

CROSS-BORDER AND REGIONAL ISSUES

Abstract

In general, relevant laws, regulations, and other provisions applicable to banks, their customers, and deposit insurers, are that of the bank's country of charter or incorporation. Circumstances change if a bank operates branches in other jurisdictions, or provides services on a cross-border basis to customers located abroad. Depending on the volume of these activities, the implementation of appropriately adapted policies by home- and host-country deposit protection schemes can be crucial for the effective operation of deposit protection arrangements and for the achievement of public-policy goals.

Issues that require particular consideration from a cross-border and regional perspective are: membership, coverage, funding, interrelationships between safety-net participants and, in the case of failures, the process of reimbursing depositors and the recovery of assets. This paper identifies relevant cross-border and regional issues from the perspective of deposit protection, and will examine the trade-offs associated with a variety of approaches. It also includes considerations with regard to the process of accession to the European Union (EU) by candidate countries.

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In most countries, deposit taking is primarily a domestic business. However, cross-border aspects of this business are increasing in many jurisdictions (for example, e-finance developments). In some countries, cross-border aspects play a considerable role in the design of deposit insurance arrangements. This is the case, for example, if a banking system is characterised by a strong presence of foreign-bank branches. In weak banking systems, especially after a crisis, the outflow of deposits to foreign countries may have to be taken into account when establishing or reforming deposit insurance arrangements. Special considerations may apply in regions where economies are closely related—for example, North America—or closely integrated—for example, the EU.

The considerations presented in this paper regarding cross-border claims and recoveries of foreign branches also are applicable to domestic banks with foreign subsidiaries and domestically chartered foreign-bank subsidiaries, but these are not the focus of this paper.³

¹ This paper represents the work of the Subgroup on Cross-Border and Regional Issues. The Subgroup is comprised of representatives from Germany (coordinator), Canada, Hungary, Mexico and the United States. For the purposes of this paper, the home country is the jurisdiction of the bank's head office; the host country is the jurisdiction where the foreign branch is located.

² The EU minimum requirements for deposit insurance and other regulatory aspects are harmonised and the responsibilities for deposit protection lie primarily with the home country.

³ A bank's foreign subsidiary is in general separately chartered, and supervised in the same way as domestic banks. The only differences are that its shareholder is a bank located in a different country and that the parent bank should be subject to consolidated supervision by the parent bank's supervisory authority. For deposit protection purposes, the subsidiary is treated like domestic banks. Cross-border issues arise if the subsidiary has transferred assets and liabilities to foreign jurisdictions or otherwise established business relationships, for example in derivative markets, that may produce claims and obligations with counter parties in other countries.

Membership Issues

Policy approaches with regard to the membership of banks from foreign countries in deposit protection schemes vary widely. Foreign branches could be included in or excluded from a host-country deposit protection scheme. Host countries also could choose to prohibit foreign branches from accepting deposits that are covered by the host-country deposit protection scheme unless the branches participate in this scheme and comply with entry criteria. Another approach is to waive or limit protection to supplementary coverage in circumstances where the deposit protection scheme of the bank's home country is recognised by the host country. Finally, countries may require banks from foreign jurisdictions to set up legally separate subsidiaries if they wish to accept covered deposits.

It may not be necessary to include foreign-bank branches in host-country deposit protection schemes to achieve public-policy objectives when foreign banks play a limited role in a country's financial system. Excluding foreign-bank branches may facilitate the administration of the scheme and prevent it from covering deposits at banks that it may not be able to supervise adequately. A drawback of this policy is that consumer protection may be weakened because depositors may be uncertain about the coverage provided for their deposits.

