Deposit-Protection Schemes: Issues for an EC Directive

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Foreword

Deposit-Protection Schemes: From Issues for an EC Directive to a European Scheme?

This CEPS Report in Finance and Banking by Sydney Key was originally published in 1992, more than 15 years ago. We decided to re-issue it in its original form because it is very instructive in showing both how little has changed since then and how much needs to change.

How little has changed: The terms of the debate that preceded the EC Directive on Deposit Insurance in 1992-93 still ring true today. Home country supervision, bank insolvency and the treatment of branches versus subsidiaries remain important topics in 2009.

How much needs to change: The financial crisis has shown that confidence in the banking system cannot be taken for granted and that in times of crisis, public measures for the protection of deposits become crucial. So far the reaction at the EU level has been only to unify and increase the amounts insured (this was a hot topic in 1992 as well). But today the question is no longer only how to adjust an existing Directive at the margin, but whether a radically new approach is needed, namely the creation of European Deposit Insurance Scheme. This would have been unthinkable before, but is now likely to be put on the European agenda (for a concrete proposal, see the report of a High Level Group chaired by Alexandre Lamfalussy: http://www.premier.be/files/Lamfalussyreport_0.pdf).
The argument for such a European-level scheme is clear: it would distribute the risk of a large-scale bank failure, and experience has shown that this risk looms large, even for large member countries. The opposition is also likely to remain strong, as in many quarters it is still unthinkable for sovereign countries to share any fiscal risk. Sydney's paper provides an interesting background to this debate.

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INTRODUCTION

As part of the program to complete the internal market, the European Community undertook to remove barriers to the provision of banking services among the Member States, including those provided across borders and through the establishment of branches or subsidiaries. The challenge was to establish a regulatory and supervisory framework that not only would promote a competitive and efficient Community banking market but also would satisfy other public policy concerns such as ensuring the safety and soundness of banks, protecting against systemic risk, and ensuring adequate protection of consumers. To develop such a framework, the Community had to choose rules to govern trade in banking services among the Member States.

National treatment--the application of host-country rules without discrimination between domestic and foreign banks--might have seemed an obvious choice. But the EC wanted to go beyond national treatment to remove *nondiscriminatory* barriers, that is, barriers created by differences in national rules such as those governing permissible activities of banks. One approach--complete harmonization of national rules--was ruled out because early attempts in the product sector had been unsuccessful. So, for services provided across borders or through branches, the Community turned to the approach of mutual recognition and home-country control. Mutual recognition involves two elements: harmonization of essential rules and, where harmonization has not occurred or has occurred only in general terms, acceptance by host countries of home-country rules. Home-country control refers to administration of the rules by the home country, as opposed to the host country or a supranational entity.

Should the EC use the approach of mutual recognition for deposit protection schemes? Both within and beyond the Community, there is general agreement that a host country has a policy interest in protecting deposits of its residents against the possible failure of a foreign bank. Can that policy goal be achieved best through reliance on home- or host-country rules and administration? And, if the former, what constitutes "essential" harmonization---what elements, if any, of national schemes need to be harmonized to make the home-country approach acceptable to host countries?

Moreover, even if the Community were to achieve substantial harmonization of deposit protection schemes, how uniform would be the overall protection countries offer depositors given the variations among them in other features of the safety net: "too-big-to-fail" policies; government ownership of banks, with its implicit guarantee; and potential government support for publicly or privately administered deposit protection schemes in times of crisis. In practice, differences in these other elements of the safety net could be more important than differences in deposit protection schemes per se.

In April 1992, the EC Commission proposed a directive on deposit protection schemes that uses a modified home-country approach for branches of banks from other Member States and involves a limited amount of harmonization (see Section I below). The Member States had urged the Commission to propose a home-country deposit insurance directive, primarily because of the shift to home-country supervision and regulation of EC branches mandated by the Second Banking Directive (see Section II.A below). This paper attempts to identify and analyze the major issues facing the Member States as they seek agreement on the Commission proposal. It does not deal with whether deposit insurance is necessary in the first place. Instead, it accepts the political consensus in the Community that the Member States should have deposit protection schemes, that the primary purpose of these schemes should be to protect unsophisticated depositors of small amounts, and that an additional goal is the reduction of systemic risk in the old-fashioned sense of a run on the banking system caused by a lack of depositor confidence.

The difficulty is that in furthering these goals, deposit protection schemes may encourage banks to take excessive risks--the problem of moral hazard--and thereby tend, perversely, to undermine their safety and soundness. Moreover, subsidies in these schemes may also introduce competitive distortions into financial markets. Thus all such schemes involve striking a balance between competing public policy concerns. However, an EC directive may well alter the balance in the existing schemes of some Member States. It could, for example, inadvertently exert pressures for convergence of national schemes toward that of the most generous Member State, thereby increasing moral hazard.

The first section of this paper provides a brief summary of the Commission proposal and presents a table to facilitate comparison of different approaches. The second section sets forth the arguments for the home- and host-country approaches to deposit insurance in the European Community for three methods of providing banking services--across borders, through subsidiaries, and through branches. The third section analyzes the extent to which the home-country approach requires harmonization of national schemes to ensure adequate protection of consumers and reduce systemic risk, on the one hand, and to minimize moral hazard and avoid competitive distortions, on the other. The fourth section deals with the external dimension of an EC deposit insurance directive. The fifth section briefly discusses the relationship between deposit insurance and the functions of a possible future European Central Bank, such as that envisioned in the Maastricht Treaty. A final section contains the conclusions.

I. COMMISSION PROPOSAL

The Commission proposal uses a modified home-country approach to deposit insurance for branches of banks from other Member States and contains a limited amount of harmonization (see Annex for text of the proposal). The modification, which appears to have been introduced as a substitute for the more extensive harmonization of coverage that would have been required to make a complete home-country approach acceptable, involves host-country "topping up" of a branch's home-country coverage.

To analyze the extent of the harmonization proposed by the Commission, the elements of deposit protection schemes can be grouped into three general categories: first, the level and scope of coverage; second, the financial and administrative structure of a scheme; and third, its operational rules. The level and scope of coverage includes minimum or maximum levels of protection; depositor coinsurance; types of depositors, instruments, and currencies covered; whether coverage is compulsory or voluntary; and treatment of branches in and from non-EC countries. The financial and administrative structure of a scheme involves the pricing of deposit insurance, including the issue of government subsidies; whether the scheme is based on a standing fund or ex post contributions; whether it is publicly or privately administered; and the extent of its authority. Operational rules include disclosure of coverage, and the speed and convenience of payouts.

At present, deposit protection schemes within the Community vary considerably with regard to almost all of these features. The harmonization proposed by the Commission focuses on the level and scope of coverage and on operational rules and contains virtually no harmonization of financial and administrative structures. The Commission proposal is analyzed in terms of policy goals in Section III below.

The proposed directive would make coverage compulsory for all credit institutions in the Community and would establish a Communitywide minimum level of coverage of ECU 15,000 (about $19,000) per depositor per bank. Depositor coinsurance at low levels of coverage would be limited by a requirement that at least 90 percent of a deposit be covered up to a payout amount of ECU 15,000. The proposed harmonization of coverage does not, however, include any limitation on the amount of coverage that a scheme may provide. Thus, for example, the German schemes will be able to continue to provide virtually unlimited coverage. As noted above, the proposal would require host-country schemes to offer branches from Member States with lower coverage the option of topping up their coverage to the host-country level. In addition, the proposed directive would require the exclusion of interbank deposits from coverage and allow the exclusion of certain other types of deposits. Coverage would be required for deposits in all currencies, including non-EC currencies. Member States would continue to have discretion as regards coverage of deposits at branches in and from non-EC countries.

The Commission proposal does not attempt to harmonize the financial and administrative structures of deposit protection schemes. As a result, both publicly administered schemes, like those in the Netherlands and the United Kingdom, and private schemes administered by associations of banks, like those in France and Germany, may continue to operate. The one element of harmonization involves reconciling the requirement for membership with the existence of privately operated schemes. The proposal does not address the issue of pricing of deposit insurance; the implications of this decision are discussed in Section III.B below.

The Commission proposal deals with operational rules governing disclosure and the promptness of payouts. Disclosure of the scheme to which an institution belongs and of the scheme's limits on coverage would be mandatory. The directive would also establish a time limit on payouts that would be independent of the progress of liquidation proceedings. After a maximum "unavailability" of deposits of ten days, payment could generally take no longer than three months.

As discussion of the Commission proposal proceeds, questions have arisen, inter alia, about whether the harmonization of coverage is sufficient. This concern has led the Banking Federation of the European Community, for example, to propose a further modification of the Commission approach to limit the coverage a home country may provide for a branch to the maximum allowed by each host-country scheme (see Section III.B.1 below). Such hybrid approaches, as well as the "pure" home- and host-country approaches, are referred to throughout this paper. The labels are somewhat confusing, and some seemingly different proposals are conceptually similar.

Table 1 identifies, for each approach, whether the home- or host-country scheme determines the level of coverage and which scheme assumes the financial responsibility. These two elements are shown in the rows of the chart for branches from low–coverage countries and from high–coverage countries. The columns show the pure home–country approach, two variants of that approach, two variants of the host–country approach, and the pure host–country approach. For example, the home–country approach plus topping up (column 2, the Commission proposal) differs from the home–country approach (column 1) with respect to the role of the host scheme in determining the level of coverage for branches from low–coverage countries (line A.1) and with respect to the financial responsibility for such branches (line B.1).

