

crisis response

PUBLIC POLICY FOR THE PRIVATE SECTOR

Blanket Guarantees

Necessary during the Crisis, but What Next?

The expansion of deposit insurance and introduction of debt guarantees have played a crucial role in containing the financial crisis while giving governments time to develop suitable policy responses. But these measures do not address the root causes of the crisis, and they lead to competitive distortions, moral hazard, and large fiscal contingent liabilities. Rolling them back is likely to require an internationally coordinated effort—and an answer to the important question, “exit to what?”

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This is the fourth in a series of policy briefs on the crisis—assessing the policy responses, shedding light on financial reforms currently under debate, and providing insights for emerging-market policy makers.

The basic objective of deposit insurance schemes is to avoid bank runs by small, uninformed depositors by protecting their deposits. Large depositors are left largely unprotected, because they are deemed to be better informed and thus better able to exert discipline on banks. In normal times deposit insurance schemes, coupled with lender-of-last-resort facilities, have a stabilizing effect by reducing the risk of contagion to illiquid but solvent banks and facilitating the orderly resolution of troubled banks. They can also foster financial development and stability by encouraging small depositors to place their savings in bank accounts and strengthening the competitive position of small, local banks.

Before 1980, explicit deposit insurance schemes were rare, found mainly in the United States, Canada, and several Latin American countries. Following financial crises in the 1970s through the 1990s, they were gradually adopted in most European and Asian countries as well.

But they are still rare in low-income countries, where the institutional capacity for effectively operating such schemes is lacking. According to the International Association of Deposit Insurers, 119 countries had an explicit deposit insurance scheme in June 2008.¹

The effectiveness of deposit insurance schemes in preventing bank runs is seriously weakened when large depositors and other counterparties are unable to assess the solvency of individual banks and lose confidence in the overall stability of the banking system.² This becomes particularly problematic in systems where short-term wholesale funding is dominant. In such circumstances the offer of blanket guarantees that extend protection to interbank deposits and other bank debt may become necessary. The guarantees seek to restore investor confidence while avoiding the systemic implications of closures and liquidations. Once issued during a crisis, blanket guarantees give governments time and opportunity to resolve failing banks, recapitalize



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and restructure viable entities, and liquidate those deemed to be nonviable. These guarantees were successfully used in the 1990s by both high-income countries (such as Finland, Japan, and Sweden) and emerging economies (such as Indonesia, the Republic of Korea, and Mexico).

Main characteristics and shortcomings

Essential features of explicit deposit insurance schemes include the following:³

- *Compulsory participation* to avoid adverse selection (in which only weak banks join the scheme)⁴
- *Relatively low ceilings on insured deposits* to protect the vast majority of small depositors while still providing incentives to larger and better-informed depositors to discipline banks⁵
- A *coinsurance requirement*, so that a specified fraction (from 10 to 25 percent) of insured deposits is not covered, to further induce market discipline⁶
- *Timely access to insured funds* to help prevent bank runs

The coverage of deposit insurance schemes varies widely across countries. The schemes generally focus only on retail deposits, although they also cover interbank deposits in some low-income countries in Africa and Asia. Local subsidiaries of foreign banks are typically covered, but the treatment of foreign branches varies widely. The treatment of foreign currency deposits and of nonresident deposits often depends on their relative size and the impact that their abrupt withdrawal could have in causing a bank run. Where there is widespread “dollarization,” foreign currency deposits tend to be covered, although there may be uncertainty about the currency in which the compensation will be provided and the rate of exchange that will be used.

Blanket guarantees offer unlimited protection for all nonretail deposits (wholesale and interbank) and generally cover new issues of short- and medium-term unsecured senior debt to stem acute wholesale funding problems. Depending on the severity of the crisis, existing debt may also be included. In some cases junior subordinated or even secured debt, such as covered bonds, is included as well. This introduces additional market distortions, however, since junior debt is supposed to be inherently riskier, while the

coverage of secured debt defeats the purpose of recourse to the underlying asset.

The ability of deposit insurance and blanket guarantees to prevent bank runs depends largely on their credibility, based on the schemes’ access to adequate funding. Schemes are funded by premiums levied on participating banks and sometimes supplemented with public funds. Prefunding provides greater certainty but raises the issue of efficient management of accumulated funds.

Deposit insurance schemes (whether explicit or implicit) generally weaken the incentive of depositors to monitor bank performance and may thus induce moral hazard.⁷ To control this, many schemes charge risk-based premiums. In principle, these should be high enough to discourage weak banks from taking on excessive risk and offering higher deposit rates. However, risk-based premiums are difficult to design in practice and, because they typically need to be higher for smaller local banks, often face strong political opposition. Indeed, although many countries have expanded deposit insurance coverage in recent years, few expansions were accompanied by an increase in premiums.

