. It is noteworthy for example that the recent crisis which had as one of its principal origins retail mortgage underwriting practices in the banking sector, necessitated liquidity and de facto solvency support to be extended to non-bank intermediaries, especially in the US[5].

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3 Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations. Joint FSB/IMF/BIS Report, October 2009.

4 The consensus, to the extent that there is one, suggests that typically they are not. See for example the report of the Geneva Association 'Systemic Risk in Insurance: An analysis of Insurance and Financial Stability', March 2010.

5 See comments by Paul Tucker, Deputy Governor of the Bank of England 'Shadow Banking, Capital Markets and Financial Stability' remarks at the BGC Partners Seminar, London, January 2010.

- Systemic risk is highly time and condition dependent. History provides multiple examples of firms and groups of firms which would not in any normal circumstances be regarded as systemic but which have been treated as such in circumstances in which confidence is particularly fragile, usually at times of more general systemic tensions.

Because systemic risk is such a complex and elusive phenomenon, the policy response to it needs to be carefully thought through. One clear overall message emerges from this, namely that it is very misleading to take a simplistic or uni-dimensional view of the issue. Some recent debate has fallen into this trap – in particular a tendency to equate size or geographic scope with systemic risk[6].

This leads on to the second point, which is about the need for balance in this debate. A great deal of emphasis has (understandably) been placed on the risks attaching to large, complex and global firms. But there has been a tendency to lose sight of the other side of the equation – the benefits that such firms bring to the global economy. There is great superficial appeal to the idea that the failure of large/complex/global firms has catastrophic consequences and that the only realistic response is therefore to force such firms to be less large, complex or global in the first place – that is break them up or restrict their activities. This argument is flawed on a number of levels. But even if it conceded that such firms *may* be harder to manage and supervise and that their failure *may* (other things equal) pose particular systemic challenges, the simplistic solution of 'breaking them up' or requiring global groups to operate through tightly ring fenced national structures would impose enormous costs on the global economy.

A recent study by the IIF drew on a wide array of case studies to demonstrate that large, globally active firms provide services to the globally economy that would simply be unavailable if they were replaced by firms engaged in a more limited range of activities with more limited geographic reach[7]. Such firms match savings and investments on a global level; they support the banking needs of international corporations; they facilitate the growth of regional companies; they make markets on a global scale and they provide payments services across the globe. They also spread good practice and expertise which has been developed in one market to others, to the benefit of their customers and they act as drivers of economic and financial development in emerging markets. It is obviously the case that such companies pose particular challenges in the areas of management, supervision and (as we will see) resolution and it is imperative that considerable effort and resources are invested in doing better in these areas. But simplistic approaches to

6 For a much fuller discussion of these issues see 'Systemic Risk and Systemically Important Firms: an Integrated Approach', Institute of International Finance, May 2010.

7 Institute of International Finance, May 2010 (op. cit.).

making them 'less systemic' would impose very great costs on the global economy and would create complex unintended outcomes.[8]

We can be reasonably confident that policy makers will avoid the trap of taking an over simplistic view of the problem and its solution. The remainder of this article looks at what is being done to address the problem of 'too big to fail' and to hint at what more needs to be done in the future.

REDUCING THE PROBABILITY AND IMPACT OF FAILURE

Two concepts which underline much conventional risk management are the *probability* of failure and the *impact* of failure. In other words, how likely is it that an undesirable event will occur? And if it does, how much will it matter? An approach based on this simple but powerful distinction underlies much of the development of regulatory policy that is currently under way.

Financial regulation typically seeks to reduce the likelihood that firms will fail to some acceptable level. It does not aim to eliminate the possibility of their doing so – that would be impossible and it would undermine essential market mechanisms. The most basic function of regulators is to ensure that firms have enough financial resources – capital and liquidity – to enable them to support the risks inherent in their business. The Basel Committee on Banking Supervision is currently examining ways of strengthening these requirements. The details are complex but the objective – of making firms more resilient – is clear and one which the industry generally supports.

One question which has arisen in this context is whether systemically important firms should hold more capital and liquidity in relation to the size of their balance sheets than other, non-systemic ones. The rationale for this can be expressed in a number of ways. Perhaps the simplest would be that the failure of these firms results in disproportionate costs (for society as well as their owners) so the likelihood of their failing should accordingly be made very remote[9]. One variant on this argument is that systemically important firms might be required to hold 'contingent' capital. This term has been used to mean different things but in this context it means that firms would be required to issue debt instruments which would convert into capital on the basis of some pre-determined trigger if the firm

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8 It is very tempting here to quote the American journalist and sage H.L. Mencken who famously said that 'for every complex problem there is an answer that is clear, simple …. and wrong'.

9 The economic version of this argument is that the failure of systemic firms creates externalities which the firm, in the normal course of its operations, has no incentive to recognize or internalize.

became distressed. This would provide additional financial resources which would help it recover[10].

At the time of writing, the official sector has still to come up with firm proposals on these issues[11]. Until they do, it is hard to know how the industry will (or should) react. Some points however are clear even at this stage. First of all it is quite unrealistic to imagine that it would be possible to create a definitive list of firms that are 'systemic' – and hence eligible for some kind of capital surcharge. As discussed above, systemic risk is a complex and elusive phenomenon and any such list would be highly misleading. Even if it were possible to create such a list, policy makers would be very unwise to do so. The fact that the firms on the list were seen as being 'systemic' would tend to create a presumption that, in the event of their failure, they would be treated in a certain way. And as soon as such a view gained currency, it would lead to the kind of market distortions and moral hazard outlined above.

Policy makers know this of course and will not seek to create a simple list. They recognize that the most that can be established is that some firms exhibit more or less 'sytemic-ness' based on a range of indicators such as size, interconnectedness with other parts of the financial system and whether the firm provides services of a type or scale that could not easily be provided by others in the event of its failure. On this basis 'more systemic' firms might be required to hold more capital (for example) than less systemic ones. Such an approach would reduce – but not eliminate – the problem of moral hazard outlined above. Great care would still be needed to avoid the creation of perverse incentives and competitive distortions however, even if a more carefully calibrated approach to systemic risk surcharges were to be adopted.

A second aspect of reducing the likelihood of failure is to increase the intensity with which large/complex/global firms are supervised. There is compelling logic to the idea that such firms pose particular business and management challenges. Both managements and supervisors need to have a good grasp of these (something which has not always been evident in the past). Arriving at this understanding is all the more challenging the greater the complexity of the firm. This kind of thinking underlines the proposals for so called recovery and resolution plans or 'living wills'. These broad headings actually cover quite a diverse range of things, including:

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10 In some other variants of the idea, the conversion of contingent capital at, or close to the point of, failure would provide additional equity resources to the receiver to enable it to be liquidated in an orderly way without recourse to public funds.

11 See for example 'Strengthening the Resilience of the Banking System', Basel Committee for Banking Supervision, December 2009.

- Recovery plans – outlining the mechanisms by which the firm would shed risk and rebuild its financial resources in the event of a (non-terminal) crisis, with a view to returning it to a healthy state; and
- Resolution plans – which are really about providing the information and wherewithal for the firm to be wound down in an orderly way in the event of its failure[12].

