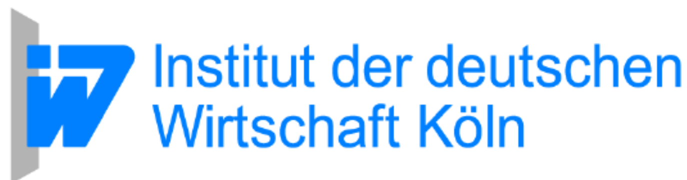
Mutual Guarantee Schemes:
Importance and Outlook

Thomas Hartmann-Wendels
Department of Banking
University of Cologne
hartmann-wendels@wiso.uni-koeln.de



Manfred Jäger-Ambrożewicz
Cologne Institute for Economic Research
jaeger@iwkoeln.de

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The conclusions made based on the analysis outlined in this opinion paper can be summarised into the six points presented below.

1. The cooperative mutual guarantee solution in place at the VR Banking Group is a sustainable organisational structure. We see the VR Banking Group as a special form of organisation combining elements of centralisation – similar to a corporate group – with features of a franchise system and of a strategic alliance between independent banks. Member banks of the VR Banking Group are legally and financially independent, but exist in a relationship of mutual solidarity as participants in a liability-sharing arrangement (Haftungsverbund). In the following the German Cooperative Banking Group is referred to as the VR Banking Group. The Group consists of the German cooperative banks, most of which are Volksbank and Raiffeisen-brand banks, the two central Group banks and a number of other group organisations including mortgage lenders, Bausparkasse Schwäbisch Hall, the investment company Union Investment, R+V Versicherung and the National Association of Cooperative Banks (BVR).

2. The mutual guarantee scheme is an essential element of the VR Banking Group. The retail banks comprising the membership of the Cooperative Group largely share the same corporate identity. Consequently, the Cooperative Group is perceived as a distinct brand. Accordingly, financial distress on the part of one member bank poses a major risk of customers becoming concerned over the safety of their deposits at other member banks, eroding confidence in the Cooperative Group overall. Deposit insurance is thus insufficient in and of itself to protect the common brand of banks in the Cooperative Group; a VR mutual guarantee scheme is additionally required, the aim of which is to restore the viability of a member bank in financial distress and put it back on track for profitability. The preventive and restructuring measures possible under the mutual guarantee scheme signal the ability to take specific action, which fosters confidence in the soundness of the larger group.

3. The mutual guarantee scheme hinges upon far-reaching guarantees that greatly exceed that afforded under simple deposit insurance. The conclusion is advanced that the VR mutual

guarantee scheme is, with reasonable assurance, adequate for backing up these guarantees. Although the guarantees are broader in scope, the level of necessary reserves is in fact lower than with deposit insurance. The amount of reserves required under the mutual guarantee scheme is a function of three features of the shared liability arrangement: 1. The mutual guarantee scheme is designed as a preventative measure, i.e. potential financial distress situations are to be identified as early as possible and countered by means of a system of progressive interventions before they become worse. This also effectively addresses the potential for moral hazard. The mutual guarantee scheme is equipped with the means necessary for the early identification of risks and with adequate intervention options. The shared liability aspect makes this comprehensive internal arrangement compatible from an incentive standpoint. Early intervention prevents problematic developments from escalating into a full-blown distress situation in which deposit guarantees can only be upheld by means of substantial allocation of reserves. 2. With a few exceptions, the cooperative shared liability arrangement is comprised of relatively small banks. Because of this granular structure the Cooperative Group benefits from risk diversification, rendering the potential for unexpected losses relatively low, so that these would with reasonable assurance be covered by an adequate reserve fund. 3. The deposit and lending businesses have always been the primary focus of the member retail banks. The Cooperative Group banks are well-established in these segments. This eliminates the potential for Cooperative Group banks taking on excessive risk as a result of lack of a concrete business model.