Blanket guarantees also have adverse side effects. Research has found that issuing such guarantees under lax policy interventions is associated with high fiscal outlays (Honohan and Klingebiel 2003). Doubts about the credibility of blanket guarantees—especially when countries lack sufficient foreign exchange reserves and have limited fiscal resources or when there is uncertainty about the terms of the guarantee (whether compensation will be in local or foreign currency and whether an unfavorable exchange rate may be used)—undermine their effectiveness in preventing the outflow of foreign liabilities (Laeven and Valencia 2008). To contain the risk of moral hazard and the fiscal cost, most governments limit the volume and duration of guaranteed debt, and they often impose a fee that can be linked to a bank’s default risk. Guarantees are therefore temporary instruments intended to be used only as a last resort, and they are meant to be withdrawn when normal market conditions are restored.

Crisis responses

Particularly after the collapse of Lehman Brothers in September 2008, fears about systemic insta-

bility spread because market participants were unable to distinguish between illiquid and insolvent financial institutions or to gauge the level of government support. Faced with eroding investor confidence, most high-income economies expanded deposit insurance and introduced guarantees on bank debt. These emergency measures were replicated by some emerging economies as a prudential response to the deepening global recession and the reversal of capital flows that accompanied the deleveraging process.

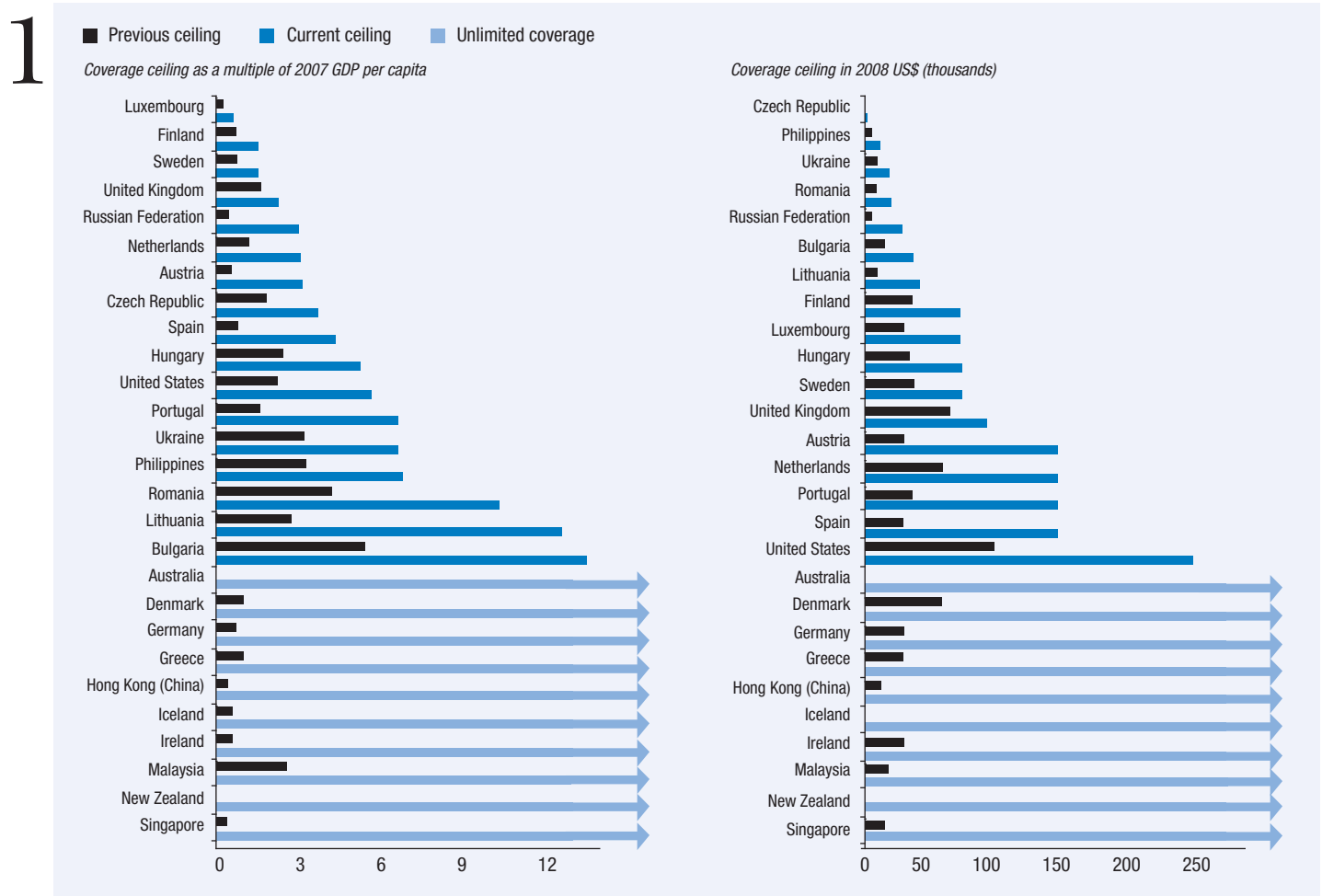
Responses in high-income economies

Many high-income economies raised the ceiling on insured deposits in addition to providing ample liquidity support to the financial sector (figure 1). In most cases this action was motivated

by the desire to avoid runs by large depositors, which represent a disproportionately large fraction of total deposits. In the United Kingdom, for example, 50 percent of bank deposits were held in large accounts not covered by the traditional deposit protection scheme. In other cases coverage was raised because of competitive concerns. For example, Australia introduced a deposit insurance scheme after other high-income countries in the region had raised their own coverage, generating fears of destabilizing cross-border deposit flows.

Excluding blanket guarantees on deposits, the average deposit coverage as a multiple of GDP per capita increased from roughly 1.5 to 5 on average. The United States raised the ceiling on insured deposits from US\$100,000 to

Figure 1 Increases in retail deposit insurance coverage as of January 2009