The logic of all this is unassailable. Putting such plans in place and keeping them workable and relevant will be a challenge for all concerned. Perhaps most important for firms will be the extent to which regulators see such requirements as a pretext for insisting on changes in business models or structures. Prior to the crisis these were not matters that regulators have typically involved themselves in. Regulators have already begun insisting that firms develop recovery plans and are examining the need for resolution plans. Doing this on a sustained and routine basis and on any significant scale, however, would involve quite significant burdens for supervisors and the broader implications, including the moral hazard resulting from any perceived transfer of responsibility from managements to supervisors, would need to be thought through carefully[13].

The other part of the conventional risk management equation – reducing the impact of failure – underlies the current emphasis on making markets and infrastructure more resilient. The drive to have credit default swaps cleared through central counterparties (CCPs), both to improve management of counterparty risks and to improve market transparency, is an example of this. Such measures are not a panacea – it is necessary to think about the potential systemic risks posed by the CCPs themselves and to ensure that they are regulated accordingly for example. But the recent crisis illustrated rather vividly that some markets and structures were more fallible than had been assumed and rectifying this is a key part of reducing systemic risk.

BETTER RESOLUTION ARRANGEMENTS

It is worth taking stock at this point. It is highly likely that within a reasonably short space of time, the official sector will have put in place a range of regulatory and other measures which will make it less likely that firms will fail and mitigate

12 For an excellent discussion of recovery and resolution plans see 'Crisis: Cause, Containment and Cure' by Thomas Huertas. Palgrave MacMillan 2010.

13 While supervisors have always challenged firms on whether their controls, management and financial resources are equal to the risks inherent in their business models, there has typically been a reluctance – other than in the most extreme cases – to challenge business models themselves.

the impact of their doing so. But the risk of failure will not have disappeared and the potentially systemic impact of failure will not have been eliminated altogether. Such outcomes would be neither feasible nor desirable. That would leave policy makers with three possible directions in which they could go. They could:

- ❖ Conclude that they have done everything that feasibly can be done and acquiesce in the residual risks to the financial system. This would be consistent with a conclusion that, with appropriate ongoing supervisory vigilance, the optimal balance has been achieved between risk and efficiency;
- ❖ Decide that the residual risks are still unacceptable and seek to minimize these at source by forcing firms to be less systemic – for example by placing restrictions on their size, scope of their operations (in terms of products and services) or their geographic reach; or
- ❖ Decide that the residual risks are still unacceptable and seek to minimize them further through improving the arrangements for resolving failing firms.

As noted above, the second option is highly problematic and would entail significant costs. There is therefore a powerful argument for going down the third route (which would also allow policy makers to feel more comfortable with the risk/efficiency trade off). The recent crisis demonstrated clearly that conventional insolvency arrangements are not equal to the task of resolving complex financial institutions – particularly where their activities are global in scope.

These issues were explored at length in a recent publication by the Institute of International Finance[14]. That report emphasized the following points:

- ❖ All firms, regardless of their size or complexity, should be able to exit the market in an orderly manner – that is without creating systemic trauma;
- ❖ There should be no presumption that taxpayers' money will be used to support failing firms;
- ❖ All major financial systems need to have in place special resolution regimes which facilitate the orderly winding down of financial firms. Such special regimes are necessitated by the specific challenges – especially with regard to complexity, speed, the need to minimize the destruction of value which invariably accompanies conventional insolvency and the need to protect depositors – that are more acute in the resolution of financial firms than in the resolution of commercial ones;
- ❖ The special resolution regimes need to be harmonized to the maximum possible extent internationally. At the very least they must not conflict – for example as a result of conflicting national depositor preference arrangements;
- ❖ But even a harmonization of national arrangements will not be sufficient. An ambitious global approach to resolution is needed if there is to be any hope of resolving globally active firms in an efficient and equitable way.

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14 A Global Approach to Resolving Failing Financial Firms: an Industry Perspective. Institute of International Finance, May 2010.

The issues here are complex and there is no scope for going into them in great detail in this article. Readers are referred to the IIF report on this subject. It is, however, worth highlighting a number of the key issues that need to be resolved if progress is to be made in this difficult area.

The first important point is the need to restore market discipline. It is understandable that, confronted with the prospect of widespread systemic trauma, governments have often followed the line of least resistance and used taxpayers' money to recapitalize banks and keep them in business. Not only is this a deeply unpopular thing to do but, as noted above, it sends the signal that certain types of firms will always be 'bailed out' – with very damaging consequences for market discipline. The costs of failure should not be borne by governments but, in the first instance, by the owners of the firm – that is the shareholders – and if the firm is taking too many risks, the shareholders should exercise discipline through the board to restrain them.

In reality, the systemic trauma that comes about from the failure of firms results from the fact that the equity capital in the firm is insufficient to absorb losses or to contain them in a way which avoids systemic damage. This means there needs to be a second line of defense. There is quite widespread agreement that this needs to be the unsecured creditors of the firm – those who took a view on the firm's risk by investing in its debt – in accordance with the normal hierarchy of creditor seniority. On this view, the debt markets would supplement the discipline exercised by the shareholders by demanding an appropriate risk premium. This very basic premise of corporate finance was to some extent eclipsed by reactions to the crisis and there is a need to reaffirm the principle that the risk implications of firms' activities need to be felt also by its unsecured creditors.

There is a variety of ways in which general unsecured creditors could be called upon to bear their share of losses. The idea of so called 'gone concern' contingent capital sees debt instruments being converted into equity near to the point of failure (an analogy is sometimes made here to 'pre-packed' corporate reorganizations)[15]. A similar idea which has gained a considerable amount of currency is that of the 'bail-in'[16]. Here, debt holders would see the value of their holdings reduced (ie subjected to 'haircuts') as part of the winding down process.

All of these ideas need to be examined further. Would investors have an appetite for gone concern contingent capital instruments? Exactly which categories of obligation would be subject to haircuts in a bail-in? Would traditional hierarchies of claims be respected? What would trigger the activation of these mechanisms and

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15 This is quite distinct from the idea of 'going concern' contingent capital in which debt is converted into equity but at a much earlier stage, as part of the recovery phase to restore the firm's capital base to enable it to continue as a going concern.

16 Paul Calello and Wilson Ervin 'From Bail-out to Bail-in', "The Economist January" 28, 2010.

what legal and contractual changes would be needed to give effect to them? These are complex issues to which there are not ready answers. But the broad principle – that a range of creditors need to be on the hook to bear losses instead of the public – is well established.

A second set of issues arises out of the fact that the failure of any sizeable firm will undoubtedly entail costs. Imagine for example a firm which has a prominent role in the payments system. It is unlikely that the firm would be able precipitately to withdraw from these activities in the event of wind down. Similar issues (with even greater complexity) may arise with respect to any extensive operations in repo and derivatives markets. It is quite possible that parts of the firms' activities which are legitimately judged to have a systemic dimension would need to be transferred to a temporary 'bridge bank', even if there is a good prospect of the business line eventually being sold off. This would require financing – if only in the provision of working capital. The principle that taxpayers should not foot the bill for failures leaves only one place to go for this, namely the industry itself.

