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Sustainable Architecture for Finance in Europe

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Deposit insurance in Germany: An example for Europe?

Jan Pieter Krahnen: There is often talk about the model character of the German banking system for Europe – here is a positive example

Since the sudden bank runs in the U.S., U.K., and Switzerland a few months ago, followed by extensive government and Federal Deposit Insurance Corporation bailouts, the form and scope of deposit insurance have been in the spotlight. The European Commission has submitted a legislative proposal currently under discussion.

Let's wind back the clocks: Dramatic deposit runs, the likes of which are usually only found in dusty textbooks, have recently been witnessed in real time, starting with California's Silicon Valley Bank, followed by New York's Signature Bank and Switzerland's Credit Suisse.

None of these institutions survived the bank runs; at the same time, extensive bailouts and, in each case, an abrupt extension of the collateral pledge became necessary to protect investors from further outflows.

Eliminating bank runs

Therefore, this is an excellent moment to recall that Germany has already developed and applied a deposit insurance model for decades that virtually rules out deposit or bank runs like those in the US or Switzerland. We therefore want to ask to what extent the German model can and should serve as a model for other countries and the euro area.

The special, not to say worldwide, uniqueness of the "German model of deposit insurance" results from the de facto unlimited guarantee obligation for depositors. In the case of the associations that dominate the German banking market (savings banks and cooperatives have a deposit market share of 80 percent), this de facto deposit guarantee is achieved through the so-called institutional protection scheme.

To remain competitive, even the third "pillar" of the German banking industry (private banks with a deposit market share of less than 20 percent) increased their protection from the standard European level of 100,000 euros per account holder to a much higher amount in the 1980s. At Deutsche Bank, for example, the protection limit was six billion euros per account holder until recently and was reduced this year to a still impressive five million euros for individuals and 50 million euros for companies.

German deposit insurance as a full-coverage model

The German full-coverage model of deposit insurance is probably one of the main reasons why shock withdrawals of deposits from demand depositors have not been and are not expected in Germany, at least not on the part of those depositors to whom this full guarantee obligation applies. In the case of the associations, this applies to all account holders, whether individuals or companies, small or large. In the case of private banks, the comprehensive guarantee now applies only within the limits mentioned above.

The profound experience with the comprehensive deposit guarantee in Germany underpins the proposal for a reform of the European deposit guarantee recently presented by SAFE. It calls for extending the full deposit guarantee model to all European banks, with one crucial restriction. The essential limitation relates to the fear of increased credit risks. To exclude moral hazard in the form of increased credit risks, it is demanded that, in addition to the full guarantee of sight deposits, all institutions must have a separate asset class that is de facto liable capital.

Bail-inable debt as a lever for market discipline

In the hands of risk-conscious investors, bail-inable debt capital is intended to provide the necessary modicum of market discipline, without which we cannot speak of a market-based legal order for the banking sector. Fortunately, this additional regulation is already firmly anchored in the European framework of the Bank Recovery and Resolution Directive (BRRD).

Notably, the quasi-full coverage of bank deposits created in Germany is a functioning regulation that can serve as a model for other European countries and can, therefore, be forcefully introduced into the ongoing reform debate on the European framework for crisis management and deposit insurance (CMDI).

At the same time, however, it must be ensured that to protect against risk-taking incentives (moral hazard), a sufficiently high financial cushion of bail-in debt capital must be maintained in parallel for each institution (or for each association as a whole) in addition to equity capital. Then, and only then, can the shielding of banks against run risks go hand in hand with their openness to market discipline and bank restructuring.

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