Sources: International Association of Deposit Insurers; International Monetary Fund.

US\$250,000.⁸ The European Union raised the minimum ceiling from €20,000 to €50,000 in late 2008 and to €100,000 by the end of 2009, a change that some member states adopted immediately. In other cases the authorities provided insurance coverage for the first time, extended full blanket guarantees on deposits, or did both.

In addition, countries extended guarantees to other bank liabilities in systems with large wholesale exposures so as to prevent the nonrenewal of contracts—or “silent runs”—by institutional investors and other counterparties. The scope and conditions of access to such guarantees differ substantially among countries (table 1). For example, Australia, Korea, the Netherlands, New Zealand, and Spain offered guarantees only on new senior unsecured debt issues. Eligible maturities typically range up to five years, although in some cases no maturity limit has been specified. Other countries, such as Denmark and Ireland, went even further and extended coverage to interbank deposits and existing and new senior unsecured debt. Ireland also guaranteed covered bonds and even subordinated debt. Guaranteed debt issuance by banks has grown significantly—primarily in the United States, the United Kingdom, Germany, and France—with overall gross issuance exceeding €200 billion by early March 2009.

Responses in emerging economies

Most countries in Central and Eastern Europe expanded their deposit insurance coverage because of their dependence on foreign funding to finance domestic credit expansion and the importance of Western European banks in their financial system. Some countries in the Middle East (Jordan, Kuwait, Saudi Arabia, the United Arab Emirates) and East Asia (Indonesia, Malaysia, the Philippines, Thailand) took similar measures as a precautionary or competitive response. Interestingly, these moves have not been matched by Latin American, South Asian, or African countries, presumably because of their stronger starting positions or lower financial integration.

Few emerging economies have taken measures beyond deposit insurance, either because of the significant fiscal costs entailed or because their banking systems have limited wholesale exposures. Heavily affected countries in Central and Eastern Europe are an exception. For example, Hungary has extended guarantees to interbank loans and new bank debt issues for up to five years. However, such guarantees are unlikely to be credible in countries with sizable public sector debt, a large banking system, and an open capital account. Selective controls on capital outflows,