There is a remarkably wide measure of agreement about the principle that the industry as a whole should by responsible for residual losses once the equity and debt resources available from the failing firm are exhausted. There is however a lively debate about whether this should require the creation of a standing fund in advance of any failures (the *'ex ante'* approach) or whether the industry should be made liable to pick up any costs after the event (the *'ex post'* approach). Proponents of the ex ante approach argue that it would provide incentives to firms to monitor the risk taking activities of their competitors on an ongoing basis and that an ex post arrangement would penalize survivors who would be required to pay for the failures of less responsible competitors. Supporters of the ex post approach believe that the existence of a standing fund would provide a temptation to bail out failing firms in their entirety and obviate the need for the difficult decisions involved in forcing an orderly winding down. The European Union in its proposals on bank resolution funds[17] envisages the creation of an ex ante fund. The Dodd Frank Wall Street Reform and Consumer Protection Act in the United States makes provision for ex post financing.

Perhaps most difficult of all is the international dimension to the resolution issue. Many large firms operate on a global basis. They have product lines and management structures which extend across national boundaries. Insolvency regimes – and even special resolution regimes – tend however to be entirely national in their focus and modus operandi. This creates enormous tensions when global firms fail. It is frequently the case for example that in the period immediately ahead of failure, assets move quickly around the group so that when the music stops and the firm is officially declared insolvent, the geographical distribution of

[17] European Commission: Communication on Bank Resolution Funds, May 2010.

assets may be completely out of line with past experience and with the legitimate expectations of creditors.

These problems may be compounded by the fact that legal requirements applicable in traditional resolution and bankruptcy cases have in some cases created conditions which make it difficult or impossible for administrators or receivers to cooperate to achieve results that are optimal or equitable from an international or group-wide perspective.

For as long as these problems remain unresolved they will be insuperable barriers to the orderly resolution of global firms. There seem to three broad approaches that might be followed:

- Put in place financing mechanisms such as bail-ins which ensure: a) that all categories of creditors understand their potential liability in the event of failure; and b) that there will under most circumstances be sufficient resources to ensure that legitimate creditor claims can be met, without recourse to public funds (on anything other than a temporary basis). Ideally, 'bail in' arrangements should operate to treat all claimants equally, regardless of their geographical location. It is too early to say whether the current 'bail-in' and other proposals being discussed would deliver this outcome.
- Force (currently global) financial groups to adjust their structures and business models to conform more closely than at present to the (national) limitations of insolvency and resolution regimes. That would, in effect, involve breaking up global groups or requiring their operations in each market to be tightly ring fenced, in either case creating substantial management and efficiency constraints. As noted above, this would make it very difficult for the financial services industry to continue to provide many valuable services on which global businesses rely.
- To put in place a truly international framework for the resolution of global financial firms. Making progress in this will be difficult and it will take time. But if the only alternative is to delude ourselves into believing that global firms can really be made national again without severe costs, there is no realistic choice but to go down this route. The difficulty of achieving a fully effective international framework is not an acceptable argument against making the effort. As an interim matter, there is a great deal of progress that can and needs to be made in reforming national resolution regimes, not least to increase the scope for greater international coordination and cooperation among administrators and receivers.

CONCLUSION

There is a wide measure of agreement between the official sector and the financial services industry that we can no longer countenance a situation in which governments feel that they have no choice but to support large financial firms when they get into difficulty. That means that ways must be found to ensure that such firms can exit the market in a way which does not cause unacceptable systemic damage.

Improvements to regulation and supervision together with measures to make markets and infrastructure more resilient will go a long way towards reducing the incidence and impact of failures. Mechanisms such as bail-ins and gone concern contingent capital offer the prospect of bolstering the resources available to failing firms, permitting failures to occur in an orderly way and, critically, improving market discipline. There are many unresolved technical issues surrounding these ideas; these need to be resolved quickly so that the real value of these promising ideas can be fully evaluated. It is imperative that solutions to these problems are capable of addressing the very complex challenges posed in resolving globally active groups. All of this calls for high levels of ambition by the official sector and the industry alike.

What is clear however is that simplistic solutions will not do. Systemic risk is a complex problem and whether we like it or not, it may require complex solutions. We must not lose sight of the benefits that large global firms bring by rushing to find solutions to the problems that some of them have created in the past.

Elemér Terták[*]
Konrad Szeląg[**]

THE FINANCIAL CRISIS AND THE REFORM OF DEPOSIT GUARANTEE SCHEMES IN THE EU[1]

INTRODUCTION

When President Franklin D. Roosevelt took office in 1933, during the Great Depression when millions of Americans lost their money because of massive bank failures, he said: *"After all, there is an element in the readjustment of our financial system more important than currency, more important than gold, and that is the confidence of the people themselves"*[2]. A few months later, President Roosevelt established the world's first deposit protection system.

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1 This article has been prepared on the basis of E. Terták's presentation at the Bank Guarantee Fund's conference on 21 May 2010. It is also based on the European Commission's package on the review of the Directive on Deposit Guarantee Schemes (DGS) presented on 12 July 2010 (ec.europa.eu/internal_market/bank/guarantee/index_en.htm). However, the article reflects the views of the authors and not necessarily those of the Commission.

2 F. D. Roosevelt, *First Fireside Chat*, Washington DC, 12 March 1933 [in: J. Grafton (ed.), *Franklin Delano Roosevelt – Great Speeches*, Dover Publications, Mineola, New York, 1999].

After 75 years, when another financial crisis (sometimes compared to the Great Depression) intensified in autumn 2008 and many Europeans lost their confidence in the financial system, the EU ministers of finance stated: *"In the current troubled situation in the financial sector (…), we agree that the priority is to restore confidence and proper functioning of the financial sector"*[3]. As one of the measures to restore confidence of European depositors and avoid bank runs, the ministers agreed that EU Member States must ensure adequate deposit protection.

Both cases highlighted the importance of public confidence for the proper functioning of any financial system.

THE LESSONS OF THE CURRENT FINANCIAL CRISIS

The current crisis has provided a number of lessons for both regulators and the general public, including in relation to deposit insurance. The first lesson was offered by the case of Northern Rock in September 2007. The run on this bank was a clear crisis of public confidence in the banking system: depositors sought to claim back their deposits at the first signs of bank trouble as they were not convinced that their savings were secure. In order to halt the run and prevent a widespread panic, the UK authorities saw no solution other than to announce state guarantees for all deposits with that bank. They also abandoned the rule of co-insurance (which stipulated that deposits were not guaranteed in full) because people were panicked by the prospect that if Northern Rock failed they would lose a considerable part of their deposits. The UK experience confirmed that it is of utmost importance for financial stability to convince depositors that their money at banks is fully protected.