Some countries choose to include all foreign branches in their deposit insurance scheme. In countries where foreign-bank branches have a large market share, the inclusion of foreign branches may be considered necessary to achieve stated public-policy objectives. The mandatory inclusion of foreign branches in the host-country deposit protection scheme ensures that all eligible depositors benefit from deposit protection. However, this strategy could threaten the viability of the host-country deposit protection system, if the respective bank and its foreign branches are not subject to an adequate supervisory regime. To ensure adequate supervision and the financial strength of foreign branches, supervisors may require foreign banks to pledge assets as a capital substitute, and to conform with capital adequacy and other regulatory requirements of the host country.

If special membership or entry criteria for deposit protection schemes exist, foreign branches should comply with them in order to preserve the financial strength of the system and competitive equity. Accession criteria could include supervisory capacity to carry out audits at the branch- or head-office level, and the possibility of receiving information from the head office or the home country's supervisor.

It may be appropriate to recognise the coverage already provided through membership in a home-country scheme, if this scheme also covers deposits collected by foreign branches. In such cases, the relevant host-country authorities (generally banking supervisors) would have to be informed about the level of coverage provided by the branch's home-country scheme during the licensing or chartering process, if the coverage of deposits is mandatory. Authorities should be given the ability to not recognise the branch's home-country deposit protection scheme, if they conclude that the protection policies of the home-country scheme are inadequate.

Membership in a deposit insurance scheme for banks that only collect deposits directly from customers abroad without having established a branch or a subsidiary (that is, a physical presence) in the foreign jurisdiction generally is not appropriate. Cross-border deposits generally are protected by the bank's home-country scheme (in cases where one exists), since deposits are booked in the home country where the bank is physically located and licensed to operate. In all cases, depositors should be appropriately informed of whether the home-country deposit protection scheme, the host-country deposit protection scheme or a combination of both is applied.

Coverage Issues

Deposits that are collected by a bank directly from depositors in other countries (for example, *via* the Internet) may or may not be covered by the bank's deposit protection scheme. If a bank has established a branch in a foreign country, a wide spectrum of coverage arrangements for the branch's deposits may apply.

The coverage of deposits of foreign branches that only participate in the host-country deposit protection scheme is, in general, determined according to that scheme's regulations. This does not rule out that the scope and level of coverage may be fixed with a view to the coverage provided in other countries, so that, in addition to domestic factors, external aspects are taken into account. Coverage that is comparable to that in competitor countries may be one element of an overall strategy to strengthen the financial system and to stop the outflow of deposits, especially in weak banking systems and banking systems that have experienced a recent crisis. However, it is important to avoid a competitive process by which national deposit insurance schemes adapt to the ones with the most encompassing features and the lowest premiums or levies without taking due regard of the country's domestic situation. Such a process may have negative implications for the viability of the protection scheme and could jeopardise financial stability.

The determination of an appropriate coverage policy could become more complex if the bank's home-country scheme also covers deposits raised by foreign branches in foreign jurisdictions. The coverage of deposits at foreign branches may be appropriate because the branch is a legal part of the bank and its solvency and liquidity cannot be separated from the soundness of the bank itself. Furthermore, domestic customers of the bank doing business with its foreign branches might expect to be protected in the same manner as that provided when they deal with the bank's head office. If the coverage of the home-country scheme is lower or less encompassing than the coverage provided by the host-country scheme, the branch could be given the opportunity to top-up the home-country coverage; this supplementary coverage could be provided by the home- or by the host-country deposit protection scheme. On the other hand, if the coverage of the home-country scheme of the branch is higher or of broader scope, the branch's customers would benefit from more-encompassing protection than that provided by the host-country scheme. Limitations may run counter to policies that allow free provision of financial services on a cross-border basis.

If a branch that already benefits from coverage by its home-country scheme is obliged, or granted the right, to join a host-country scheme, care should be taken to ensure that insured deposits are not covered twice. This might require appropriate provisions in contracts, statutes and laws, and possibly mutual agreements between the deposit protection schemes concerned.