4. The mutual guarantee scheme in place within the Cooperative Group is – with respect to (a) its design, (b) current functioning and (c) compliance – equivalent with a properly designed deposit insurance scheme in terms of (1) the safety of deposits, (2) financial system stability and (3) pro-competition considerations.

This opinion concerning equivalence is based primarily on specifics particular to the banks in the Cooperative Group and pertaining to the implementation of the mutual guarantee scheme within the VR Banking Group. Empirical evidence supports this opinion, the BVR having been able at all times to achieve its objectives without having to accept government assistance. The VR Banking Group's mutual guarantee scheme furthermore remained stable during the financial markets crisis. Comparability is given when the objectives (1) and (2) can be attained at

reasonably adequate levels and commensurate cost without giving rise to competitive distortions (particularly from an overall economic standpoint). Cost would not be commensurate if there is an inappropriate increase in moral hazard. Three conditions must be fulfilled for comparability to be in evidence: (1) The survival of the bank is only secured if it has a viable business model after restructuring. (2) The security scheme must be capable of early verification of distress situations, and be equipped with the necessary authority and means to conduct restructuring/reorganisation. (3) It is in the interest of the member banks to support the survival of a bank in distress. In our view the VR Banking Group's mutual guarantee scheme fulfils these three criteria.

5. There are three salient issues in relation to the VR Banking Group's mutual guarantee scheme requiring attention: risk concentration, profitability and compliance. In our view these concerns do not represent acute problems, but must be specifically and constantly monitored by the retail banks (as the controlling entities of the Cooperative Group), regulators (Federal Financial Supervisory Authority/BaFin and the Bundesbank) and the National Association of Cooperative Banks (BVR). We do not, however, consider regulatory legislation to be necessary at this time, or in the foreseeable future.

5.1 DZ Bank and WGZ Bank represent a special challenge for the mutual guarantee scheme of the BVR due to two specific characteristics: both banks are large, and their business models are distinctly different from that of the retail banks (for the good reason that these banks perform special functions). The significance of this problem should not be underestimated, but in fairness the concentrated risk created by these central group banks within the VR Banking Group is not large in comparison to concentrated risk within other banking groups, and the existence of concentrated risk is not a criterion distinguishing mutual guarantee schemes from pure deposit insurance schemes. It must also be considered that the retail banks, as the controlling entities within the VR Banking Group and as shareholders of the central Group banks in particular, exercise control over the central group banks, so concentrated risk is not an unaddressed issue.

5.2 If the profitability of the Cooperative Group should suffer due to competitive pressures, this would undermine the functional effectiveness and sustainability of the mutual guarantee scheme. If income and cost problems were widespread within the Banking Group, there would be a risk of the mutual guarantee scheme not being effectively implementable, and moral hazard would pose an acute problem. Profitability thus must be carefully and constantly monitored by the retail banks, regulators (BaFin and Bundesbank) and the National Association of Cooperative Banks (BVR).

5.3 In our view – with respect to (a) design, (b) current functioning and (c) compliance – internal regulation adequately addresses the moral hazard that the mutual guarantee scheme gives rise to. Compliance in relation to institutions and individuals responsible for internal arrangements for avoiding moral hazard must be specifically and constantly monitored by the retail banks (as the controlling entities of the Cooperative Group), by regulators (the Federal Financial Supervisory Authority/BaFin and the Bundesbank) and by the National Association of Cooperative Banks (BVR).

6. The proposed EU regulation unnecessarily restricts freedom of contract thereby inflicting 'collateral damage' upon the VR banks. Furthermore, the specific measures are flawed. The European Commission has evidently held the view (until now) that deposit guarantee standards must depart from the subsidiarity principle, as otherwise distortions result in depositor decision-making. Undoubtedly regulation at the EU level is relevant to our integrated financial market, as exploitation of inconsistent national standards is possible and has occurred in some cases. We believe however it is not called for or objectively justified to address this potentially critical issue with a maximum harmonisation approach. The Commission argues: "In times of stability, allowing differing coverage amounts can lead to depositors choosing the product offering the highest guarantee/insurance amount instead of the product that best suits them." This argument is insubstantial, however. The guarantee level is, after all, a defining characteristic of what makes a product most suitable. Undeniably, though, competitive distortions can arise. When governments allow banking groups to offer guarantees they cannot properly fulfil, this is equivalent to indirect aiding and abetting. In such case a race may result to see who can offer the biggest unmeetable guarantee, the effects of