A lesson for the entire EU was learnt a year later, following the collapse of Lehman Brothers Holdings. When the crisis worsened in 2008, most Member States raised the coverage levels significantly or announced unlimited deposit guarantees. First, the Irish government declared in late September 2008 that the level of coverage would be raised to € 100 000 and provided a temporary unlimited state guarantee for the major Irish banks. As a result, many depositors quickly shifted their money to banks covered by higher or unlimited guarantees, and notably from UK to Irish banks. This resulted in heavy liquidity strains for the banks not covered by such guarantees. Accordingly, in early October 2008, the UK authorities were forced to raise the coverage level from £ 35 000 to £ 50 000. In order to prevent the outflow of deposits and avoid competitive distortions, other Member States also felt obliged to increase significantly the level of coverage (see Figure 1). Those unilateral and uncoordinated actions created serious competitive distortions between Member

3 *Immediate responses to financial turmoil*, Ecofin Council Conclusions, Luxembourg, 7 October 2008.

States, undermined depositor confidence and threatened the overall stability of the EU financial markets.

These events brought into focus some serious drawbacks in the DGS framework existing at that time in the EU. First, the coverage level stipulated by Directive 94/19/EC (minimum € 20 000) had become too low in the intervening fourteen years since it had been agreed. Second, the approach of minimum harmonisation as to coverage levels led to unintended side-effects and jeopardised financial stability.

A further painful lesson of 2008 was the Icelandic banking crisis. Although Iceland is an EEA country where the DGS Directive applies, the Icelandic DGS was not prepared or able to pay out depositors at British and Dutch branches of a failed Icelandic bank. As a result, the UK and Dutch authorities were forced to intervene in order to maintain public confidence in the banks although they were legally not liable for deposits at branches of foreign banks. Those unfortunate events also highlighted the importance of fast payout and proper depositor information, notably for depositors at branches of foreign banks and confirmed the need to facilitate the payout process in cross-border situations.

Moreover, some lessons had to be learnt as to the funding of DGS. When the crisis deepened in 2008, it became evident that several DGS were underfunded relative to their obligations and exposure to risks. The most prominent example was the Icelandic scheme, but it was the same case in many EU Member States. The Commission's research from spring 2008 revealed that DGS in six Member States would not be able to cope with the failure of a medium-sized bank and one scheme had just overcome a deficit in which it had been for years[4]. Besides, in autumn 2008, most Member States significantly raised their coverage levels without any financial strengthening of their DGS. The capacity of (some) Member States to provide for the implicit or explicit guarantee that they had announced was therefore questionable[5].

In the wake of a crisis, the issue of pro-cyclicality always arises. It is often argued that mere ex-post funding is highly pro-cyclical as it drains liquidity from banks in times of stress. It might worsen the overall situation of sound banks and have implications on credit supply by banks. Ex-post systems (still existing in six Member States) have more serious drawbacks. In normal times, banks that do not pay ex-ante contributions have a competitive advantage vis-à-vis banks in Member States with ex-ante DGS. In ex-post systems, unlike in ex-ante ones, the failed bank does not contribute to payout (which increases moral hazard). This was raised by many stakeholders in the public consultation conducted by the Commission last year[6].

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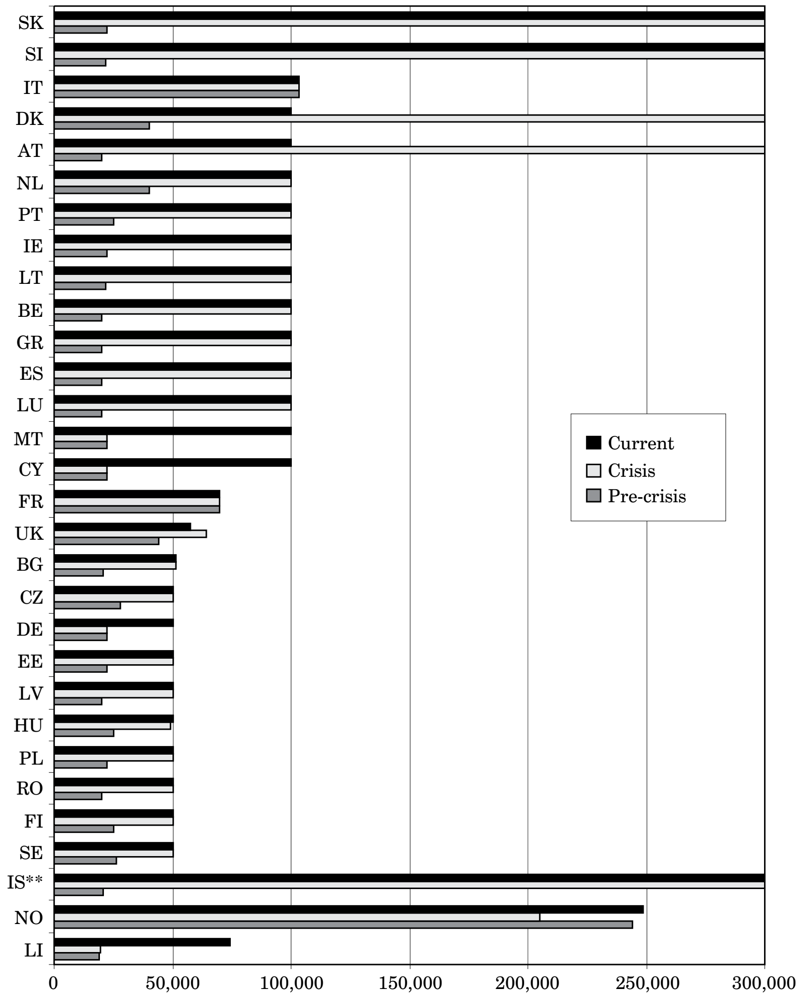
4 *Investigating the efficiency of EU Deposit Guarantee Schemes*, European Commission, Joint Research Centre, May 2008.

5 S. Schich, *Challenges associated with the expansion of deposit insurance coverage during fall 2008*, May 2009 (www.economics-ejournal.org/economics/journalarticles/2009-20).

6 *Consultation on the review of the Directive on Deposit Guarantee Schemes*, May-July 2009 (ec.europa.eu/internal_market/consultations/2009/deposit_guarantee_schemes_en.htm).

Figure 1. Coverage levels in EU Member States and EEA countries before and after the aggravation of the financial crisis (as of 1 October 2010)*



* Note: Pre-crisis period – as of 15 September 2008; crisis – October–December 2008; current situation: as of 1 October 2010. For non-euro area countries, € equivalents have been calculated on the basis of relevant ECB exchange rates. For scaling purposes, the coverage level for Member States with unlimited deposit protection has been shown as € 300 000. Political declarations on increasing coverage levels or unlimited deposit guarantees, which were not followed by any legislative action in autumn 2008, as well as guarantees for selected banks only, have not been taken into account.

** Unlimited coverage only for deposits at domestic banks and their branches in Iceland, but not at foreign branches of Icelandic banks.

Source: Commission services.

Regarding bank contributions to DGS, they are set in most Member States as a fixed percentage of deposits (usually eligible deposits). Under such a system, the degree of risk incurred by a given bank is not taken into account. This may be perceived by risk-averse banks as a competitive disadvantage and disincentive for sound risk management.