Table 1

Scheme determining level of coverage and assuming financial responsibility under various approaches to deposit insurance for branches

		Hybrid approaches				
	Home-country approach (1)	**Home-country + Host topping up (2)**	**Home-country + Host topping up + Host limit on coverage (3)**	**Host-country + Home reimbursement (4)**	**Host-country + Home reimbursement not exceeding home level of coverage (5)**	**Host-country approach (6)**
A. Level of coverage[1]						
1. Branches from low-coverage countries	HOME SCHEME	HOST SCHEME[2]	HOST SCHEME[2]	HOST SCHEME	HOST SCHEME	HOST SCHEME
2. Branches from high-coverage countries	HOME SCHEME	HOME SCHEME	HOST SCHEME	HOST SCHEME	HOST SCHEME	HOST SCHEME
B. Financial responsibility						
1. Branches from low-coverage countries	HOME SCHEME	HOME + HOST SCHEMES[2]	HOME + HOST SCHEMES[2]	HOME SCHEME	HOME + HOST SCHEMES	HOST SCHEME
2. Branches from high-coverage countries	HOME SCHEME	HOME SCHEME	HOME SCHEME	HOME SCHEME	HOME SCHEME	HOST SCHEME

[1] The nonmonetary aspects of coverage are not addressed in this table.
[2] Under the Commission proposal, the host scheme would apply only if a branch exercised the topping-up option.

II. HOME- VERSUS HOST-COUNTRY APPROACH

Deposit protection schemes must deal with three different ways of providing banking services internationally: across borders, through subsidiaries, and through branches. Both within and beyond the Community, depositor protection can be provided much more easily for the first two ways than for the last.

For cross-border services, the home-country scheme must necessarily apply. The host country could, of course, best protect its consumers if basic elements of deposit insurance schemes were harmonized. However, the effort to achieve such harmonization does not seem justified by the host country's concern with insurance of its residents' deposits in home-country offices of home-country banks. Of course, any harmonization of national deposit protection schemes that allowed the use of the home-country approach for branches (see below) would also affect cross-border deposits and those at subsidiaries of foreign banks, regardless of which country provided coverage.

For subsidiaries, which are separately incorporated in the host country, deposit protection can readily be provided by the host-country scheme.[1] This approach is consistent with the overall EC approach to subsidiaries of banks from other Member States, which, unlike branches and cross-border services, are governed by host-country rules applied on a nondiscriminatory basis. Because a subsidiary is separately incorporated, host-country authorities can, in general, regulate and supervise it as if it were a domestic bank. Home-country consolidated supervision and capital requirements envisioned by the Basle Accord and the Concordat complement but do not replace host-country supervision and capital requirements for subsidiaries.

Moreover, because a subsidiary is incorporated under a host-country's legal system, the insolvency of a subsidiary would fall under that country's jurisdiction. Host-country authorities would, of course, look first to the parent bank as a source of strength; and they would also consult with home-country authorities. But they would be responsible for deciding whether to close the subsidiary and for its liquidation proceedings, which would

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[1] In this context, the host-country is the country in which the subsidiary is incorporated. However, under the Second Banking Directive, the country of incorporation of the subsidiary would, in effect, be its home country for purposes of Communitywide branching and cross-border provision of services.

necessitate the use of deposit insurance. Moreover, it is possible that the home-country parent bank could be insolvent, while its subsidiary remained solvent. True, the assets of the subsidiary held by the parent bank would be part of the liquidation of the parent, but that just implies a change in ownership of the subsidiary; it would not trigger the use of deposit insurance for the subsidiary.

Branches are another matter. Unlike subsidiaries, they are an integral part of the parent bank: They operate off the capital of the bank, and they do not have a separate corporate identity. Under the Second Banking Directive and other EC banking legislation, branches, like cross-border services, are subject to a regime of mutual recognition and home-country control. In general, the home country has responsibility for regulation and supervision of branches of its banks in other Member States, subject to the minimum requirements set forth in EC directives.

Four main arguments favor the <u>home</u>-country approach for deposit protection for branches from other Member States:

(1) It eliminates the financial exposure of host-country deposit protection schemes to the risk of inadequate supervision and regulation by the home country;

(2) It is consistent with home-country responsibility for other aspects of the safety net;

(3) By further internalizing the cost of failure within the home country, it may add to home-country incentives to supervise adequately;

(4) It works in tandem with the single-entity approach for bankruptcy, which itself has advantages and was proposed by the Commission in 1985.

At the same time, two main arguments favor the <u>host</u>-country approach:

(1) It offers uniformity of coverage for depositors at banking offices within a single Member State, at a level determined by the host country;

(2) It avoids both the conceptual and the practical difficulties inherent in harmonization of deposit protection schemes among the Member States.

To help evaluate the Commission's proposal--and the preference of the Member States--for the home-country approach for branches these arguments are discussed below.

A. Home-country supervision

Member States have advocated the home-country approach for deposit insurance primarily to eliminate the financial exposure of host-country schemes to the risk of inadequate home-country supervision and regulation, a problem the BCCI episode highlights. Under the Second Banking Directive, the authority to license EC branches will shift from the host to the home country, and the home country will in general be responsible for branch supervision as part of its overall responsibility for the solvency of the bank. For example, beginning in 1993, Luxembourg not the United Kingdom, will license and supervise the UK branches of a Luxembourg bank. Therefore, if a Luxembourg bank fails, why should the British deposit protection scheme, rather than the Luxembourg scheme, be required to compensate depositors at the UK branches?

The risk of inadequate supervision and regulation of banks from other Member States is reduced considerably by the harmonization of prudential rules provided by the Own Funds and Solvency Ratio Directives, the Consolidated Supervision Directive, and the Second Banking Directive. The quality of a home Member State's enforcement of these rules will be enhanced both by specific provisions of the directives and by other steps the Community is taking to encourage further cooperation and coordination among supervisory authorities. However, the risk of inadequate home-country supervision and regulation cannot be eliminated altogether. Moreover, regulation and supervision to ensure safety and soundness--the first line of defense against bank failures--cannot guarantee that a bank will never fail. If they could, measures to deal with systemic risk or depositor losses would be unnecessary. Deposit protection comes into play only ex post, that is, after measures designed to deal with safety and soundness have failed.

If the host-country approach for deposit insurance is used, exposure of the host-country scheme to inadequate home-country supervision could, in theory, be eliminated by requiring the home-country insurer to reimburse the host-country insurer for any payout. But, without substantial harmonization of coverage provided by deposit protection schemes, this arrangement would be unacceptable politically. Take, for example, the failure of a UK bank with a branch in Germany. The UK scheme would reimburse the German scheme. But, because the German scheme provides virtually unlimited depositor protection, a depositor at the German branch of the UK bank would receive compensation far in excess of that received by an equivalent depositor at a UK office of the bank--and the UK scheme would pay it (Table 1, column 4, lines A.1 and B.1).

A variation of the reimbursement idea addresses this problem. Under this variation, the UK scheme in the example above would reimburse the German scheme only up to the amount of its own less comprehensive coverage. Thus the German scheme (i.e., the host-country scheme) would bear the cost of the difference in coverage between two schemes (column 5, line B.1). In this respect, the arrangement is similar to "topping up" (see column 2 and Section III.B.1 below). But, as does topping up, this partial-reimbursement arrangement reintroduces exposure of the host-country scheme to the risk of inadequate home-country supervision, although to a lesser extent than under the ordinary host-country approach.

Another way to to try to reduce the cost of a payout to the deposit protection scheme of a host-country is agreement to use the separate-entity or territorial approach for bankruptcy. If all countries adhered to this regime, each host country would have jurisdiction over branch assets in a liquidation and could thereby ensure that the host-country deposit protection scheme had access to any branch assets that were available to settle outstanding claims. However, as the BCCI episode has emphasized, there is no generally accepted international rule governing treatment of foreign branches when a bank is liquidated. Financial institutions are not covered by a bankruptcy convention agreed in the Council of Europe or by a draft EC convention still in longstanding negotiations. Moreover, a 1985 Commission proposal for a directive regarding the reorganization and winding up of banks would give home-country authorities exclusive responsibility for branches of EC banks (see Section II.D. below).

B. Safety net responsibilities of home country

Deposit insurance is only one element of a safety net that may include central bank lending to or government recapitalization of failing institutions. These are home-country responsibilities, both within the Community and beyond.

Approaches to failing banks fall into three categories: (1) a rescue that preserves the institution through lending or recapitalization; (2) a reorganization involving the purchase of assets and assumption of liabilities by another institution; and (3) a liquidation, which necessitates a deposit insurance payout. In practice, these categories may overlap. For instance, a resolution effort might begin with lending but ultimately involve a reorganization or liquidation. In any case, the method of resolution clearly affects the cost to the deposit insurance fund. The timing of a closure--whether for a reorganization or a liquidation--is also important. In the savings and loan crisis in the United States, for example, many institutions were not closed until liabilities greatly exceeded assets even though moral hazard is greatest when insolvent and near-insolvent banks are allowed to remain open.

In view of these considerations, why should a host-country deposit insurance fund be dependent on home-country decisions about how to deal with a failing bank? Moreover, if a bank is to be liquidated and home-country deposit protection comes into play, should not the home country have jurisdiction over assets of foreign branches in the liquidation proceedings? (This question is discussed below.)

C. Incentives for supervision

The need for the home country to internalize the cost associated with deposit insurance for foreign branches--in addition to the costs of other aspects of the safety net--could be a further incentive for adequate supervision. Because this cost would be directly related to activities of branches in other Member States, it could affect the care taken in authorizing and supervising such branches. As already noted, within the Community these will become home-country responsibilities.

D. Bankruptcy jurisdiction

The fourth argument for home–country deposit insurance involves use of the single–entity approach for bankruptcy, also referred to as the unity and universality of the bankruptcy. In contrast to the separate– entity approach, under which a branch is liquidated separately from the bank, the single–entity approach treats the branch as an integral part of the bank in a liquidation proceeding. As already noted, there is no international agreement on the approach to be used when a bank is liquidated. In general, home countries take the position that they should have jurisdiction over the entire entity in a liquidation. However, as host countries they may take a different view. For example, as a home country, the United States uses the single–entity approach for branches of its own banks; however, as a host country, it uses the separate–entity approach for branches of foreign banks.

In theory, the single–entity approach to bankruptcy is preferable to the separate–entity approach. Since the bank as a whole is insolvent, and the branch is not a separate corporate entity, fairness suggests that in a liquidation claims should be resolved in one collective proceeding, in which similarly situated creditors are treated alike. Such treatment should not depend on the office at which the deposit was booked. Moreover, the separate–entity approach could hamper the rational determination of the method of resolution. For example, dismemberment of an insolvent bank through independent host–country liquidations of branches could effectively prevent the home country from restructuring or selling the bank and thereby interfere with the preservation of the bank's overall value.