which no country can effectively avoid. Accordingly, it appears entirely legitimate to oversee and regulate competition-distorting guarantees at a European level. It is indeed inherently **inappropriate** for banks operating on a **high-risk** business model to be members of a guarantee scheme offering a **high level** of insurance protection. Banking groups that choose to operate on a conservative business model with binding internal regulations on the other hand should be allowed to offer a different guarantee level, as they are in fact safer, and the funds necessary to back up this guarantee can be secured exclusively by private funding.

1 Introduction and full summary

This opinion paper was written against the backdrop of

- the 2007-2010 financial markets crisis and
- the European Commission draft legislation for a common deposit insurance scheme in the EU

Commissioned by the National Association of Cooperative Banks (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, BVR), this opinion paper is to address in particular the structuring and sustainability of the bank deposit insurance model in place at VR Banking Group, which rests upon the mutual guarantee scheme member banks participate in. This opinion paper is organised into three sections:

- The authors of the paper contend that deposit insurance and mutual guarantee systems cannot be understood without a fundamental understanding of the economics behind deposit account contracts. Accordingly, a detailed discussion of deposit account contracts is provided as a preamble to a presentation of the mutual guarantee scheme in place at BVR banks. Aspects of the deposit account contract are identified calling for regulation, in response to which every economically developed country has established guarantee schemes for and regulations governing customer deposits. These banking regulations themselves cannot be properly considered out of relation to the deposit account contract between banks and depositors.
- Sections 3 and 4 of the paper are devoted to discussing the special organisational form “Verbund” of the VR Banking Group and the structuring of the bank mutual guarantee scheme. In the following the German Cooperative Banking Group is referred to as the VR Banking Group. The Group consists of the German cooperative banks, most of which are Volksbank and Raiffeisen brand banks, the two central Group banks and a number of other group organisations including mortgage lenders, Bausparkasse Schwäbisch Hall, the investment company Union Investment, R+V Versicherung and the National Association of Cooperative Banks (BVR). It is outlined how the VR Banking Group is organised as an association of legally independent banks, representing a special and proven organisational solution for a complex enterprise

organisation problem. The VR Banking Group represents an organisational alternative to a corporate group, characterised by both solidarity and independence. It is then outlined how shared liability is a logical element of the VR Banking Group arrangement. In our view it is unlikely that the organisational form of a Verbund is a sustainable business model unless shared liability is a feature; in any case regulation substantially affecting the mutual guarantee scheme would grossly compromise freedom of contract. We then provide an opinion on the special structuring of the mutual guarantee scheme in place at the BVR (BVR MGS).

- In section 5 the reasons are outlined why we consider the EU Commission proposal to be overregulation. The European Commission evidently holds the view that deposit protection standards must depart from the subsidiarity principle, as otherwise distortions result in depositor decision-making. We do not deny the existence of jurisdictional externalities, especially in the integrated European financial market, justifying some regulation; jurisdictional externalities occur when a country enacts regulations that have repercussions on other national economies which are not internalised by contractual arrangements or prices. We believe, however, that it is neither necessary nor objectively justified to address this potentially critical issue with a maximum harmonisation approach.

In this introductory summary the structured argumentation of the paper is presented in bullet-point fashion. The full discussions are set forth in the sections following.