As a result of the recent experience of various authorities of crisis management, there is a growing body of opinion that DGS should not be a merely passive element of the safety net, with their function limited to pay out to depositors on a bank failure, but they should instead play a more active role in crisis prevention or resolution. Furthermore, the crisis encouraged the idea of establishing bank resolution funds. In this context, there is an ongoing debate on how to ensure DGS involvement in bank resolution while avoiding duplication of the functions of DGS with those of bank resolution funds.

Moreover, in light of the considerable degree of concentration in the EU banking market, the crisis also prompted the idea of establishing EU-wide supervision in the coming years. This, in turn, raised the question of whether a pan-EU DGS should be set up in the future.

THE NEED TO REFORM DEPOSIT GUARANTEE SCHEMES IN THE EU

The EU Directive on DGS was adopted in 1994 and remained unchanged for many years despite of the dynamic development of financial markets in the 1990s and 2000s. The first review of Directive 94/19/EC was conducted by the European Commission in 2005–2006. It was aimed at identifying potential weaknesses and proposing appropriate actions to address them. However, based on the opinion of Member States, the Commission concluded at that time (i.e. good economic and financial conditions in the world, including the EU) that there was no appetite to amend the Directive. Member States preferred to maintain the status quo as to their DGS and avoid expensive investment to change the existing framework in the absence of a firmly established case for doing so[7].

The need for reform was highlighted in autumn 2007 after the run on Northern Rock, but as it was considered to be an isolated episode, changes were only made to the UK DGS. A year later, the worsening of the global financial crisis had an impact on financial systems and deposit protection schemes in the EU as a whole. As already mentioned, the crisis prompted a number of emergency policy measures related to the deposit insurance systems in both the US and the EU. The crisis

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[7] *Communication concerning the review of Directive 94/19/EC on Deposit Guarantee Schemes*, European Commission, COM(2006)729, Brussels, 27 November 2006.

revealed furthermore numerous drawbacks of the DGS framework in the EU and increased the urgency for reform.

First, in order to convince depositors that their money at banks is safe, the Commission proposed a sizeable increase of coverage – from the then minimum of € 20 000, via an interim level of € 50 000, to the ultimate level of € 100 000 (the latter was to be a fully harmonised level in all Member States – in recognition of the fact that the threat to depositor confidence and financial stability would exist as long as there were different levels of coverage in the EU). Second, keeping in mind the lessons of the Northern Rock case, the Commission proposed to abandon co-insurance. Finally, it proposed to reduce substantially payout delay after a bank failure (measured in days and not in months as before)[8].

The above changes, agreed in autumn 2008 and implemented by Directive 2009/14/EC, proved to be successful in restoring depositor confidence and stabilising financial markets. They represented significant progress in comparison with the original Directive. However, as the crisis situation required prompt action, the changes were a 'quick-fix' rather than a reform based on a comprehensive review of the Directive. For that reason, from early 2009, the Commission services worked on a more thorough-going reform of the DGS system in the EU. The relevant legislative proposal was published in July 2010 and the new Directive is expected to be adopted next year under the Hungarian or Polish Presidency of the EU Council. The following sections outline some key aspects of the proposed reform.

BETTER DEPOSITOR PROTECTION TO MAINTAIN DEPOSITOR CONFIDENCE

This section presents issues that are usually of greatest interest to depositors (level and scope of coverage, payout, depositor information), and thereby essential to maintaining depositor confidence.

One of the most visible elements of deposit protection is the level of coverage. It is not therefore surprising that when the crisis deepened in autumn 2008, the Commission proposed a sizeable increase of the coverage level (up to € 100 000) in order to convince depositors that their money was safe in EU banks. However, at that time, due to the urgency of the situation, there was no time to analyse in detail what level of coverage was most appropriate. That analysis was conducted after the financial markets had been stabilised.

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8 *Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on Deposit Guarantee Schemes as regards the coverage level and the payout delay*, European Commission, COM(2008)661, Brussels, 15 October 2008.

In the detailed impact assessment (published in July 2010), the Commission analysed various potential coverage levels from € 50 000 up to € 200 000. It concluded that the harmonised coverage level of € 100 000 is the optimal solution since it would ensure substantial progress in terms of increased deposit protection (see Table 1) without disproportionably increasing costs for banks and depositors. As to the other levels, it would be politically difficult to adopt € 50 000 (keeping in mind that many Member States had already announced higher or even unlimited deposit guarantees – see Figure 1) while the benefits of adopting a coverage level higher than € 100 000 would be very limited. It confirmed that the decision from 2008 was right and the fixed level of € 100 000 would be applied in all Member States from end-2010[9].

Table 1. The amount and the number of covered deposits in relation to the eligible deposits in the EU

Ratio	As of end--2007	Coverage level			
		€ 50 000	**€ 100 000**	**€ 150 000**	**€ 200 000**
$\frac{\text{Amount of covered deposits}}{\text{Amount of eligible deposits}}$	61.1%	58.6%	71.8%	81.0%	88.4%
$\frac{\text{Number of fully covered deposits}}{\text{Number of eligible deposits}}$	88.8%	91.0%	95.4%	96.5%	97.2%

Source: Commission's Joint Research Centre (JRC).

While harmonizing the level of coverage is of utmost importance, this is not enough. In order to create a level playing field, the scope of coverage should be harmonised as well (see Table 2). In this context, the Commission is of the view that all enterprises (regardless of their size) should be covered by DGS. Covering the deposits of all enterprises means adding medium and large firms (only 1.3% of EU firms) since roughly all micro and small enterprises (98.7% of EU firms) are currently covered. It would eliminate the need to make time-consuming verification of the size of firms (staff, turnover, assets, etc). In turn, it would allow for considerably faster payout, which would increase depositor confidence in DGS.

In contrast to enterprises, which should be treated in the same way as individuals, all financial institutions and all public authorities (central and local ones) should be excluded from coverage. For financial institutions, the coverage level of € 100 000 is irrelevant, and authorities have easy access to other financial resources.

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9 As an exception to this general rule, it may be justifiable to offer (subject to some restrictions) higher coverage for so-called 'temporary high deposit balances' stemming from real estate transactions and some specific life events.

As regards products, deposits in non-EU currencies should be covered by DGS in all Member States. This is important for both individuals and enterprises, notably those involved in import and export business. On the contrary, for example, structured products not repayable in full should be excluded from coverage (rather, because of their investment nature, they should be covered by investor compensation schemes).

Table 2. Harmonised scope of coverage proposed by the European Commission (key examples)

	Covered	Not covered
Depositors	all enterprises (micro, small, medium and larger)	financial institutions, public authorities
Products	deposits in non-EU currencies (USD, CHF, etc.)	debt certificates, structured products

Source: Commission services.