The single–entity approach to bankruptcy––in effect, a home–country approach to bankruptcy––works in tandem with the home–country approach to deposit insurance. Mixing the approaches by using host–country deposit insurance could raise difficult questions regarding the status of the host–country deposit protection scheme in the home–country liquidation proceedings. For example, even if a host–country scheme is subrogated to the rights of insured depositors, its ability to enforce those rights would be affected by differences in national rules regarding the priority of the scheme vis–à–vis other creditors or by differences in rules regarding "set–off," which involves netting a customer's insured deposit and outstanding loans. The opposite mixture––home–country deposit insurance and the separate–entity approach to liquidation of branches––could raise similar issues regarding the status of the home–country scheme in host–country liquidation proceedings, as well as the issue of inequities among creditors in different countries discussed above. For example, even if the home–country scheme were subrogated to the rights of host–country insured depositors, host–country liquidation measures could still reduce the assets available both to pay off the home–country scheme in its role as insurer of home–country depositors and to pay off uninsured home–country depositors.

A 1985 Commission proposal for a directive on the reorganization and winding up of banks would require that all home– and host–Member States use the single–entity approach, that is, that branches in other Member States be treated as an integral part of a home country's reorganization or liquidation of a bank. Despite the theoretical benefits of this approach, the lack of progress on the Commission's proposal suggests that even if agreement is possible, reaching it will involve a lengthy and extremely difficult process. Thus the Community is almost certain to adopt a deposit insurance directive before further progress is made on the winding up proposal. However, the relationship between deposit insurance and bankruptcy should not be ignored and, to the extent possible, consistent approaches should be used.

E. Uniformity of protection within host country

The two arguments in favor of host–country deposit insurance for branches involve the desirability of uniformity of coverage within each country and the difficulties associated with harmonization. Compared with the United States, deposit protection schemes in the Community are quite new. Only Germany had a scheme in place before the 1970s. In 1986, the Commission issued a recommendation that each Member State have some type of deposit protection scheme in place. Since that time, four of the six Member States that did not have schemes have introduced them. In the remaining two––Greece and Portugal––legislation has been proposed.

Although the focus of all of the schemes is the protection of retail depositors, their features differ. For example, Germany is at one extreme as regards the level of protection with a maximum per depositor equal to 30 percent of bank capital (as of the last annual report).[2] By contrast, four of the schemes now in place offer protection of less than the equivalent of ECU 15,000 (about $19,000), the minimum level of coverage the Commission proposed. Under the <u>host</u>-country approach for branches, harmonization among the Member States is unnecessary to achieve uniformity of coverage within each host country. As in the present situation, branches would be covered, in general, by the host-country scheme and different levels of protection would continue <u>among</u> the Member States. (Germany is the only Member State that provides comprehensive coverage for its banks' foreign branches.[3])

Under the <u>home</u>-country approach--absent complete harmonization--a banking office in, say, the United Kingdom, might be subject to one of twelve different deposit protection schemes depending on whether it is a domestic bank or a branch from another Member State. One could argue that the home-country approach could be used with stringent disclosure requirements and no harmonization, but this alternative seems politically unacceptable. A directive that, in reality, contained very little harmonization might in practice come close to this approach, however. In any case, without more extensive harmonization than may be readily achievable, coverage among banking offices <u>within</u> a single Member State could vary widely.

At present, most branches of banks from other Member States are engaged primarily in wholesale banking activities. However, the issue of deposit protection at branches may come to greater prominence if the completion of the internal market is associated with increased penetration of host-country retail banking markets through the branch form of organization. Moreover, a larger number of bank failures may be associated with the more competitive post-1992 environment. In that event, under the home-country approach, as discussed below, major differences among schemes could present problems.

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[2] This limit is part of the German scheme for banks. Germany has separate deposit protection schemes for banks, savings banks, and credit cooperatives. The savings bank and credit cooperative schemes are designed to rescue or reorganize a failing institution and thus do not involve direct payouts to depositors.

[3] Belgium, Denmark, and Italy provide coverage for branches located abroad when the host country does not provide it.

III. HARMONIZATION ISSUES

If the home–country approach is to be used, harmonization may be necessary to promote several policy goals: ensuring adequate protection of consumers, reducing systemic risk, minimizing moral hazard, and promoting competitive markets. As noted earlier, the first two goals suggest comprehensive deposit insurance, whereas the latter two suggest a minimalist approach. Besides dealing with these inherently conflicting goals per se, an EC directive must deal with them in the context of twelve different national schemes. The elements of deposit protection schemes that might require harmonization by the Community––the level and scope of coverage, financial and administrative structures, and operational rules––are discussed below in reference to these policy goals.

A. Protecting consumers and avoiding systemic risk

Each Member State has a policy interest in protecting deposits its residents hold at branches of banks from other Member States. If the home–country scheme is to apply, some harmonization measures are necessary to satisfy the host country's policy interest. Such measures might include establishing a minimum level of coverage, limiting the amount of depositor coinsurance that may be applied at low levels of coverage, limiting the types of deposits that may be exempted from coverage, requiring disclosure of coverage, setting time limits and other requirements for payouts, and attempting to ensure financial soundness of the schemes.

These measures could also contribute to the reduction of systemic risk in a host–country banking market that might be associated with retail deposit activities of branches of banks from other Member States. However, even if such a bank experienced difficulties, the risk of imitative runs on domestic banks by nonbank depositors would probably not be very high. The channel of transmission to the host–country banking system would more likely be the interbank market and the payment system.

1. Level and scope of coverage

A Communitywide minimum level of coverage--that is, a lower bound on the level of coverage each Member State may provide--seems essential to ensure at least some protection for depositors at branches of banks from other Member States. But how should such a minimum be chosen? The EC Commission has proposed a figure of ECU 15,000 (about $19,000), based on the current levels of coverage in the Member States. If Germany and Italy, which have extremely high levels of coverage, are excluded, this is approximately the median of the levels of coverage provided by existing schemes. It would involve increases in coverage of about ECU 1,500 to ECU 4,000 (about $1,900 to $5,000) for four Member States--Ireland, Belgium, Luxembourg, and Spain--and establishment of schemes for Portugal and Greece.

How much overall protection would a figure of ECU 15,000 afford? To answer that question calls for survey data about the number of households and nonbank businesses in each Member State holding balances at credit institutions, classified by size of account. It would then be possible to estimate, for example, the aggregate amount of potentially uninsured deposits relative to deposits for which insurance would be mandatory under an EC directive. Unfortunately, according to the Commission's explanatory memorandum, such data were not available.

If the minimum level of coverage established by the Community is lower than that of a host country, say, France, depositors at French branches of banks from some Member States would have less protection than they would at a French bank. Would France and similarly situated host countries accept such differences? Imposing a high Community minimum would address this problem. However, more protection is not necessarily a good thing, since overly generous schemes could increase moral hazard (see Section III.B.2 below).

As noted earlier, the Commission proposal provides for host-country topping up of coverage for branches from countries where coverage is lower (see Table 1, column 2, lines A.1 and B.1). For example, the German scheme would be required to offer a Berlin branch of a UK bank the option of topping up coverage to the German level. The branch would not be required to accept, however. Thus topping up appears to be designed to reduce competitive distortions rather than to increase consumer protection (see Section III.B.1 below). Moreover, making it compulsory would imply the impossibility of choosing a Communitywide minimum level of coverage to ensure adequate protection of consumers.

Instead, each host country would, in effect, determine its own minimum.

Another aspect of the minimum amount of protection involves depositor coinsurance, specifically, whether risk sharing by the depositor may be required even for very small deposits. At present, for example, the UK scheme requires a bank depositor to share 25 percent of the risk on an insured deposit, beginning with the first dollar of the deposit.[4] The rationale for depositor coinsurance is to reduce moral hazard. However, the goals of consumer protection and reducing systemic risk suggest that coinsurance should not be allowed below the fairly low minimum level of protection established by the Community.

The Commission proposal is a compromise. It would allow depositor coinsurance on any balance, however small, provided that at least 90 percent of the deposit is covered by the scheme up to a payout amount of ECU 15,000 (this amount would cover a deposit of ECU 16,667). As a result, if the directive were to be adopted as proposed, the UK scheme applicable to banks would be required to lower the amount of coinsurance from 25 percent to 10 percent for balances up to ECU 16,667.

As regards the scope of coverage, because the primary aim is to protect unsophisticated depositors with small accounts, some categories of depositors may be excluded. The proposed directive *requires* banks to be excluded and *permits* certain other categories of depositors or instruments (listed in an annex to the directive) to be excluded.

The unit of coverage is depositor per bank. Thus accounts held at a bank's branches throughout the Community would be aggregated. A depositor could, however, have insured accounts at more than one bank. Deposits would be covered regardless of the currency in which they were denominated. As a result, schemes such as those in Belgium, France, Ireland, and the United Kingdom, which now cover only deposits denominated in domestic currency, would be required to expand their coverage.

2. Financial and administrative structure

To ensure adequate protection of consumers, the financing arrangements for a home–country fund must be sufficiently sound to pay, in the event of failure, all covered depositors,

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[4] A separate scheme for building societies currently requires depositor coinsurance of 10 percent.

including those at branches in another Member State. The Commission has not proposed any specific measures in this regard, and the proposed directive does not deal with questions of pricing or subsidization (see Section III.B.2 below). As long as they conform to the requirements of the directive, schemes may be statutory or contractual, publicly or privately administered. They may be funded by contributions to a standing fund, by ex post assessments, or both. In its explanatory memorandum, the Commission notes that it has received assurances from the Member States that the schemes are set up on a sound financial basis. It also notes that although subsidies under normal circumstances would be undesirable and could not conflict with the rules of the Treaty concerning state aid, the authorities of the Member States should not be precluded from providing assistance in event of a dire emergency.