Table Overview of bank debt guarantee programs in selected countries

Feature	Details
United States—Temporary Liquidity Guarantee Program	
Coverage	Program will guarantee all new senior unsecured debt issued by banks, bank holding companies, and thrifts on or before June 30, 2009, for a period of 3 years.
Eligibility	Participation by default, unless institutions opt out.
Pricing	Flat-fee pricing structure based on maturity of the instrument: 180 days or less, 50 basis points (bps); 181–364 days, 75 bps; 365 days or more, 100 bps.
United Kingdom—Credit Guarantee Scheme	
Coverage	Scheme will guarantee short- to medium-term debt issuance of up to 36 months, including certificates of deposit (CDs), commercial paper, and senior unsecured bonds and notes.
Eligibility	Participation is conditional on the institution having Tier 1 capital in an amount and at a date to be specified by the government.
Pricing	Pricing structure is based on the median 5-year credit default swap spread of the institution calculated over the period July 2007–July 2008, plus 50 bps.
Germany—Stabilization Fund	
Coverage	Fund will provide up to 400 billion in guarantees for interbank loans of up to 36 months and for newly issued bank debt.
Eligibility	State-owned and commercial banks, including subsidiaries of foreign banks.
Pricing	Flat-fee pricing structure for short-term debt (3–12 months): 10 bps to issue government-guaranteed bonds plus 50-bps fee. Risk-based pricing structure for longer-term debt (1–5 years): the median 5-year credit default swap spread of the institution calculated over the period January 2007–August 2008, plus 50 bps.

while not yet broadly evident in this crisis, have been introduced in a few countries. The pace of such measures may quicken as more countries try to prevent “leakages” of domestic liquidity injections or become unable to credibly guarantee the liabilities of their domestic banking industry.

Policy issues

The crisis has raised important issues relating to the design of deposit insurance schemes, while the use of emergency measures has led to questions about distortionary effects and how best to roll back these measures.

Design of deposit insurance schemes

The crisis has exposed flaws in the structure of deposit insurance schemes that may compromise both their ex ante deterrent role and their ex post role in orderly and efficient bank resolution. In particular, the crisis has led to a growing realization that the use of coinsurance requirements created insecurity among depositors and weakened the protection from bank runs. This was highlighted by the case of Northern Rock in the United Kingdom. Although the proximate cause of the bank’s failure was massive withdrawal or nonrenewal of wholesale funding, the lines of anxious depositors forming outside its branches prompted the U.K. authorities to announce the removal of coinsurance. The new EU rules prescribe abandoning coinsurance, which most member states have already done, or reducing it to no more than 10 percent of insured deposits.

The crisis has also underscored the importance of timely access to insured deposits. In the United States federal law has long required payment of insured deposits as soon as possible after the failure of an insured bank. The authorities in some other countries have announced plans to expedite access to insured deposits in cases of bank failure. In the European Union payouts used to be made after three months, but recent plans contemplate allowing access to funds after only three days.

More broadly, the crisis has shown that deposit insurance schemes have not kept pace with changes in the size and structure of the banking industry⁹ or in the composition of bank funding.¹⁰ The increased cross-border expansion of

banks has introduced additional complexities, such as providing deposit insurance coverage for the foreign activities of domestic banks in home jurisdictions¹¹ as well as for the branches of foreign banks in host jurisdictions.¹² Iceland, whose deposit insurance scheme could not support the large offshore deposits of its collapsed domestic banks, is a case in point.

Distortionary effects of emergency measures

The emergency policy measures have done much to help contain the crisis. But they have also led to significant distortions in the competitive landscape that will eventually need to be resolved. For example, cross-border financial links motivated several countries to expand their deposit insurance schemes primarily out of competitive (rather than prudential) concerns, leading to a “race to the bottom” in fully guaranteeing coverage.

Moreover, many countries have not yet charged banks a higher premium for the expanded deposit insurance coverage. Doing so entails problems of defining an appropriate pricing mechanism and may create additional stress for weaker banks. But the absence of risk-based pricing increases moral hazard and may lead to excessive risk-taking by weaker banks.

Inappropriate pricing of bank debt guarantees has also given rise to distortions. For example, in contrast to the U.K. scheme, under the U.S. scheme banks are charged a small, flat fee for their guaranteed debt issuance despite significant differences in their risk profiles. The guarantees have effectively become a cheap source of funding for many banks, crowding out other, nonguaranteed debt issuance,¹³ creating an uneven playing field for financial institutions without access to them,¹⁴ and, together with other measures, helping to keep weaker banks afloat.

More broadly, the large-scale emergency measures adopted will inevitably shape the expectations of banks and investors about government interventions in future financial crises. These expectations could influence their behavior, diminishing the monitoring incentives of investors while inducing moral hazard by banks. This reinforces the challenge of developing a more effective regulatory framework going forward.

Exit strategies

The distortions and fiscal risks introduced by bank debt guarantees and extended deposit insurance arrangements call for their early removal. But this task can only be undertaken once the conditions for a sustainable recovery are in place. Sunset clauses and an explicit timeline can bring clarity, but their credibility would suffer if repeated extensions become necessary. Instead, governments could choose a gradual phaseout and unwinding of emergency measures while the economy improves, problem institutions and assets are sufficiently addressed, and adequate regulatory frameworks are put into place. However, the cross-border financial links mean that the rolling back of emergency measures may take longer and require international coordination to ensure a reasonably level playing field once sound conditions return in most countries.