The deposit account contract is a classic banking product. It is thus important to first elucidate why it is banks that offer such a product. The prevailing opinion is that banks provide economic utility by offering deposit accounts, which fund lending, and deposit-related transaction services. This is not something that goes without saying, as investments unquestionably can be financed by other means than bank loans funded by deposits. Nor is there a natural connection between this specific means of financing and transaction services. Section 2 is devoted to examining the thesis that *bank deposits as a financial instrument, and related payment services, create economic utility.*

History has demonstrated and theoretical analysis suggests that this arrangement is not always a stable one. There have been many instances of bank runs in which depositors have suffered financial losses. Bank runs substantially damage the economy as well. Thus both logic and experience dictate that deposit insurance schemes are a good idea. Deposit insurance schemes may hinge upon government guarantees or solidarity arrangements benefiting the economically weak (protective function). And the economic utility of deposit accounts speaks in favour of there being a bank deposit protection scheme. If bank deposits did not afford significant economic utility, a protective function could be achieved without significant problem other than by protecting bank deposits. Therefore we contend: *In light of the potential for instability and losses suffered by the economically weak, it is appropriate to establish deposit insurance schemes, as these can ensure protection, stability and efficiency.*

The increased security comes at a price though, as insurance schemes create moral hazard. When consumers are assured of their deposits being safe at all times, they have very little incentive to consider the financial soundness of the bank where their deposits are kept. Banks conversely are incentivised to adopt riskier business policies, and banks operating on a poor business model may exploit this to attract deposits. Under ideal market conditions, increased risk would entail higher funding costs or immediate withdrawals of deposits. If the market does not internalise the acceptance of risk on a price basis and in an absence of other effective sanction mechanisms, a risk arises of banks – weaker banks in particular – taking on too much risk rather than pursuing restructuring, for example. Both logic and history support these assertions, thus it must be considered that *deposit insurance gives rise to distortion effects*.

In conclusion: *A good deposit insurance scheme will take account of this problem by attempting to internalise risk-taking through risk-based contributions and by deploying monitoring and regulation mechanisms*.

In section 2 the following theses are advanced on the basis of economic and historical considerations:

1. The specific service of banks offering deposit accounts plus related transaction services creates economic utility.

2. In light of the potential for instability and losses suffered by the economically weak, it is appropriate to establish deposit insurance schemes, as these can ensure protection, stability and efficiency.
3. Deposit insurance gives rise to distortion effects.
4. A good deposit insurance scheme will take account of this problem, by attempting to internalise risk acceptance through risk-based contributions and by deploying monitoring and regulation instruments.

In Sections 3 and 4 an examination is provided of the Cooperative Group as an organisational form and of the mutual guarantee scheme as implemented by the BVR group banks. We characterise the Cooperative Group as a special form of organisation combining elements of centralisation – similar to a corporate group – with features of a franchise system and of a strategic alliance between independent banks. The VR banks are legally and commercially independent business enterprises. As a Cooperative Group, however, they share a common corporate identity. In section 3 the argument is advanced that *the VR Banking Group is a distinct organisational form with proven advantages, the following four of which are salient:*

1. The ability to establish a common brand name that signals quality.
2. Shared utilisation of risk management instruments (like VR Control and VR Rating) and joint marketing capture synergies.
3. The Cooperative Group permits more effective risk diversification, both through the use of modern risk management tools too expensive for a single bank to employ and through the transfer of risks within the member banks of the Cooperative Group.
4. The shared liability arrangement creates positive incentives and solidarity effects that foster group-internal management and self-regulation.

The mutual guarantee scheme is a core element of the Cooperative Banking Group. The administration unit of the VR Banking Group's mutual guarantee scheme receives contributions and holds guarantee pledges from member banks. The mutual guarantee system involves preventive measures, providing assistance to banks in or at risk of encountering financial distress and realigning their business policies to return them to viability, thereby ensuring their survival. This mutual guarantee system is designed to avoid the necessity for making

depositors whole under deposit insurance by ensuring that the bank remains a going concern. And in fact the VR Banking Group banks have been successful in protecting depositors in this manner ever since the introduction of the mutual guarantee scheme in 1934. The shared liability aspect of the mutual guarantee scheme has multiple functions:

1. It fosters depositor confidence. As members of a cooperative group, banks that individually are quite small enjoy greater stature and the insurance effect of the VR mutual guarantee scheme.
2. The security mechanism the VR mutual guarantee scheme provides solves an information problem. Depositors concerned about the financial position of certain banks on the basis of negative news cannot know whether their bank is affected. In such case they may withdraw their deposits as a precaution, thereby exacerbating the bank's difficulties. Having substantially more information than depositors, the solidarity scheme administrator is able to demonstrate the ability to take effective action by implementing preventive and restructuring measures.
3. The binding shared liability arrangement makes the Cooperative Group an association with concrete incentives for internal regulation and management.
4. The shared liability arrangement clearly represents an answer to the 'too-big-to-fail' problem. While big banks enjoy a de facto government guarantee, the VR Banking Group banks achieve the same thing on their own.

As with deposit insurance – albeit perhaps to a greater extent – there is a risk of banks taking on too much risk under the mutual guarantee scheme and offering distortive terms to attract funds (such as deposits). It is therefore necessary to examine what mechanisms are in place for addressing moral hazard. Our analysis indicates that both

- the bylaws governing the mutual guarantee scheme in place at the VR Banking Group, and
- the modus operandi of the mutual guarantee scheme

are adequate (a) in design, (b) at this time and (c) with respect to compliance to address the problem of moral hazard. This opinion is based on our assessment of the business model employed and the

internal regulations/management in place at the VR banks. The fact of member banks not being stock corporations does create negative incentives, as the company owners are less exposed to loss risks, but the owners are in many cases clients of the banks, so they have no interest in the speculative practices that typically get banks into trouble.

While our opinion is fundamentally positive, we would make note of the following qualifying points:

- DZ bank and WGZ bank pose a particular challenge with regard to the sustainability of the shared liability arrangement. Accordingly, special rules for and oversight of these banks are in order. DZ Bank and WGZ Bank represent a special challenge for the mutual guarantee scheme due to two specific characteristics: both banks are large, and their business models are distinctly different from that of the retail banks (for the good reason that these banks perform special functions for their shareholders). The significance of the problem should not be underestimated, but in fairness the concentrated risk created by these central banks within the VR Cooperative Banking Group is not large in comparison to concentrated risk within other banking groups, and the existence of concentrated risk is not a criterion distinguishing mutual guarantee schemes from pure deposit insurance schemes. It must also be considered that the retail banks, as the controlling entities within the VR Cooperative Banking Group, exercise control over the central group banks, so concentrated risk is not an unaddressed issue.
- As external consultants hired to provide an expert opinion, we have not had opportunity to observe the detailed functioning, i.e. in day-to-day use, of the mutual guarantee scheme over an extended period of time. However, we have not become aware of any indications that the VR mutual guarantee scheme does not function adequately. The primary reason why the cooperative mutual guarantee solution represents a sustainable business model is the fact that it has functioned and continues to function **without a government** subsidy. However, the Cooperative Group solution does not simply run itself, but rather requires adequate interbank arrangements. In our opinion the architecture of the Cooperative Group such as it is at this time is adequate in this respect, i.e. in terms of compliance. These conclusions were arrived at on the

basis of institutional economic analysis, published data and several detailed discussions with representatives of the VR and the VR-MGS.

- The VR Cooperative Group banks have to constantly succeed in competition to remain profitable. Should the VR Cooperative as a whole experience income or expense problems, this would threaten the incentive architecture of the cooperative shared liability arrangement. While the Cooperative Group has demonstrated itself to be strongly committed to and strategically focused on the issue of protection in view of the robustness of the scheme employed, other areas have not seen the same degree of strategic focusing. There is thus a risk of being slow to respond to structural changes in the financial sector, leading to income or expense problems that jeopardise solidity. The broad scope of the promised protections demands a high level of solidity within the group.