The proposed directive would make participation in a deposit protection scheme compulsory for all credit institutions in the Community. But such a requirement must be reconciled with the continued existence of privately administered schemes. A problem arises if a private scheme may reject or expel members even though they are duly licensed banks. Under a compulsory requirement for membership, such a scheme could, in effect, deprive a bank of its license. One approach is to require a role for the public authorities in the determination of whether an institution receives coverage. Another is to establish a fallback publicly administered scheme to provide insurance coverage to duly licensed institutions that were not acceptable to a private scheme. The latter approach has the major drawback of creating a small pool of poor risks for a publicly administered scheme and, unless premiums were set very high, the potential of a continuing government subsidy.

The Commission's proposal takes the first route, although it may not address all aspects of the dilemma. Under the proposed directive, if a bank has violated the terms of its contractual arrangement with a privately administered scheme, the supervisory authorities must be notified. After attempts have been made to secure compliance and the supervisory authority has considered whether to withdraw the license, the scheme may expel the bank. If it does so, it still must cover the deposits for the subsequent twelve months. However, the proposed directive does not address the possibility of refusal by a privately administered scheme to admit a bank in the first place or to readmit a licensed institution previously expelled. Moreover, it is not clear what would happen if the contractual terms that were violated included not only payment of assessments and provision of information but also compliance with prudential standards. If steps were taken to expel a bank on the basis of the last, the judgment of the scheme administration would, in effect, be substituted for that of the supervisory authority in determining a bank's retention of its license.

3. Operational rules

In the event of a bank failure, the speed and convenience of a payout are of particular importance to consumers. These factors are also important for avoiding systemic risk. The longer the time between a bank failure and the payout, the less effective will be a deposit protection scheme in preventing destabilizing runs on banks. Also, for the home–country approach to be acceptable, depositors at host–country branches must be treated the same as home–country depositors (any discrimination would presumably be a violation of the Treaty of Rome). Payout rules established by the home–country scheme should facilitate equality of treatment as well as prompt payouts. Thus some harmonization as regards the speed and convenience of payouts is necessary for home–country coverage to meet host–country policy concerns.

To facilitate reimbursement of depositors, the Commission's proposal requires that a payout take place within three months after a deposit becomes "unavailable." A deposit is defined as unavailable if a bank experiencing "a financial crisis" is unable to repay the deposit for ten consecutive days, regardless of whether a "suspension of payments" has been declared by an administrative or judicial authority. Presumably, the administrators of the deposit protection scheme would determine whether deposits were unavailable; however, the directive might need to set forth more specific, objective criteria.

This provision is designed to break the link that exists in some Member States between the timing of payouts under deposit insurance schemes and the progress of liquidation proceedings. The goal is to prevent the type of delay that occurred in the payout by the UK Deposit Protection Scheme to depositors at the UK branches of BCCI's Luxembourg bank. These depositors were covered by the UK scheme (i.e., the host–country scheme), but under UK law, use of the scheme could not be triggered by the "provisional" liquidation of the branches declared by the UK court. For this reason, and also because of delays in verifying claims, payments under the UK scheme did not begin for nine months. However, many depositors at the UK branches received payments more quickly because of a special fund set up by the government of Abu Dhabi under which disbursements began within two months.

The Commission proposal, if adopted, could create pressure for some Member States to modify their resolution procedures to give higher priority to depositors' access to funds. One possibility is for a Member State to require that an administrative or judicial decision as to whether to reorganize or liquidate an insolvent bank be taken within three months of the deposits becoming unavailable, that is, before the deadline for beginning a deposit insurance payout. If imposing such a time limit on the resolution decision is unacceptable, another possibility is to allow the deposit protection scheme to proceed with a payout even though the bank might subsequently be restructured rather than liquidated. For example, in France, the scheme purchases the insured deposits and is then subrogated to whatever rights the depositors would have had in a newly restructured bank or in a liquidation. Another possibility involves a technical closure of an insolvent bank and a simultaneous transfer of its assets and liabilities to a new interim bank, the shares of which are held by the authorities (e.g., a "bridge bank" owned by the FDIC in the United States).

The limit of three months (plus, at most, ten days), which can be extended only in special circumstances, also ensures that a payout is not delayed until the liquidation proceedings--or particular aspects of those proceedings--are completed. In some cases, this proposal might require deposit insurance schemes to verify claims and calculate offsets before the liquidator has done so. The three-month period reflects the realities of existing arrangements in the Community. However, in comparison with the situation in the United States, three months seems long; although there is no statutory requirement to do so, insured funds are typically made available to depositors within a day or two after the closing of a bank that is to be liquidated. Similarly, in the case of a reorganization, there is no break in depositors' access to funds.

To ensure the ease and convenience of a payout for depositors at host-country branches, the directive specifies that documents must be drawn up in the host-country language and payment be made in the host-country currency or in ECUs. Because the Treaty of Rome precludes discrimination between home- and host-country residents, further provisions along these lines in the directive may have been considered unnecessary. However, it might be useful to establish some guidelines to facilitate communication and access for host-country residents in the event of a payout.

Disclosure requirements are also extremely important for consumer protection. For example, information regarding the scheme providing coverage, the maximum level of coverage, coinsurance requirements, if any, and the types of deposits that are covered is essential. Complete information is also important in reducing moral hazard (see Section III.B below). The directive requires that disclosure of the scheme and its limitations on coverage be provided to depositors in the host-country language and with numerical amounts expressed in the host-country currency and in ECUs. The proposed directive does not specify the timing and manner of such disclosure.

The directive is also silent on the matter of advertising, which in some instances might be difficult to distinguish from disclosure. In some Member States, comparative advertising of deposit protection schemes by domestic banks and branches of foreign banks would be permitted, provided that it was not misleading. (Deceptive advertising is prohibited under the Misleading Advertising Directive, but EC law is silent as regards comparative advertising.) Some Member States, concerned about competitive issues (see Section III.B below), strongly advocate including restrictions on advertising in the directive.

B. Minimizing moral hazard and avoiding competitive distortions

The problem of moral hazard--whereby the presence of insurance may encourage banks to act in a manner that increases the insurer's risk--is complicated even in the context of a single nation's deposit protection scheme. The best that can be done to minimize the moral hazard created by deposit insurance is to take a variety of measures to increase market discipline by both shareholders and debtholders and to strengthen supervision.

To the extent possible, the guarantee provided by deposit insurance could be priced according to the riskiness of an individual bank and the cost of its failure to the scheme. Ideally, such pricing would be based on continual monitoring and accurate evaluation of a bank's portfolio. In practice, however, risk must be measured largely from past performance. Besides pricing, other measures to reduce moral hazard include imposing strong capital requirements to encourage stockholder discipline on bank behavior; careful monitoring of a bank's condition; when a bank's capital position deteriorates, taking prompt supervisory action to recapitalize or close it before moral hazard increases drastically; and ensuring that depositors, including insured depositors, and other creditors of the bank are exposed to at least some of the risk of bank failure.

However, as already noted, some measures designed to reduce moral hazard may jeopardize other policy goals. In particular, as a scheme imposes more risk on depositors, it may be less effective in reducing systemic risk. Moreover, deposit protection schemes are not the only cause of moral hazard. Other features of the safety net--too-big-to-fail policies, including lending to or recapitalization of problem banks, and implicit guarantees provided through government ownership--could be much more important.

Competitive distortions--more precisely, allocative inefficiencies--can arise from subsidies in deposit protection schemes. There are two types of subsidies: first, subsidization of unsound banks by sound banks; and second, subsidization of banks as a group by the government and, ultimately, by the taxpayers. The former involves a misallocation of resources within the banking industry. If the price of insurance does not reflect the riskiness of individual banks, sound banks will subsidize unsound banks, which will then be able to expand more rapidly than they otherwise would. The second type of subsidy involves a misallocation of resources between banks and other financial institutions. The government will be subsidizing banks as a group if the pricing of insurance does not cover expected losses to the scheme or if the "implicit" charge, in the form of supervisory and regulatory requirements for insured institutions, is not high enough.

It is difficult, however, to disentangle the effect of a government subsidy for deposit insurance from effects of the subsidies inherent in other elements of the safety net. Such subsidies could, in fact, be much the larger. The safety net as a whole should be viewed as a subsidy to the banking sector unless this package is fully priced to the banks. Thus it is misleading to view the deposit protection scheme as the sole source of the potential government subsidy. Moreover, a subsidy can be present even without routine government funding of a deposit protection scheme and without an explicit commitment to stand behind a scheme. If, in practice, a government would support a scheme--whether publicly or privately administered--that was unable to meet its obligations, the government and ultimately the taxpayers, would be subsidizing the banks.

All of these subsidies will introduce competitive distortions to the market to the extent that they allow banks to obtain deposits at a rate below a market, risk-adjusted rate. Banks would thus have a competitive advantage over noninsured financial institutions offering similar products, such as money market mutual funds in the United States. As a result, other things being equal, the growth of bank assets and liabilities would be greater than it otherwise would have been. By contrast, if the price of the safety net to the banks (including the cost of regulation and supervision) were to exceed the value of the subsidy, banks would be at a competitive disadvantage vis–à–vis noninsured institutions.

In the context of an EC directive based on the home–country approach, addressing the policy goals of minimizing moral hazard and avoiding competitive distortions is even more complicated because they have a Community dimension. Within a given country, consumers would be able to choose among deposits at banking offices covered by as many as twelve different schemes. These schemes could differ significantly with respect not only to the level and scope of coverage but also with regard to their financial and administrative structures and their operational rules. In addition to deposit insurance, banking offices located in the host Member State would be subject to other features of the safety net that vary among the respective home countries. As already noted, too–big–to–fail policies and the implicit guarantee for nationalized banks could be more important than deposit insurance per se.

At present, retail banking activities outside the home Member State are conducted primarily through subsidiaries. Suppose, however, the internal market program serves to increase the penetration of host–country retail banking markets by branches of banks from other Member States and that the coverage provided by the two countries with the greatest protection–––Germany and Italy––remains unchanged. Consumers in, say, Ireland, might choose to hold deposits in Dublin branches of German or Italian banks rather than in an Irish bank. In that event, Irish banks would presumably pressure the Irish scheme to increase its coverage; banks in other Member States might act likewise to retain their domestic customers. Thus extremely large differences in coverage among the national schemes might induce depositors to shift to banking offices with higher coverage and thereby create pressure for adoption of more generous schemes.