As mentioned above, one of the key factors for depositors is the length of payout. As people today barely keep cash reserves, it must be as short as possible. After the crisis in autumn 2008, the Commission proposed to shorten it to three days[10]. Finally, it was agreed that it would be reduced from 3–9 months to 4–6 weeks from end-2010 onwards. However, the Commission strongly believes that even this shortened payout period is still too long and needs to be substantially reduced – preferably to one week (after a transitional period)[11].

Rapid payout is crucial for individuals: according to a consumer research, depositors would be likely to suffer financial difficulties after a few days[12]. Continual access to bank accounts is also important for enterprises (especially for smaller ones) since the lack of it may cause problems with liquidity and eventually lead to bankruptcy. If depositors have fear that they will have to wait several weeks after the DGS steps in, this substantially increases the risk of a bank run if there are any signs of deterioration in the overall situation of the banking sector.

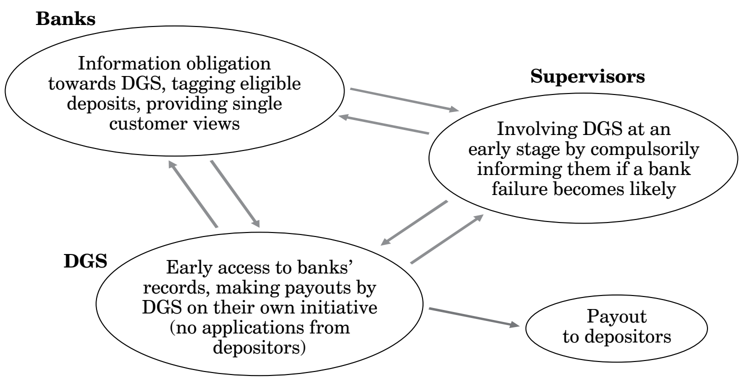
10 It is worth mentioning that the US deposit insurance scheme (FDIC) usually makes payouts within two business days. However, the FDIC (acting as deposit insurer, supervisor and receiver) has a much broader mandate than DGS in the EU. Moreover, it makes payouts after a 90-day pre-closing period.

11 The same payout delay has been considered in recent years in the UK and is to be applied there next year. See www.fscs.org.uk/industry/single-customer-view-for-faster-payout/rules/; see also *Financial Services Compensation Scheme reform. Fast payout for depositors and raising consumer awareness*, FSA, Consultation Paper 09/3, January 2009; *Fast payout study. Final report*, Ernst & Young, November 2008 (report commissioned by the FSA, BBA and FSCS).

12 *Consumer awareness of the Financial Services Compensation Scheme*, FSA, Research Paper no. 75, January 2009.

However, a short payout deadline is only feasible if several conditions are met (see Figure 2). First of all, it is necessary to ensure early access of DGS to information on deposits. In this context, it is important to involve DGS at an early stage by requiring supervisors to inform the relevant DGS if a bank failure becomes likely. DGS should make payouts on their own initiative (without being prompted by applications from depositors) and verification of claims should be simplified (inter alia, by abandoning time consuming set-off, i.e. netting customers' deposits against their liabilities (e.g. loans) at the same bank). Banks should tag eligible deposits, provide single customer views, etc. It would entail some one-off administrative costs for banks, but they would be more than counterbalanced by increased depositor confidence that would reduce the probability of bank runs and contribute to overall financial stability. Finally, it should be noted that although it may not be feasible to make rapid payout in some complicated cases, DGS should be able to ensure it for a vast majority of depositors.

Figure 2. Conditions for faster payout of deposits after a bank failure



Source: Commission services.

In view of the Icelandic crisis, and notably the serious problems with payouts at foreign branches of a failed bank, there is also a need to facilitate the payout process in cross-border situations. To this end, the host-country DGS should act as a 'single point of contact' for depositors at branches of foreign banks. This includes communication with those depositors, but also acting as a 'paying agent' on behalf of the home-country DGS (coupled with an obligation for the home-country scheme to reimburse the host-country one or to provide the latter with relevant financial means in advance). It would bring several advantages for depositors at branches: information would be provided in their country and in their language, quick payout, etc. It would involve some administrative costs for the host-country DGS but they would be marginal in comparison with the gain in depositor confidence and would be reimbursed by the home-country DGS (for which this option is cheaper than if it had to operate cross-border).

In order to maintain and strengthen public confidence, DGS should inform the general public, including depositors, about the benefits and limitations of key deposit protection aspects (on an ongoing basis and via various tools and channels of communication).[13] To this end, before making a deposit, depositors should have to countersign a special information sheet including brief information on all relevant aspects (coverage level, payout deadline, DGS contact details, etc.). Depositors should also be informed about coverage on their account statements. There should be a mandatory reference to DGS coverage in advertisements if an advertised product is covered. Mandatory depositor information should be complemented by more general financial education, and DGS should be among institutions which play an active role in raising financial awareness and literacy of both bank customers and non-customers (so-called 'unbanked' or 'underbanked'). Better financial education of society in general, along with proper regulation and supervision of financial institutions, is one of the key factors in maintaining stability of the financial system[14].

ENHANCED FINANCING OF DEPOSIT GUARANTEE SCHEMES

As mentioned, several DGS turned out to be underfunded in the financial crisis. Several schemes in the EU still do not have funds adequate to meet the level of deposit protection offered under the EU regime. This situation may undermine depositor confidence and the credibility of DGS. Moreover, the lack of harmonised funding of DGS may lead to significant differences in bank contributions to their schemes, which may in turn create an unlevel playing field within the EU single banking market. A significant enhancement of DGS funding is also necessary to support the other reforms: the higher coverage level, faster payout, broader mandate of DGS, etc.

For those reasons, in July 2010, the Commission suggested a four-step approach (see Figure 3), consisting of several elements, each of which would be called upon only once the preceding one had been exhausted:

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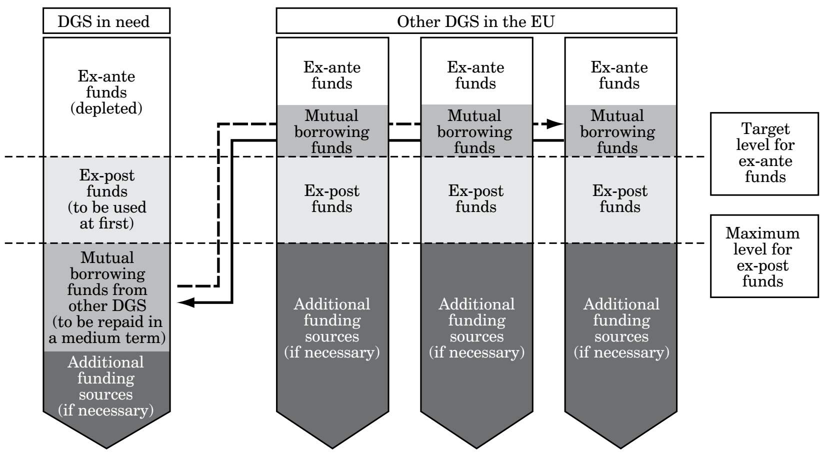
[13] *Core principles for effective deposit insurance systems*, Basel Committee on Banking Supervision & International Association of Deposit Insurers, Basel, June 2009.