In the EU, the home-country deposit protection scheme of a bank also covers deposits of the bank's branches in other EU jurisdictions according to the deposit protection directive.⁴ This directive specifies minimum features for deposit protection schemes in member countries and supplements the overall harmonisation of banking supervisory regulations in the EU. As the minimum coverage in the EU already is provided by the branch's home-country scheme, the branch cannot be obliged to join the host-country deposit protection scheme. If the coverage of a host-country deposit protection scheme is higher or of broader scope, branches may choose supplementary coverage by this scheme, provided that they accept the membership conditions of the host-country scheme.

For candidate countries preparing for accession to the EU, transitional arrangements with lower initial coverage are under consideration. With lower initial coverage there may be a risk that if an accession country were allowed to export its lower deposit guarantee coverage to another member state with higher coverage, depositors could be insufficiently protected. To solve this problem, branches of banks from accession countries could be requested by the host country to top-up to the minimum level of the home-country scheme during the transition period. This arrangement could be a safety device to ensure that an adequate, minimum deposit guarantee level is offered in all member states.

On the other hand, there may be requests for a limited export prohibition ban in the EU toward certain accession countries. This means that an accession country may request EU branches operating in its territory to not exceed the lower initial minimum EU deposit guarantee during the transitional period. Implementation of this approach could be difficult if the transitional export ban would have to be altered by amending the law in the branch's home-member state. Furthermore, it should be taken into account that the freedom of establishment only may be restricted in the EU for a limited period and on exceptional grounds.

Funding Issues

If deposits at foreign branches are covered by the bank's home-country deposit protection scheme, the same funding mechanisms as for the head office of the bank could apply to its foreign branches. If deposits at foreign branches are not covered by the bank's home-country scheme, but the foreign branch belongs to the deposit protection scheme of the host country, the branch could be considered for funding purposes as a separate legal

⁴ The EU Directive on Deposit Guarantee Schemes (Directive 94/19/EEC) is available in the Internet under the following address: http://europa.eu.int/eur-lex/en/lif/dat/1994/en_394L0019.html

entity; levies or premiums could be collected according to balance-sheet data, the level of business and deposits, or other relevant branch-specific information. Special adaptations could be necessary if premiums are assessed *ex-ante* on a differential (risk-adjusted) basis. As the financial condition of the branch can not be separated from the situation of its head office, in principle the risk profile of the whole bank would have to be taken into account for the calculation of differential levies and premiums. If there is a lack of adequate data for a differential premium system, the branch could be assessed under criteria consistent with that applied to domestic banks. This could be an appropriate approach if the branch is required to have endowment capital or to pledge assets as a substitute for its own funds.

More-complex approaches may be necessary if the basic coverage of the bank's head office is provided by the home-country scheme, and supplementary coverage would be granted by a host-country scheme. In this case, the calculation of funding requirements for the supplementary coverage often could not follow the standard approach for domestic banks. It could be necessary to develop special funding formulas for supplementary coverage, possibly adapted to the financing approach of the home-country scheme (especially *ex-post* or *ex-ante* financing; flat-rate or differential (risk-adjusted) premiums). Regardless of the concrete formula developed, the protection already provided by the home-country scheme should be recognised in the determination of levies and premiums to avoid double charging.

Interrelationship Issues

Cross-border deposit taking may require close interrelationships among safety-net participants in different jurisdictions. In general, information received by safety-net participants in other jurisdictions should be subject to strict confidentiality rules that comply with international standards and that are not more lenient than the rules for information received by other domestic safety-net participants. If this is assured, all relevant information could be exchanged between deposit insurers in different jurisdictions. In addition, it may be helpful if deposit insurers were able to benefit from information channels established between supervisory authorities in different jurisdictions. Relevant information concerning banks and branches in other countries could, where appropriate, be requested by contacting the deposit insurer. In some cases, it also could be useful to exchange information directly between deposit insurers and other safety-net participants in foreign jurisdictions. In any case, foreign deposit insurers should receive all information necessary to enable a prompt reimbursement of depositors.