Will this scenario play out? If so, would it matter?

First, depositors may or may not shift to high coverage branches. Whether they do depends not only on the disparity of coverage but also on a multitude of factors influencing the demand for and supply of bank deposits. These include the price and risk elasticities of demand consumers have for such deposits, the pricing of deposit insurance to banks, and the incidence of the cost of deposit insurance (for example, whether it is passed on to consumers).

This reasoning assumes, of course, that consumers are adequately informed about insurance coverage and that they act accordingly.

Conceivably, the first question might be answered in light of the disparities that already exist in coverage within a host country between branches and domestic banks. For instance, branches of German banks in other Member States are, at present, covered by the home–country scheme. But this disparity is not a useful test of the scenario. For one thing, these branches are not engaged primarily in retail deposit taking. Moreover, before the BCCI episode at least, European consumers had little awareness of the protection afforded by deposit insurance schemes, according to the conventional wisdom. Thus even if detailed data on deposits and depositor behavior were available, the example would not be useful in addressing the question of shifting.[5]

If depositors were to shift funds in search of higher coverage, would it matter? The answer is yes. The likely result would be an increase in the potential for moral hazard and the introduction of allocative inefficiencies that over time might be increasingly difficult to reverse. Moral hazard could increase throughout the Community because market pressures would encourage governments to adopt more comprehensive schemes. In addition, unless deposit insurance is accurately priced, shifting could also introduce new competitive distortions. In a world in which market distortions already exist, the introduction of new ones does not <u>necessarily</u> reduce overall economic welfare. However, absent evidence to the contrary, it is customary to assume that additional distortions represent a movement away from a welfare optimum. Indeed, that assumption has long been applied to subsidies in international trade. By offering host–country consumers a readily available choice of deposits with a multiplicity of guarantees, home–country deposit insurance for branches would give them greater scope for their preferences. With accurately priced deposit insurance, this broadening of choice would enhance consumer welfare. But if consumers' choices were based on <u>mispriced</u> insurance, allocative inefficiencies would arise in their holdings of bank deposits.

The question of who would be better off and who would be worse off is extremely complicated to answer empirically. For example, an Irish depositor at a Dublin branch of a

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[5] Coverage also differs among types of domestic institutions. For example, in the United Kingdom, depositor coinsurance is higher at banks than at thrift institutions. The question about shifting cannot be answered by this example either.

German bank might be subsidized by sound German banks or by the German taxpayer. The taxpayer would ultimately pay if the German government in fact stood behind the scheme or if it considered the bank too big to fail. Moreover, shifting could lead to a Communitywide increase in government subsidies. If higher levels of coverage were adopted in response to market pressures, the risk that schemes might be unable to meet their commitments might increase. As a result, governments might be pressed to make up any shortfall.

For the Community, the issue of pricing of deposit insurance is extremely complicated because it involves twelve different schemes. Under the home–country approach, consistency of pricing among schemes and differences in the incidence of the cost of deposit insurance would become more important, since banking offices located in a host country would be covered by different schemes. To be accurate, pricing should reflect differences in coverage among schemes as well as differences in risks among banks and expected losses to the scheme. However, even if pricing were accurate both within and among schemes, equivalent deposit insurance coverage would not necessarily compensate for significant differences in other features of the safety net. For example, if a government will not allow a bank to fail, whether a scheme has a maximum level of coverage becomes much less important. Presumably the level of coverage is always irrelevant for nationalized banks; but the level would be irrelevant for a privately–owned bank only if it were unquestionably too big to fail.

Mutual recognition has been used in other EC directives for the purpose of achieving convergence of national regulatory systems. For example, although the Community has not required each Member State to allow its banks to engage in the activities listed in the Second Banking Directive, it has created a situation in which market forces will create pressures for convergence with regard to the listed activities. For deposit insurance, however, it might not be desirable to use the market behavior of bank customers to pressure national governments for convergence of rules that have not been completely harmonized. There was a consensus within the Community regarding the activities on the list in the Second Banking Directive; in effect, the list is an explicitly agreed goal for convergence. Certainly no such consensus has emerged about raising the levels of deposit insurance above the relatively low minimum level proposed in the directive, or that doing so is worth the introduction of more distortions into the marketplace.

These considerations suggest that an EC directive include provisions relating to pricing and to the sharing of risk by depositors through coinsurance or a maximum level of coverage.

However, these approaches appear to be politically unacceptable. Indeed, political constraints on adopting a Communitywide limit on coverage, which some Member States have advocated, may have led to the Commission's proposal for host-country topping up of coverage.

1. Level and scope of coverage

Measures that would impose a greater share of the risk on the depositor include requiring depositor coinsurance above the EC minimum level of coverage and establishing an EC maximum level of coverage. The latter would serve as an upper bound on the maximum level of coverage a scheme may provide and would, in effect, be a requirement for depositor coinsurance of 100 percent above that amount. The Commission's proposal does not include either.

Depositor coinsurance below a minimum level of coverage was discussed earlier in relation to the goal of ensuring adequate protection of consumers (see Section III.A.1 above). Here, the issue is whether depositor coinsurance should be required above a minimum level of coverage. The rationale for coinsurance is that giving insured depositors an interest in the safety and soundness of their bank reinforces market discipline. Banks with the riskier portfolios would, in theory, be compelled to offer their depositors higher interest rates (at least on uninsured balances) and thereby be discouraged from holding such portfolios.

This analysis assumes that depositors are adequately informed about their coverage and are able to evaluate the riskiness of individual banks. Risk-based premiums that were publicly disclosed would help depositors to make such an evaluation. Even so, depositors might choose to place funds subject to coinsurance in government-owned banks and very large banks that are the least likely to be permitted to fail, not necessarily in the most sound banks. Despite these potential problems, it is widely believed that depositor coinsurance reduces the moral hazard that deposit insurance creates.

Limiting coverage by depositor coinsurance or by setting a maximum level would also reduce the magnitude of potential competitive distortions. However, such measures would not address the underlying pricing and subsidization issues (see below).

An EC directive might, for example, set a maximum ratio of coverage of 75 percent from ECU 15,000 to ECU 50,000 (about $62,500), and a maximum of 50 percent thereafter. In addition, or instead, the directive could set a Communitywide maximum level of coverage, which no scheme would be allowed to exceed. Such a level might be approximately that of the French scheme (about ECU 60,000 or $75,000), which would require only Italy and Germany to lower their levels. However, because the unit of coverage is depositor per bank, depositors could escape the ceiling on coverage by holding accounts in different banks. Another issue, which is prominent in the US experience and involves the safety net more broadly, is limiting the circumstances under which uninsured depositors could, in effect, be reimbursed.

The political obstacles to the imposition of limits on coverage may be insurmountable because it would call for the German scheme to curtail its virtually unlimited coverage. Presumably for this reason, the Commission proposal does not include a maximum level of coverage or a requirement for depositor coinsurance.

Instead, the proposed directive provides for host–country topping up (see Section III.A.1 above). Because it would narrow differences in coverage within a host country, topping up can be viewed as a means of forestalling demand for increases in coverage that might develop in the absence of a Communitywide limit. Under the proposal, a host–country scheme must offer each branch of a bank from a Member State where coverage is lower the option of topping up coverage to the host–country level. The proposed directive states that objective conditions relating to the membership of such branches must be established by all schemes. However, it appears inconsistent with the Second Banking Directive for the host–country scheme to charge premiums greater than those charged to domestic banks (after adjusting for the amount of home–country coverage already provided).

Topping up is asymmetrical in two respects. First, it would not, in fact, equalize the level of coverage among all banking offices within a host country. The home–country coverage of some branches would still be greater than the host–country coverage of domestic banks and branches of banks from low–coverage countries (Table 1, column 2, lines A.1 and A.2). Moreover, some low–coverage branches might prefer to avoid extra premiums or assessments and choose not to have their home–country coverage topped up. Thus the host–country scheme would, in effect, provide only an optional minimum level of coverage within that country.

Second, topping up treats banks and their own foreign branches asymmetrically. For example, in Germany, a branch of a Dutch bank could choose the same high level of coverage that German banks enjoy. But, in the Netherlands, coverage for the Dutch bank would be at the lower Dutch level. Topping up thus appears to be based on a rough notion of competitive equity among host–country banks and branches of banks with lower home–country coverage, which are assumed to be at an inherent disadvantage in competing in host–country retail banking markets.

Because of these asymmetries, topping up would remove only one source of pressure to increase coverage, namely, competition between low–coverage branches and high–coverage domestic banks. However, pressures to increase coverage could still arise because low–coverage domestic banks would be competing with high–coverage branches within a host country.

Moreover, topping up would reintroduce some of the disadvantages of host–country deposit insurance for branches, if in a milder form. Although the amounts would be smaller, the host–country insurance scheme would still be exposed to the risk of inadequate home–country supervision (Table 1, column 2, line B.1). Other disadvantages of the host–country approach for deposit insurance are also relevant, for example, home–country responsibility for other aspects of the safety net.

Another argument against topping up is the enormous practical problems it presents. It would be complicated for authorities to administer and confusing for depositors. Moreover, it could create uncertainties about coverage that could contribute to systemic risk.

Topping up the monetary differences in coverage between home and host countries would be extremely difficult without harmonization of the nonmonetary aspects of coverage––for example, the definition of eligible deposits. Rules for a variety of situations would have to be established. Suppose, for example, the home scheme has depositor coinsurance and the host scheme does not. What base would be used for topping up––the home scheme's maximum level of coverage or its maximum payout amount (that is, the level of coverage reduced by the amount of coinsurance)? Or suppose that a particular type of deposit or depositor is not eligible for coverage under the home scheme but would be eligible under the host scheme. Would such deposits or depositors benefit from topping up? If so, would a payout be necessary if the monetary amount were below the home–country's ceiling for covered deposits? Finally, suppose a depositor has a loan outstanding from the bank. How would any right of set–off be allocated between the home– and host–country schemes?