Conclusion

The expansion of deposit insurance and introduction of debt guarantees have played a crucial role in containing the crisis while giving governments time to develop suitable policy responses. These measures are relatively easy to implement, have no significant up-front fiscal costs, and are important commitment devices because they signal the willingness of the authorities to take action to avert a financial market meltdown. The extraordinary circumstances in which policy makers found themselves in late 2008, when faced with the potential collapse of the financial system, make objections about the desirability of introducing them a moot point.

Such arrangements are no panacea, however, and they come at a cost. They do not address the root causes of the crisis, and they lead to competitive distortions, moral hazard, and large fiscal contingent liabilities. They need to be promptly phased out once concerted action has been taken to reestablish the soundness of banks and restore confidence in the financial system. Because competitive pressures stemming from increased cross-border financial links complicates their rollback, the exit strategy will likely require an internationally coordinated effort and may take longer to complete.

Just as important as the exit strategy is the question, “exit to what?” The crisis has underscored

important weaknesses of deposit insurance schemes—ranging from coverage arrangements to risk-based pricing—that need to be addressed. The central question, however, is what safety net design will be credible after these emergency measures are suspended. In particular, future reforms will need to address the dynamic trade-offs between the ex ante deterrent role of such schemes, with its emphasis on reducing moral hazard, and their ex post role of facilitating efficient bank resolution and minimizing depositor losses.

Notes

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1. Where explicit deposit insurance arrangements are not in place, as is the case in many, particularly low-income, countries, this does not mean that deposits are not implicitly protected by the government.
2. See Garcia (2000) for a general discussion on deposit insurance in financial crises, and OECD (2008 and 2009) for recent experiences and considerations for financial safety nets.
3. See BCBS and IADI (2009) and Demirgüç-Kunt, Kane, and Laeven (2008) for an overview of design principles of such schemes.
4. Most, but not all, countries that have adopted explicit deposit insurance schemes impose compulsory participation.
5. In practice, the application of the ceiling on a per-depositor, per-bank basis allows individual depositors to shield large sums of money by maintaining deposits with multiple banks.
6. Coinsurance is predicated on the argument that the fear of some deposit loss would force even small depositors to monitor the performance of individual banks and thus limit moral hazard.
7. Empirical research underscores the moral hazard problem. Countries with ill-designed deposit insurance systems have a higher probability of experiencing a banking crisis, especially if they have a poor institutional and contracting environment (see, for example, Demirgüç-Kunt and Detragiache 2002).

8. The U.S. authorities also extended unlimited insurance to non-interest-bearing transaction accounts, often used by small and medium-size enterprises for payroll activities, and have insured outstanding balances by money market mutual funds, as losses suffered by some funds on supposedly prime-quality investments created concerns about massive withdrawals.

9. For example, the presence of a few very large banks may limit the credibility of deposit insurance schemes in the absence of adequate prefunding arrangements, forcing the authorities to keep these banks alive, including through forbearance.

10. The shift from retail deposits to other sources of bank funding may limit the effectiveness of deposit insurance and lead to unintended consequences. Consider the U.S. bank IndyMac. At the time of its failure in July 2008, it had borrowed large sums from the Federal Home Loan Banks (FHLBs) to fund mortgage lending. Since this funding was overcollateralized and had preferred-creditor status, the FHLBs were repaid ahead of the Federal Deposit Insurance Corporation (FDIC). As a result, the IndyMac bankruptcy led to FDIC losses estimated at US\$10 billion (a third of IndyMac's size), illustrating the complex interplay between deposit insurance and bank resolution.

11. To the extent that deposit insurance schemes cover (but do not adequately price) the cross-border activities of a few banks, they can indirectly lead to the unfair subsidization of these banks' activities relative to those of smaller domestic competitors.

12. In the European Union foreign bank branches are covered by the deposit insurance scheme of their home country. Because the schemes are not harmonized and capital can move freely within the single market, this has led to competitive pressures during the crisis. By contrast, in most Latin American and Asian countries foreign bank branches are covered by the host country scheme.

13. There is anecdotal evidence of crowding out and higher pricing in the nonguaranteed bank debt markets as well as in some sovereign debt markets as a result of such guarantees.

14. This is particularly true for nonbank financial institutions, which have lobbied heavily to be included in such schemes in countries (such as the United States) where they play an important role in the financial system.

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