If a foreign branch belongs to the deposit protection scheme of the host country—possibly only for supplementary coverage—it could be appropriate to establish information channels between this scheme and the home-country deposit protection scheme. If the host-country scheme is a risk minimiser, and has the power to audit banks belonging to its scheme, including foreign branches, it may detect facts that also are material from a supervisory point of view. Such information could be made available to the supervisory authority, even if it is located in a different jurisdiction under information-sharing agreements. To fulfil its task as a risk minimiser, it also may be appropriate for the deposit insurer to require the provision of relevant information

concerning the whole bank and to verify such information with the home country's supervisory authority.⁵ If a crisis occurs at the bank or the branch, the information sharing between safety-net participants also could include the host-country deposit insurer. In any case, the host-country deposit insurer should be informed early when a bank fails.

If the foreign branch belongs to the host-country deposit protection scheme only for supplementary coverage, while basic coverage is provided by the home-country deposit protection scheme, regular contacts between the home- and the host-country deposit protection scheme also might be useful. Close cooperation may be necessary during the reimbursement process after a failure has occurred. Moreover, if bankruptcy proceedings were to be initiated, all relevant deposit insurers would have to be informed immediately about the closure of the bank, including its foreign branches.

Also in the case of the accumulation of cross-border deposits without the establishment of a branch, communication between the home-country deposit insurer and the supervisory authority of the depositors jurisdiction may be appropriate. This issue could be especially important in a crisis, if the bank has a strong position in the foreign market.

Claims and Recovery Issues

In general, the determination of claims and the recovery of assets are more complex for foreign branches than for domestic banks. As foreign branches are a legal part of a bank chartered in a different jurisdiction, cross-border transfers of assets and liabilities can be easily executed and occur during the normal course of a bank's business. If such a bank fails, and deposits at foreign branches have to be reimbursed by the relevant home- or host-country deposit protection scheme, the proper recognition of rights of set-off and collateral arrangements may complicate the determination of the depositors' claims. Furthermore, subrogation may imply that assets have to be recovered by the deposit protection scheme in foreign jurisdictions. The issue becomes even more complex when the branch's home-country deposit protection scheme provides the basic coverage and the host-country scheme provides supplementary coverage.

Deposit protection schemes should analyse cross-border legal issues and develop solutions from a cost-benefit perspective for potentially major legal disputes before failures occur. In some cases, memoranda of understanding between deposit protection schemes might contribute to the resolution of complex legal issues related to bank failures. Deposit protection schemes should have quick access to legal advice and try to avoid unresolved legal issues and disputes, which may lead to delays in the reimbursement of depositors.

⁵ See Annex II (a) of the EU Directive on Deposit-Guarantee Schemes (Directive 94/19/EC).

Conclusions

Funds collected from depositors located in other countries where a bank has not established a branch or subsidiary normally are covered by the deposit protection scheme of the bank's home country. Deposits at foreign branches may be protected by the bank's home-country deposit protection scheme, by the host-country protection scheme, a combination of both schemes, or not protected at all. In the case where protection is provided by both the home- and host-country protection schemes, the home-country scheme may provide basic coverage that is supplemented by the host country. Foreign branches participating in a host-country deposit protection scheme should conform to the membership criteria of the host-country scheme, which may possibly include the application of supervisory requirements on a stand-alone basis. If the host-country scheme provides supplementary coverage, double reimbursement of insured depositors should be avoided. The protection already provided by the home-country scheme should be recognised in the determination of levies and premiums.

In general, information received by safety-net participants in other jurisdictions should be subject to the same strict confidentiality rules applicable to information received by other domestic safety-net participants. Confidentiality rules should comply with international standards. If this is assured, all relevant information should be exchanged between deposit insurers in different jurisdictions, and possibly between deposit insurers and other foreign safety-net participants when appropriate. In any case, foreign deposit insurers should receive all information necessary to enable a prompt reimbursement of depositors.