With topping up, two deposit insurance schemes, rather than one, would be involved in a payout to branch depositors. In view of the legal and administrative burdens associated with a payout and difficulties in identifying insured depositors, the interaction of two schemes in this process could be extremely complicated. For example, the host–country scheme might need information on all payouts by the home–country scheme before beginning its own work. Among other problems, this need could hamper compliance with time limits for payouts. Moreover, unless one scheme acted as the agent for the other, each customer would have to deal with two schemes.

The main argument for topping up is that it would at least contribute to greater uniformity of coverage within a host Member State. Some have suggested that host–country topping up also has the advantage of giving host countries with very high levels of coverage ––Germany, in particular––an incentive to reduce them. It is not clear why such an incentive would be provided. The German scheme currently offers branches of banks from other Member States the opportunity to participate. Under the proposed directive, the home country would cover at least the EC minimum of ECU 15,000. Since the German scheme provides virtually complete coverage, its exposure by virtue of topping up would still be very high. The major differences from the present situation would be that the home country would have responsibility for the regulation and supervision of the branches and that more such branches might be established. Although the shift of supervisory responsibility would undoubtedly be of considerable concern to the German deposit protection scheme, it would seem unlikely to provide a sufficient motive for a reduction of coverage for domestic German banks.

For branches with low home–country coverage, the Commission proposal––that is, the home–country approach with host–country topping up (Table 1, column 2)––is conceptually similar to the host–country approach with home–country reimbursement of the host–country insurer not exceeding the home–country level of coverage (see column 5 and Section II.A above). If a branch chooses to exercise the topping up option, in both cases the coverage for the depositor is at the level determined by the host–country scheme (line A.1). In both cases, a host–country scheme with higher coverage would be responsible for the difference in coverage between the two schemes (line B.1). Thus both approaches mean that the host–country fund must incur some exposure to the risk of inadequate home–country supervision, although much less than it would under a complete host–country approach. Moreover, both approaches involve two schemes and are technically complicated. For the depositor, the host–country approach with home reimbursement might be simpler because he or she would have to deal with only the host–country scheme.

In October 1992, the Banking Federation of the European Community suggested modifying the Commission proposal to limit the home–country coverage for a branch in another Member State to the maximum level of coverage available under the host–country scheme (Table 1, column 3). The primary motivation appears to have been concern by low–coverage banks about their ability to compete with high–coverage branches located in the same market in the absence of a Communitywide limit on coverage. Under the proposal, each host–country scheme would, in effect, determine the maximum level of coverage for branches of banks from other Member States (line A.2). Thus depositors at the London branch of a German bank would be covered only up to the maximum level of protection allowed by the UK scheme, even though the German scheme would pay for it (line B.2). By contrast, depositors at the same bank in Germany would receive the higher German level of protection.

As regards the level of coverage and financial responsibility for branches from both low– and high–coverage home countries, the Banking Federation's variation of the Commission proposal is conceptually similar to the host–country approach with reimbursement by the home–country scheme not exceeding the home–country level of coverage (column 5). If low–coverage branches chose to exercise the topping up option, the primary difference between the two approaches would be whether the home or host country had responsibility for operational features of the scheme.

2. Financial and administrative structure

If pricing of deposit insurance reflected the true risk to the insurer and the cost of payout, both within and among schemes, problems of moral hazard and competitive distortions would be reduced significantly. However, in general, this is not the case at present, nor is it likely to be so in the near future. There appears to be a political consensus that an EC directive must leave pricing alone, thereby requiring the Community to rely on assurances from the Member States that their schemes are financially sound and a presumption that routine government subsidies should be eliminated, with government support limited to extreme situations.

Nevertheless, the Member States might wish to explore further the issue of pricing. The goals would be to reduce the incentive created by deposit insurance for banks to hold riskier portfolios and to minimize potential subsidies from sound to unsound banks and from governments to banks as a group. Measures might include encouraging schemes to introduce risk–based premiums, facilitating some convergence of assessment bases, and trying to ensure that overall pricing policies yielded sufficient funds to cover expected losses.

Although risk–based premiums would not solve all the pricing problems of deposit protection schemes, they would reduce the subsidy from sound banks to unsound banks that is inherent in a flat–rate scheme and thereby help to reduce moral hazard and avoid competitive distortions. Such premiums would impose direct costs on banks that had engaged in risky behavior. However, differentials large enough to influence behavior could themselves contribute to the failure of a problem bank. In the United States, risk–based premiums with relatively small differentials, at least initially, are scheduled to be implemented by the Federal Deposit Insurance Corporation (FDIC) at the beginning of 1993. The premiums will be based on a bank's capital ratios, including risk–based capital ratios, and on a supervisory evaluation of its financial condition.

However, even if systems for risk classification were identical among the Member States, the price of equivalent coverage for equally risky banks would not necessarily be uniform among schemes. For example, the risk–based premiums designed by the FDIC address the relative riskiness of banks within a scheme. The absolute level of the insurance premium would depend, inter alia, on the financial and administrative structure of the scheme and its overall funding practices. These considerations emphasize the difficulties inherent in trying to achieve consistency of pricing among schemes (see Section IV below regarding a European Deposit Protection Scheme).

Moreover, it is difficult to see how risk–weighted premiums could be used in a scheme based only on ex post assessments. Ex ante such premiums would be acceptable because no one knows which bank will fail. But, after an individual bank has failed, other banks would likely consider it unfair to be assessed ex post on their own risk characteristics to cover the deposits of the failed bank. But, at least for the present, political constraints dictate leaving the method of funding to the individual schemes.

Related legal issues are raised by private schemes administered by associations of banks. Admitting or expelling members was discussed above. Other issues include the need to use confidential information to assess a bank's condition and possible anticompetitive behavior by the members of the association. In practice, these potential problems appear to be ignored. That might not always be possible; for example, the use of risk–based premiums could exacerbate these problems. However, in the absence of pricing that adequately reflected the riskiness of individual banks and potential losses to the scheme, sound banks might wish to establish stricter qualifications for members of a mutual assistance arrangement, akin to those of a clearinghouse. Yet this practice could exacerbate the potential conflict between privately administered schemes and the requirements for compulsory membership in a scheme. A related issue is whether, and, if so, under what circumstances, a private scheme might provide financial support for a troubled institution.

As regards government subsidies, no country would want to rule out government intervention in large or multiple failures for which the scheme's resources were inadequate and market conditions might prevent levying additional contributions or assessments. The Commission's explanatory memorandum acknowledges that such intervention might be necessary; but it also notes that governmental assistance in normal circumstances is considered undesirable and that such assistance could not contravene the rules of the Treaty concerning state aid. An alternative to immediate support by public authorities for a scheme in urgent need might be a contingency arrangement whereby the deposit protection scheme could borrow the necessary funds on the market as the normal recourse. However, if the interest rate at which the funds were obtained were not a market rate (say, if the government provided a guarantee), a subsidy would still be present.

3. Operational rules

Disclosure requirements, discussed above in the context of consumer protection, are also relevant to moral hazard. Sharing of risk by the depositor through a coinsurance requirement or a maximum level of coverage is pointless if the consumer is not aware of the risk. A "black box" approach to moral hazard defeats the purpose. If risk–based premiums are used, disclosure of the premium classifications––assuming they were accurate––would assist consumers in comparing the riskiness of individual banks.

IV. THE EXTERNAL DIMENSION

Given the difficulties that the Community is facing in dealing with deposit insurance, to use the home–country approach for deposit insurance beyond the Community would be extremely difficult, if not impossible. Indeed, the 1991 banking legislation in the United States illustrates this point. For deposits at foreign branches of US banks, the legislation constrains the ability of the FDIC to provide direct or indirect protection. For US branches of foreign banks, the new legislation avoids the home/host issue by prohibiting the establishment of any new branches that take domestic retail deposits of less than $100,000 requiring insurance coverage.

The Commission's proposed directive does not attempt to establish a common Communitywide policy for branches in and from non–EC countries and implicitly acknowledges the difficulties of extending the home–country approach beyond the Community.

For EC branches of third–country banks, the Commission's proposal follows the approach of the Second Banking Directive and, in general, leaves this matter to the individual Member States. The proposed directive imposes only two requirements on the treatment of such branches. First, Member States must adhere to the provision in the First Banking Directive requiring that such branches not be treated more favorably than branches of banks from other Member States. However, for deposit insurance, "more favorable" is ambiguous, because a branch conducting primarily a wholesale business might prefer not to be subject to deposit insurance coverage and assessments. Second, the branch must be required to disclose the scheme, if any, to which it belongs (typically that of the host EC country) and the coverage provided.

The proposed directive is silent on the subject of branches of EC banks located in countries outside the Community. At present, Germany is the only Member State that provides coverage for all of its banks' foreign branches.

The proposed deposit insurance directive does <u>not</u> refer to the provision of the First Banking Directive that allows for the possibility of mutual recognition agreements between the Community and third countries with regard to branches.

V. A POSSIBLE EUROPEAN CENTRAL BANK

As of this writing, the fate of the Maastricht Treaty on European Union is uncertain. However, if an institution similar to the European Central Bank (ECB) envisioned in that treaty is eventually established, what will its implications be for the Community's approach to deposit insurance? The answer depends in large part on the extent of the ECB's role in promoting the stability of the Community's financial system, particularly as regards lender of last resort, supervision and regulation of banks, and the disposition of failing banks. Beyond its mandate to achieve price stability through defining and implementing monetary policy, the smooth operation of payment systems is the only function relating to systemic stability listed among the ECB's "basic tasks" in the Maastricht Treaty. Moreover, the Treaty provides very limited powers for the ECB in bank supervision and regulation. Only advisory and consultative powers are specified; an enabling clause would allow other powers to be transferred to the ECB, but such a transfer would require a unanimous decision by the Council of Economic and Finance Ministers.

The term "lender of last resort" is not used in the Treaty but the concept is generally considered to be embodied in the tasks and implementing powers given to the ECB. Serving as a lender of last resort, broadly defined, involves providing liquidity for the banking system and for individual institutions experiencing difficulties. In theory, the latter type of assistance is provided for illiquid but not insolvent institutions, although in practice this line is blurred. The details of the way in which the ECB would function to control liquidity, including serving as a lender of last resort, are not specified in the Treaty.