[14] K. Szeląg, *Recent reforms of the deposit insurance system in the United States: reasons, results and recommendations for the European Union*, National Bank of Poland, Working Paper no. 59, May 2009.

(1) *Ex-ante funds* (as a strong basis) – financed from regular contributions of member banks. The target level for the funds should be 1.5% of eligible deposits.
(2) *Ex-post funds* – additional contributions collected from banks if necessary (in a crisis situation). In order not to impose excessive burdens on sound banks in bad times, these contributions may not exceed 0.5% of eligible deposits.
(3) *Mutual borrowing facility* – if the financial capacity of one DGS was depleted, it would be able to borrow a limited amount from the other schemes (up to 0.5% of eligible deposits for the borrowing scheme). The loan should be repaid within 5 years (until full repayment, the debtor scheme would neither borrow from nor lend to other DGS).
(4) *Other funding sources* (as the last resort) – for example, unlimited borrowing by DGS on the financial market (e.g. by issuing bonds).

Figure 3. Structure of potential DGS funding (including mutual borrowing facility)



Source: Commission services.

Because ex-ante funding is counter-cyclical (as it imposes most costs on banks in good times and in such a way the failing banks also contribute to the costs caused by them), it should be dominant (¾ of the total fund), but supported by ex-post funds to be collected if necessary (¼ of the fund) (see Figure 4a). Setting the above target level for DGS funds would ensure that schemes are credible and capable of dealing with at least medium-sized bank failures. Enhancement of funding should contribute to preventing (or at least minimising) the need to use taxpayers' money in the event of a bank failure.

The proposed system of DGS funding is expected to be established within about 10 years, i.e. by the end of 2020. After this period of time, DGS in the EU would be much better financed than they are now. According to the Commission's estimates, they would collect about € 150 billion in ex-ante contributions and could call for additional € 50 billion of ex-post contributions if needed – compared to total ex-ante and ex-post funds of € 23 billion in 2008 (see Figure 4b). Inevitably, it would require much (four to five times) higher contributions paid by banks to DGS. This increase, however, is the consequence of past and current significant underfunding of DGS and the price of creating financially sound DGS in the future. Higher contributions may reduce the level of operating profits of banks, but this effect should not be significant. Given the competition between banks, it is unlikely that these additional costs for banks would be fully passed on to their customers. The length of transition time (about a decade) is related to the fact that the other ongoing reforms of prudential regulation will also impose additional burdens on the banks, and an excessive aggregation of new or increased charges must be avoided.

As regards bank contributions to DGS, it should be emphasized that in the future they must reflect the risk incurred by individual institutions. The premiums should be calculated on the basis of a number of indicators reflecting risk profiles of the banks. The proposed indicators cover the key risk classes commonly used to evaluate the financial soundness of credit institutions: capital adequacy, asset quality, profitability and liquidity[15] (for example, similar classes are applied in the US supervisory rating system – CAMELS). The data necessary to assess those indicators are available under existing reporting obligations. Taking into account differences between banking sectors in Member States, the Directive ensures some flexibility by developing a set of core indicators (mandatory for all Member States) and another set of supplementary indicators (optional for Member States). Proportions of the core and supplementary indicators would be ¾ and ¼ respectively. The approach to risk-based contributions proposed by the Commission provides incentives for sound risk management and discourages risky behaviour by clearly differentiating between the levels of contribution paid by the least and most risky banks (from 75% to 200% of the standard amount respectively). The current proposal is however only a starting point. Full harmonisation of the calculation of risk-based contributions should be achieved at a later stage (possibly under the auspices of the new European Banking Authority that is to be established soon).

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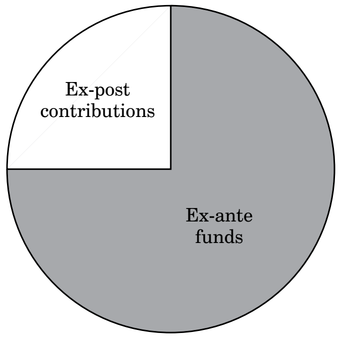
[15] *Possible models for risk-based contributions to EU Deposit Guarantee Schemes*, European Commission, Joint Research Centre, June 2009; see also *Risk-based contributions in EU Deposit Guarantee Schemes: current practices*, European Commission, Joint Research Centre, June 2008.

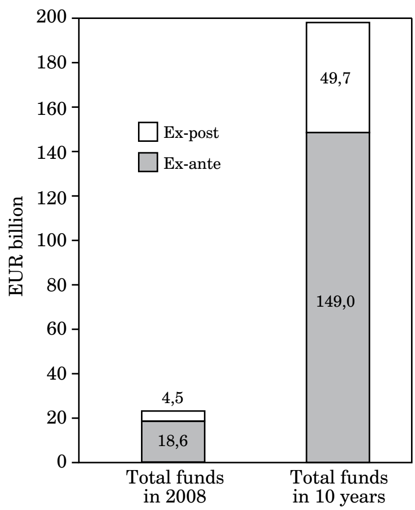
Figure 4. Ex-ante and ex-post funding as proposed by the European Commission

(a) Proportions of ex-ante and ex-post funding*



* Target level for ex-ante funds: 1.5% of eligible deposits; Maximum level for ex-post funds: 0.5% of eligible deposits.

(b) Expected amounts of ex-ante and ex-post funding after reaching the target level**



** As of 31 December 2020.

Source: Commission services.

DEPOSIT GUARANTEE SCHEMES VS. BANK RESOLUTION AND EARLY INTERVENTION

Prior to the crisis, most Member States had DGS with narrow mandates, i.e. limited to payout of deposits after a bank failure (so-called 'paybox' function). DGS in 11 Member States had broader mandates, including liquidity or restructuring support, liquidation powers, etc. During the Commission's public consultation last year, a slight majority of stakeholders was in favour of maintaining DGS as mere 'payboxes'. However, as previously mentioned, during the crisis, there has been growing support for transforming DGS from a merely passive element of the safety net to a more active player in crisis prevention or resolution.

This idea was acknowledged by the Commission in its communication on crisis management published in October 2009,[16] where it was suggested that DGS could include the possibility of funding bank resolution measures, with the advantage that the banking sector would contribute directly to ensuring its own stability. A typical resolution measure is the transfer of deposits from a failed bank to another (healthy) bank or a temporary institution (so-called 'bridge bank'). This is an alternative to payout. It is important to have such an alternative since a 'classical' payout may be quite expensive, notably if paid in cash as this is the case in quite many EU Member States (in the US, cheques are used for payout but they are not popular in Europe). The transfer of deposits has significant advantages also from the point of view of depositors as it ensures the continuity of banking services and uninterrupted access to deposited money.