Section five is devoted to discussing the European Commission's proposed deposit insurance regulations. In our view, adopting maximum harmonisation as an approach would result in overregulation. The European Commission evidently holds the view that deposit protection standards must depart from the subsidiarity principle, as otherwise distortions result in depositor decision-making. Undoubtedly regulation at the EU level is relevant to our integrated financial market, and consistent standards should be and have been implemented in some cases. We believe however it is not called for or objectively justified to address this potentially critical issue with a maximum harmonisation approach. The Commission argues: "In times of stability, allowing differing coverage amounts can lead to depositors choosing the product offering the highest guarantee/insurance amount instead of the product that best suits them." This argument is insubstantial, however. The guarantee level is, after all, a defining characteristic of what makes a product most suitable. This is particularly the case for households that the Commission considers to be especially in need of protection. Undeniably, though, competitive distortions can arise. When governments allow banks to offer guarantees they are unable to properly fulfil, this is equivalent to indirect aiding and abetting. In such case a race may result to see who can offer the biggest unmeetable guarantee, the effects of which no country can effectively avoid. Accordingly, it appears entirely legitimate to oversee and regulate competition-distorting guarantees at the European level. It is on the one

hand inherently inappropriate for banks operating on a high-risk business model to be members of a guarantee scheme offering a high level of insurance protection. Banking groups that choose to operate on a conservative business model with binding internal regulations, on the other hand, should be allowed to offer a different guarantee level, as they are in fact safer.

Aside from radically departing from the subsidiarity principle, the regulation features gaps and errors. The uniform deposit insurance level proposed is one such design error in our view. The specific wording of the proposal means that contributions may fall to zero once the fund has reached its target level. Contributions would then no longer have any controlling effect on behaviour, giving rise to moral hazard and regulation arbitrage. Tying a target level to deposits furthermore does not adequately factor in banking risk, i.e. the probability of deposit insurance benefits being payable. That too encourages large-scale misconduct. The uniform target level additionally does not take account of the differing granularities of bank systems.

Lastly we come to examine whether and in what way the proposed regulations may jeopardise the mutual guarantee scheme in place within the VR banking group. Restrictions on the appropriation of funds represent the biggest problem for the mutual guarantee scheme, which involves the utilisation of funds in such a matter as to avoid the payability of insurance benefits to depositors by virtue of the bank concerned being able to continue operations after assistance has been provided. This model has worked well for the VR banks since 1934. The regulations require funds in connection with financial security mechanisms to be utilised primarily for deposit insurance payouts. The Commission argues that this is because funds earmarked for deposit insurance are not to be used for the benefit of (or to subsidise) other counterparties. Under the VR scheme, all counterparties benefit, as depositor protection proceeds from the financial security and support provided to member banks in solidarity. Non-depositors do in fact benefit from this arrangement, but there is a cost; the guarantee of support is ‘purchased’ in effect by adherence to a conservative business model. It therefore cannot be argued that the mutual guarantee scheme promotes uncontrolled risk-taking. The self-regulation mechanisms are designed in such a manner that potential distortions are internalised.

The cooperative mutual guarantee solution creates a level of security for all VR bank counterparties as a by-product, but this can be jeopardised by tampering. The proposed regulations allow resources to be appropriated for prevention purposes, but set an appropriation limit that may be binding based on fund volume, especially in the accumulation phase. If no solution were to be found regarding this limit, the VR mutual guarantee scheme would in fact be jeopardised.

Conclusion: The Cooperative Group is an organisational form that has proven its value in the banking industry. The mutual guarantee scheme and shared liability arrangement between member banks are logical and most likely essential elements of the Cooperative Group, as long as internal regulation and management properly address the problem of moral hazard. Particularly in light of the reforms enacted in recent years, the architecture of the Cooperative Group is adequate for meeting the present challenge. If enacted, the proposed regulations would create numerous misincentives. The legislation would represent overregulation because it uses far-reaching standardisation measures to respond to a market and political failure. It would also significantly jeopardise the Cooperative Group system, as principal elements of the internal regulations system would be affected. The focus on prevention inherent to the system should continue to be put to effective use, as it reduces the potential for ignoring risks and for speculation leading to financial distress.