For example, would the ECB exercise its authority to decide whether and under what conditions to lend to a particular institution, or would it delegate such decision making to the national central banks? If the former, would the ECB have operational responsibility, or would national central banks act as agents for the ECB in extending credit? Whatever approach is used, how would it take into account the need to coordinate the decision to lend to a failing bank with the decision about the disposition of the bank---that is, whether it is to be recapitalized, reorganized, or liquidated--and also with bank supervisory practices?

In this regard, within the Community two questions arise whose answers may depend on one another. First, which functions should be conducted at the supranational level? Both institutional and market developments will likely create pressures for closer coordination of policies and practices of the Member States regarding supervision and regulation of banks and the disposition of failing banks. Can the Community accommodate such pressures by greater harmonization and cooperation within the framework of mutual recognition and home-country control, or should mutual recognition be replaced by complete harmonization of rules and home-country control by the supranational administration of rules?

Second, how should functions--whether national or supranational entities carry them out--be divided among central banks, bank supervisory and regulatory agencies, and other entities such as deposit protection schemes? At present, there is considerable diversity among the Member States. In the United Kingdom, for example, the central bank has responsibility for prudential supervision; in Germany the central bank is not the primary supervisor. Another example is the role of deposit protection schemes in the disposition of a failing bank. In four Member States (Denmark, Luxembourg, the Netherlands, and the United Kingdom) the schemes do not have any powers to participate in a rescue or reorganization.

It is not clear whether an evolving role of a European Central Bank in promoting the stability of the financial system, combined with the possible practical difficulties of a home-country approach to deposit protection schemes, would ever lead to a supranational form of deposit insurance. A European Deposit Protection Fund would mean abandoning the approach of mutual recognition and home-country control for deposit insurance. Such a fund would constitute not only complete harmonization but also supranational administration of the rules. In theory, because it could provide uniform coverage and establish a uniform pricing system for deposit insurance throughout the Community, such a fund could address a number of the problems discussed in this paper. Moreover, it could contribute to development of a uniform Communitywide policy for use of the safety net.

In any case, a European Deposit Protection Fund is a question for the next century. It is certainly not under consideration at present. Indeed, it would be politically inconsistent with the present effort to carry out as many functions as possible at the national rather than the supranational level.

VI. CONCLUSION

In principle, the home–country approach to protection of deposits at EC branches seems preferable to the host–country approach. The main rationale is that the country that is responsible for authorization of branches and their supervision and for determining the disposition of a failing bank should also be responsible for deposit insurance. It seems particularly unreasonable that a host country should have to insure a branch when it has, in general, no control over authorization and entry and when it has no responsibility for deciding when or whether to close or rescue the bank. Ideally, home–country deposit insurance should be combined with the single–entity approach to bankruptcy.

However, to ensure adequate protection of consumers and reduce systemic risk, on the one hand, and to minimize moral hazard and avoid competitive distortions, on the other, some harmonization is necessary if home–country deposit insurance is to be used. The policy goals of protecting consumers and avoiding systemic risk appear to be the easier ones to address. They suggest that the Community should establish a minimum level of coverage, limit or prohibit depositor coinsurance below that amount, and limit the categories of deposits or depositors that may be excluded from coverage. These goals also suggest a requirement for disclosure of coverage and assurance of rapid payouts. The directive proposed by the Commission addresses all of these issues, although the length of time allowed for a payout is long by US standards.

The goals of minimizing moral hazard and avoiding competitive distortions are more difficult to meet because they involve complicated interactions among the features of national schemes as well as other elements of the safety net. These goals suggest that an EC directive should address the pricing of deposit insurance. But doing so is not politically feasible at the present time. The goal of reducing moral hazard also suggests a requirement that the depositor share the risk, at least above some minimum level of coverage. This requirement could involve establishing a Communitywide maximum level of coverage or a requirement for depositor coinsurance at levels of coverage above the Community minimum. Particularly in the absence of accurate pricing within and among schemes, the goal of competitive markets also suggests such measures.

If one must accept the political constraint that the Community not establish rules rules for pricing (other than those implicit in the Treaty provisions regarding state aids), the best that an EC home–country directive can do is establish an upper as well as a lower bound on coverage, thereby creating a band within which Member States may offer insurance coverage. The topping–up approach contained in the proposed directive does not appear to be an adequate substitute. Differences in coverage might still have the unintended effect of exerting pressure on governments to raise levels of coverage; modifying the proposal to limit home–country coverage for branches located in other Member States to the host–country level would reduce such pressure. Also, topping up would reintroduce, although in a milder form, some of the disadvantages of the host–country approach. Moreover, all of the hybrid approaches involving both home– and host–country schemes would be extremely complicated in practice.

Compared with the US experience, deposit protection schemes in the Community are relatively recent, and there have been relatively few calls upon them. However, if a more competitive banking environment emerges with implementation of the EC internal market program, bank failures could become more common. Moreover, completion of the internal market may well be associated with an increase in retail banking activities by branches of banks from other Member States. Thus the viability of the deposit insurance arrangements put in place by the Community might be tested early on.

However, as has been emphasized throughout this paper, deposit insurance is only one element of the safety net. For very large banks, too–big–to–fail policies may be more important than deposit insurance, although there is some uncertainty as to which banks are too big to fail. For nationalized banks, the implicit guarantee by the government is the relevant factor. However, for privately owned banks other than the very largest ones, deposit insurance can be important. Of course, for all banks, the first line of defense in protecting consumers and reducing systemic risk is prudential supervision and regulation, including strong capital standards. Deposit insurance and other elements of the safety net come into play only after measures designed to deal with safety and soundness have failed.

Many in the United States would say that unless there is a major problem with deposit protection schemes, leave well enough alone. And certainly do not do anything that might cause deposit insurance coverage to be increased. "Getting it wrong" in designing deposit insurance is both easy to do and potentially serious in its consequences. Balancing the conflicting policy goals is difficult within a single country, let alone with the interaction of twelve schemes. With many EC directives, there is scope for correcting problems later; in general, any regulatory or supervisory gaps in the harmonization can be corrected relatively easily. Such corrections may not be as easy for deposit protection schemes. They may be more difficult politically and also more difficult economically because allocative inefficiencies may not be readily reversible. These considerations suggest that, if the Member States decide to adopt a home–country directive, they try to agree a maximum level of coverage now and give serious consideration to the issue of pricing.

The Commission and the EC Member States appear to be mindful of these pitfalls. But directives inevitably involve a considerable degree of political compromise, and it is not clear how much harmonization can be agreed. In view of the shift of supervision and regulation of EC branches from the host to the home country, present arrangements for host–country insurance of deposits at branches from other Member States seem unsatisfactory. And the Community is certainly a long way from being ready, if ever it will be, to consider a supranational EC deposit protection scheme. As a result, the practical issue facing the Member States may be whether to use the home–country approach with less than adequate harmonization or to modify it to include elements of the host–country approach, particularly with regard to the level of coverage. Whatever choice the Member States make, it remains to be seen how satisfactory it will be in practice.

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ANNEX

Text of proposed directive

II

(Preparatory Acts)

COMMISSION

Proposal for a Council Directive on deposit-guarantee schemes

(92/C 163/05)

COM(92) 188 final — SYN 415

(Submitted by the Commission on 14 April 1992)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular the first and third sentences of Article 57 (2) thereof,

Having regard to the proposal from the Commission,

In cooperation with the European Parliament,

Having regard to the opinion of the Economic and Social Committee,

Whereas, in accordance with the objectives of the Treaty, the harmonious development of the activities of credit institutions throughout the Community should be promoted through the elimination of any restrictions on freedom of establishment and the freedom to provide services while increasing the stability of the banking system and the protection of savers;

Whereas, at the same time as restrictions on their activities are eliminated, consideration should be given to the situation which might arise if a credit institution that has branches in other Member States suffers a financial crisis; whereas it is indispensable to ensure a harmonized minimum level of deposit protection wherever in the Community deposits are located; whereas such deposit protection is as essential as the prudential rules for the completion of the single banking market;

Whereas, in the event of the closure of an insolvent credit institution, the depositors of branches situated in a Member State other than that where the credit institution has its head office must be protected by a guarantee scheme, in the same way as all the institution's other depositors;

Whereas the cost to credit institutions of participating in a guarantee scheme bears no relation to the cost that would result from a massive withdrawal of bank deposits not only from a credit institution in difficulties but also from healthy institutions following a loss of depositor confidence in the solidity of the banking system;

Whereas only ten Member States have a guarantee scheme in accordance with Commission Recommendation 87/63/EEC of 22 December 1986 concerning the introduction of deposit-guarantee schemes in the Community (1); whereas this situation may prove prejudicial to the proper functioning of the Single Market;

Whereas the Second Directive 89/646/EEC (2), as amended by Directive 92/30/EEC (3), provides for a system for authorizing and supervising credit institutions which will enter into force on 1 January 1993;

Whereas branches will no longer require authorization in host Member States, because they will be granted a single authorization valid throughout the Community, and their solvency will be monitored by the competent authorities of the home Member State; whereas this situation justifies all branches, set up in the Community, of the same credit institution in belonging to a single guarantee scheme; whereas this scheme can only be the one which exists, for this category of institution, in the

(1) OJ No L 33, 4. 2. 1987, p. 16.
(2) OJ No L 386, 30. 12. 1989, p. 1.
(3) OJ No L 110, 28. 4. 1992, p. 52.

state where the head office is situated, in particular because of the link which exists between supervision of a branch's solvency and its membership of a deposit-guarantee scheme;

Whereas harmonization must be confined to the elements necessary and sufficient to ensure, within a very short period, a payment under the guarantee calculated on the basis of a harmonized minimum level;

Whereas, for economic reasons, it is undesirable to introduce throughout the Community a very high level of protection which is liable to encourage the reckless management of institutions; whereas, in addition, in the event of a serious claim, contributions to the funding of the scheme could become too burdensome for the member institutions;

Whereas, however, the harmonized guarantee level must not be too low in order not to leave too great a number of deposits outside the minimum protection threshold; whereas in the absence of statistics on the amount and distribution of deposits in Community credit institutions, it seemed reasonable to take as a basis the median guarantee offered by the national systems; whereas that amount is ECU 15 000;