It should be noted that such an option (transfer of deposits) is similar to mechanisms – insured deposit transfer (IDT) and purchase and assumption (P&A)[17] – that have been in use in the US since the 1980s as alternatives to the straight deposit payoff. P&A is generally the preferred resolution method used for failing banks in the US (before and during the current crisis, the FDIC made extensive use of such transactions). Deposit payoffs are only used when no acquiring institution can be found or if a bid for a P&A transaction is not the least costly option for the insurance fund (so-called 'least-cost principle'). Also some DGS in the EU are already tasked with funding the transfer of deposits from the failing entity. For example, the UK Banking Act 2009 created the 'Special Resolution Regime' that allowed the UK authorities to transfer all or part of a bank to a private sector purchaser, and to transfer all or part of a bank to a bridge bank (a subsidiary of

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16 *An EU framework for cross-border crisis management in the banking sector*, European Commission, COM(2009)561, Brussels, 20 October 2009.

17 See FDIC Resolutions Handbook and FDIC Claims Manual (www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf, www.fdic.gov/bank/historical/reshandbook/ch4payos.pdf, www.fdic.gov/about/freedom/DRRClaimsManualVol1.pdf).

the Bank of England) pending a future sale. Under that regime, the UK scheme (FSCS) can be used to finance such a transfer up to the net amount it would have failed to recover in insolvency if there was an actual payout.

Of course, the use of bank resolution measures (such as the above transfer of deposits) is only justified for the DGS if its cost is lower than the total cost of payout of deposits (in line with the above 'least-cost principle'). Nevertheless, resolution measures could be applied even if they were more expensive than payout. However, in such a case, DGS funds could only be used up to the amount corresponding to the potential cost of payout; the rest would have to be covered from another source. It was confirmed in the communications on bank resolution funds and crisis management published in May and October 2010[18], where the Commission stated that the use of DGS funds for bank resolution purposes should be limited to the amount that would have been necessary to pay out covered deposits (and costs beyond this limit should be borne by resolution funds). It was also confirmed in the Commission's legislative proposal on DGS published in July 2010.

Some experts take the view that DGS should have even broader mandates, i.e. including not only bank resolution but also early intervention (bank rescue) measures, such as recapitalization, liquidity assistance, guarantees, etc. If such functions are given to DGS, this would require additional funding. It means that additional funds would need to be collected beyond the target level because bank resolution is alternative to payout while early intervention does not always prevent payout later on. The Commission's proposal provides that DGS funds could be used for such purposes (subject to some restrictions). Member States may allow DGS to use their financial means in order to avoid a bank failure provided that the financial means of the scheme (which, in principle, should amount to 1.5% of eligible deposits) exceed 1% of eligible deposits after such rescue measures. In exceptional situations, and subject to the consent of the supervisory authorities, DGS funds may be used to a greater extent (up to half of the target level, i.e. 0.75%) (see Figure 5). The above rules as to financing early intervention are to be introduced gradually (in 2014, 2017 and 2020).

In summary, it seems that DGS are well placed to play a more active role in crisis prevention or resolution, but a broader mandate means that it is necessary to ensure adequate financing for DGS to undertake those additional tasks. Currently, however, DGS in many Member States are not sufficiently funded to even fulfil their narrow ('paybox') role. Moreover, it should be kept in mind that the primary function of DGS is providing quick payout of deposits in the event of a bank failure. Therefore, it is necessary to ensure that this function cannot be jeopardised by the cost of rescue or restructuring measures.

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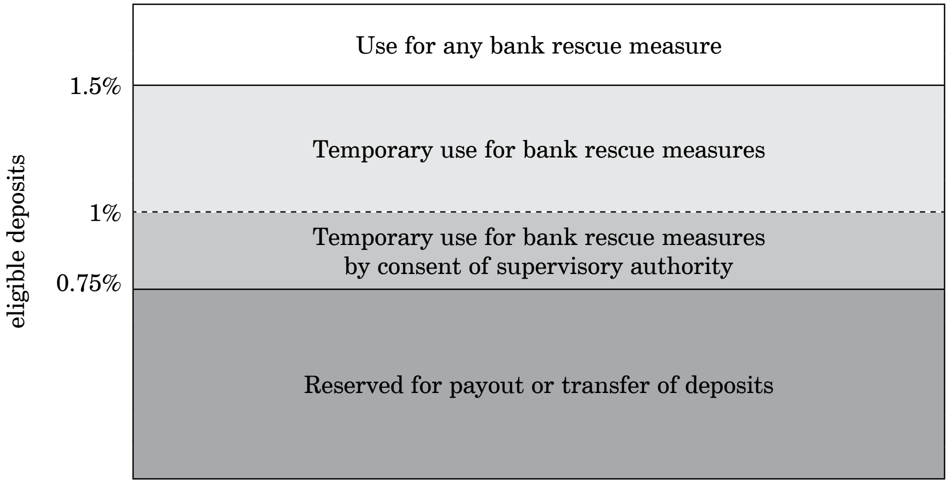
[18] *Bank resolution funds*, European Commission, COM(2010)254, Brussels, 26 May 2010; see also *An EU framework for crisis management in the financial sector*, European Commission, COM(2010)579, Brussels, 20 October 2010.

Figure 5. Limits for potential use of DGS funds for payout and bank rescue measures



Source: Commission services.

A PAN-EU DEPOSIT GUARANTEE SCHEME?

As it is known, DGS in the EU are highly fragmented – there are 39 schemes in 27 Member States. This is aggravated by the lack of adequate cooperation between DGS, which may impede coordinated actions on a cross-border basis, notably in crisis situations (it should be noted, however, that EFDI[19] makes considerable efforts to improve and strengthen the cooperation among EU DGS and to promote best practices[20]). The idea of establishing a pan-EU DGS appears attractive in the light of such fragmentation. In economic terms – based on the Commission's estimates – it would be the most effective option, as it could save administrative costs of roughly € 40 million per annum. However, there are some complicated legal aspects which have to be further investigated. Moreover, one could argue that considering the large number of small local banks, a pan-European institution would have some drawbacks.

Therefore, the idea of a pan-EU DGS is a longer-term project. However, the proposed closer cooperation between DGS in a crisis situation based on the

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[19] EFDI (European Forum of Deposit Insurers) – a voluntary professional organisation with 55 members representing 40 countries (more information: www.efdi.net).

[20] See EFDI reports of 2008 and 2009 related to payout delay, scope of coverage, depositor information, exchange of information between DGS, risk-based contributions, etc (available at www.efdi.net).

'principle of solidarity' (i.e. mutual borrowing facility) could be considered as the first important step towards a single pan-EU DGS in the future. Progress towards a pan-EU DGS should be in line with progress on the new supervisory architecture in the EU and developments in the field of crisis management, including early intervention and bank resolution. The Commission will analyse this issue again and present a detailed report by the end of 2015.

CONCLUDING REMARKS

The institution of deposit guarantee has been controversial in the past and was sometimes even blamed for increasing moral hazard. The recent crisis, however, taught us that they are indispensable for depositor confidence and thus for maintaining financial stability. Moreover, some other important lessons had to be learnt: namely that the framework of deposit insurance in the EU as established in 1994 needs substantial modernisation to reflect the developments of the past sixteen years as well as to meet the challenges of the future. We are convinced that the proposals brought forward by the Commission represent a significant enhancement of the post-crisis financial architecture and regulation.