Whereas in the six Member States which are above that median level, the guarantee schemes offer depositors a coverage of their deposits which is higher; whereas it does not seem appropriate to require that these schemes, certain of which have been introduced only recently pursuant to Recommendation 87/63/EEC, be amended on this point;

Whereas the retention in the Community of schemes providing coverage of deposits which is higher than the harmonized minimum may lead on the same territory to disparities in compensation which are prejudicial to depositors and unequal conditions of competition between national institutions and the branches of institutions of other Member States; whereas, in order to counteract these disadvantages, branches should be authorized to join the host country scheme so that they can offer their depositors the same guarantees as those offered by the scheme of the country where they are located;

Whereas, in order to speed up payments under the guarantee, the initiation of insolvency proceedings should not be awaited, unless the latter take place within 10 days of the deposits becoming unavailable because a credit institution finds it impossible to comply with the obligation of refunding them in accordance with the legal and contractual provisions applicable to them;

Whereas a number of Member States have deposit-protection schemes under the responsibility of professional organizations; whereas other Member States have schemes set up and administered on a statutory basis and whereas some schemes, although set up on a contractual basis are partly administered on a statutory basis; whereas this variety of status poses a problem only with regard to compulsory membership of and exclusion from the scheme; whereas it is therefore necessary to take steps to limit the powers of schemes in this area;

Whereas one of the objectives of the harmonized minimum protection laid down by the Directive is to ensure depositor protection up to a certain amount, while excluding from such protection only deposits of other credit institutions and claims which are the subject of special conditions such as subordinated deposits; whereas it should, however, be possible for each Member State to limit such protection to depositors who are unable to evaluate the financial policy of the institutions to which they entrust their deposits, by enabling certain categories of depositors or of deposit to be excluded from the guarantee;

Whereas the principle of a harmonized minimum limit per depositor and not per deposit has been retained; whereas it is therefore appropriate to take into consideration the deposits made by depositors who either are not mentioned as holders of the account or are not the sole holders; whereas the limit must therefore be applied to each identifiable depositor; whereas the same does not apply to collective investments in transferable securities made via financial institutions and subject to special protection rules which do not exist for the abovementioned deposits;

Whereas in compliance with the Directives governing the admission of credit institutions having their head office in third countries, and in particular Article 9 (1) of Council Directive 77/780/EEC [1], as last amended by Directive 89/646/EEC, Member States are to decide whether and on what conditions to admit the branches of such credit institutions to operate on their territory; whereas such branches will not benefit from the free provision of services by virtue of Article 59, second paragraph of the Treaty, nor from freedom of establishment in Member States other than the one in which they are established; whereas accordingly a Member State admitting such branches may decide to oblige or permit such branches access to the guarantee system in place on their territory; whereas, however, it is appropriate that such branches should be required to inform their depositors of whether or not they belong to any guarantee system and of the extent and limits of any such guarantees;

[1] OJ No L 322, 17. 12. 1977, p. 30.

Whereas depositor information is an essential element in their protection and must therefore also be the subject of a minimum number of binding provisions;

Whereas deposit protection is an essential element in the completion of the Internal Market and an indispensable supplement to the system of supervision of credit institutions on account of the solidarity it creates between all the institutions in a given financial market in the event of one of then failing,

HAS ADOPTED THIS DIRECTIVE:

Article 1

1. For the purpose of this Directive, the following definitions shall apply:

deposit: credit balances which result from funds left in accounts or from temporary situations deriving from normal banking transactions and which the credit institution must repay under the legal and contractual conditions applicable, and claims for which negotiable certificates have been issued by a credit institution;

joint account: an account opened in the name of two or more persons or over which two or more persons have rights that may operate against the signature of one or more of those persons;

unavailable deposit: a deposit which a credit institution experiencing a financial crisis is unable to repay under the legal and contractual conditions applicable to such repayment.

This suspension of payments need not necessarily be declared or decided by a judicial or administrative authority; it is sufficient for it actually to last for 10 consecutive days.

At the end of that period, the deposit shall be deemed to be unavailable.

2. The following shall be excluded from any repayment by the guarantee schemes:

— the obligations towards other credit institutions;

— subordinated loans in respect of which there exist binding agreements whereby such loans are not to be repaid until after settlement of all other debts in the event of the bankruptcy or liquidation of the credit institution.

Article 2

1. Each Member State shall ensure that on its territory one or more deposit-guarantee schemes are introduced in which all credit institutions authorized in that Member State under Article 3 of Directive 77/780/EEC must take part. The schemes shall cover the depositors of branches set up by such institutions in other Member States.

2. A branch of a credit institution authorized in another Member State may apply to join voluntarily the scheme covering the category of institution to which it belongs in the Member State in which it is established in order to supplement the guarantee which its depositors already enjoy by virtue of their obligatory coverage by the scheme referred to in paragraph 1.

Member States shall ensure that objective conditions relating to the membership of these branches form part of all deposit-guarantee shemes.

3. If one of the credit institutions required by paragraph 1 to take part in the scheme or one of the branches granted voluntary membership under paragraph 2 does not comply with the obligations incumbent on it as a member of the deposit-guarantee scheme, the supervisory authority which issued the authorization shall be notified.

After taking all the measures necessary to secure compliance by the credit institution, or branch thereof, with its obligations and after noting the decisions taken by the supervisory authority (for example reorganization or withdrawal of the authorization), the guarantee scheme may exclude the credit institution or branch. In that case, the guarantee covering the institution's depositors shall be maintained for twelve months from the date of exclusion.

Article 3

1. Subject to Article 9 (1) of Directive 77/780/EEC, Member States may stipulate that the branches established by credit institutions with their head office outside the Community must join a deposit-guarantee scheme in operation on their territory.

2. In any event, the managers of foreign branches shall provide their depositors with information enabling them:

— either to identify the guarantee scheme to which the branch belongs and to be aware of the limits or ceilings which exist in that scheme,

— or to note the absence of any such guarantee.

3. The information referred to in paragraph 2 shall be made available in the official language(s) of the Member State in which the branch is established and shall be drafted in a clear and comprehensible form.

Article 4

1. The deposit-guarantee schemes shall stipulate that the aggregate deposits of a given depositor must be covered up to ECU 15 000 in the event of a financial crisis in a credit institution rendering deposits unavailable.

2. Member States may provide that certain depositors or deposits shall be excluded from the guarantee or shall be granted a lower level of guarantee. The exceptions are listed in the Annex.

3. This Article shall not preclude the retention or adoption of provisions which offer a higher guarantee ceiling.

4. Member States may limit the guarantee provided for in paragraph 1 or that referred to in paragraph 3 to a specified percentage of the deposits. However, the percentage guaranteed must equal or exceed 90 % of the aggregate deposits until the amount to be paid under the guarantee reaches ECU 15 000.

Article 5

1. The limits referred to in Article 4 (1), (3) and (4) shall apply to the aggregate deposits placed with the same credit institution irrespective of the number of deposits, the currency and the location within the Community.

2. The share of each depositor in a joint account shall be taken into account in calculating the limits provided for in Article 4 (1), (3) and (4).

In the absence of special provisions, the account shall be divided equally between the depositors.

3. Where an account holder is not the beneficial owner of the sums held in the account, it is the beneficial owner who shall be covered by the guarantee. If there are several beneficial owners, the share of each owner shall be taken into account in calculating the limits provided for in Article 4 (1), (3) and (4).

This provision shall not apply to collective investments in transferable securities.

Article 6

1. Member States shall ensure that the managers of the credit institution provide depositors with the information necessary for them to identify the deposit-guarantee scheme in which the institution and its branches take part within the Community. The limits or ceilings applicable under the deposit-guarantee scheme shall be indicated in a readily-comprehensible manner.

2. The information provided for in paragraph 1 shall be available in the official language(s) of the Member State in which the branch is established and the guarantee limits or ceilings and the level of payments shall be expressed in ecus and in national currency.

Article 7

1. Payments under the guarantee provided for in Articles 4 and 5 shall be effected within three months of the date on which the deposit becomes unavailable, or of a court or other authority finding that payment has ceased if this has occurred prior to that date.

2. For justified reasons, relating solely to certain depositors or certain deposits, the guarantee scheme may request the supervisory authority for an extension of the time limit. Such extension may not exceed three months.

3. The time limits referred to in paragraphs 1 and 2 may not be invoked by the guarantee scheme in order to deny the benefit of the guarantee to a depositor who, due to absence or for any other justified reason, has been unable to assert his claim to a payment under the guarantee in time.

4. The documents relating to the conditions and formalities to be fulfilled in order to benefit from a payment under the guarantee referred to in paragraph 1 shall be drawn up in detail in the official language(s) of the Member State in which the guaranteed deposit is located.

5. Payment under the guarantee shall be effected in the national currency of the Member State in which the guaranteed deposit is located or in ecus irrespective of the currency in which the deposits are denominated.

Article 8

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 1 January 1994. They shall forthwith inform the Commission thereof.

When Member States adopt these provisions, these shall contain a reference to this Directive or shall be accompanied by such reference at the time of their official publication. The procedure for such reference shall be adopted by Member States.

2. Member States shall communicate to the Commission the text of the main laws, regulations and administrative decisions which they adopt in the field governed by this Directive.

Article 9

This Directive is addressed to the Member States.

ANNEX

List of deposits referred to in Article 4 (2)

1. Deposits of financial institutions within the meaning of Article 1 (6) of Directive 89/646/EEC.
2. Deposits of insurance companies.
3. Deposits of the government and central administrative authorities.
4. Deposits of provincial, regional, local or municipal authorities.
5. Deposits of undertakings for collective investment in transferable securities.
6. Deposits of pension or retirement funds.
7. Deposits of directors, managers, members personally liable, holders of at least 5 % of the capital of the credit institution, members of the external auditing bodies and depositors with similar status in subsidiaries.
8. Deposits of close relatives and third parties acting on behalf of the depositors referred to at point 7.
9. Non-nominative deposits.
10. Deposits for which the depositor has, on an individual basis, obtained from the credit institution rates and financial concessions which have helped to aggravate the financial situation of that credit institution.
11. Debt securities issued by the credit institution.

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