

THE FUTURE FOR DEPOSIT INSURANCE

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Abstract

This paper considers some major issues that need to be addressed in replacing the current crisis measures for the protection of depositors in Australia and New Zealand. It argues that the attitude to insurance has changed and that most countries now feel almost all bank deposits should be insured. Secondly it argues that any scheme even where deposits are uninsured needs to give customers virtually uninterrupted access to their banking facilities. It also draws attention to the need for credible funding arrangements and a clear basis for handling cross-border banks.

Before the financial crisis most OECD and other advanced countries except Australia and New Zealand had come to the view that limited explicit compulsory deposit insurance was necessary for retail bank deposits, where banks are defined quite widely. Of course there were wide variations in the nature of the schemes they applied and most other exceptions were in the direction of greater coverage.¹ Now all of these countries have explicit and extensive deposit insurance. Implementing blanket guarantees of various forms is a normal reaction to a severe crisis. Confidence needs to be restored. For the general public this means a guarantee that they will not suffer loss from participating in the banking system, although such guarantees do not normally extend far into other financial instruments. In some countries, New Zealand and Australia included, the comprehensive insurance is temporary and the question now arises of what the permanent regime should be. Before the crisis Australia appeared en route for adopting the then consensus while New Zealand was not exploring plans for insurance.

The experience of the crisis has shown that much of traditional deposit insurance was poorly designed, the most striking deficiencies being observed in the UK and Iceland. The obvious deficiencies that need to be corrected are that, if

¹ France, Italy and Norway for example covered almost all retail deposits.

schemes are to be effective, they must be able to pay out rapidly, as people are not willing to accept inability to access their funds for more than a few days and second they must be adequately funded and have ready access to such extra finance as is necessary to make their ability to pay out believable. There was no way that any comprehensive deposit insurance could have been possible in Iceland where deposits were around 10 times GDP. The question then is why did people accept such an obviously unviable system? The answer was of course that they did not expect banks to fail – or if they did fail the expectation was that they would be bailed out by the taxpayer in some way or other.

In much of western Europe bank failures were largely unheard of or where they did occur losses had been limited or rescues with or without recapitalisation were the norm. This time round the general perception has been vindicated. Few bank depositors have lost their deposits, whether or not the deposit insurance scheme could cope. The UK is perhaps the clearest example. Nationalisation (Northern Rock), government recapitalisation (RBS, Lloyds Group), orderly resolution with the assistance of comprehensive deposit insurance (Dunfermline Building Society) have all been used. Where depositors in the UK branches of Icelandic banks found they would not be compensated (over the reasonable future) by the Icelandic authorities, the authorities stepped in and paid out, seeking repayment from the Icelandic authorities when they could manage it.²

Some of the confusion at the international level stems from the fact that the United States has been relatively different. Deposit insurance elsewhere is largely a relatively new phenomenon but in the US bank failures have been more frequent and the scale of losses such, particularly in communities where the impact was concentrated, in the course of the Great Depression that the need to act was politically essential. Federal deposit insurance was therefore introduced in 1935. There was therefore a major contrast between the US scheme as comprehensively revised by FDICIA (the Federal Deposit Insurance Corporation Improvement Act) of 1989 and many other countries. The US had a scheme that was used and worked and indeed was able to cope with the present crisis. However, in general terms the scheme is designed to cope with small numbers of failures in a framework of generally stable

² The coverage has not been total as there have been losses for people who made deposits through Guernsey and the Isle of Man and for public authorities.

and well run banks. There are many criticisms about the quality of prudential regulation in the US and the system may well be softer than that in much of Europe and Australia. But nevertheless the system works because the vast majority of banks can survive without intervention. Where there was intervention the standard deposit insurance scheme could cope even in the greatest crisis in 75 years. However, the problems with Citibank and Bank of America did require special intervention and had not Wells Fargo been willing to buy Wachovia that too would have required special intervention through what is known as the systemic risk exception.³

The purpose of the discussion here therefore is to consider in the light of the crisis what is required for adequate depositor protection. Section 1 considers how extensive coverage should be. Section 2 considers what form payout should have, while Section 3 considers the necessary extent of funding. However, Section 4 focuses on the critical issue which relates to New Zealand, namely how to handle foreign owned banks. While most countries have addressed the other aspects of the reform of deposit insurance, cross-border banking, particularly in Europe remains a problem that is politically to difficult to resolve.

1 Coverage

As part of the review of deposit insurance, the International Association of Deposit Insurers (IADI) and the IMF have drawn up a set of principles for insurance.⁴ The early sections cover the purpose of insurance and as a consequence the appropriate coverage. The principles suggest that there are multiple objectives and as a result this means that policy will be a more difficult compromise. There are two main concerns. The first is that the ordinary person, who does not have the ability to monitor and manage risks should have their 'normal' (transactions) deposits covered. The second is that deposit insurance should contribute to the maintenance of confidence in the

³ See Mayes (2005) for an exposition of this mechanism that has not been invoked until the present crisis.

⁴ *Core Principles for Effective Deposit Insurance*, February 2008, available at http://www.iadi.org/docs/Core_Principles_final_29_Feb_08.pdf.

system such that there are not retail runs on banks that are solvent – even if they are temporarily illiquid. These two requirements have different implications.⁵

Covering the first objective entails an empirical assessment of the size of deposits, so that large majority of deposits of ordinary depositors are fully covered. Take the case of the UK for example. Even before the present crisis, the £35,000 limit covered around 95% of depositors fully in the case of the failure of Northern Rock and over 90% of deposits.⁶ (There was a specific problem with the UK's insurance scheme in that it involved 10% co-insurance after the first £2,000 so that most people were not fully covered. As a result it will be rational for anyone with over £2,000 in deposits to run on a bank at the first hint of trouble so that they can recover 100% and not 90% of the remaining deposit. Co-insurance is now a dead idea.⁷)

The size of deposits will of course be endogenous as people will be influenced by the extent of insurance. Nevertheless, insurance of £35,000 per depositor per bank is likely to cover the vast majority of the population. Even with 5 main banks as in New Zealand, this would mean that any individual would be covered for up to \$250,000 if the coverage for them in each bank were \$50,000. Not many people who are not actively managing their savings and have little ability to sort out their risks would have holdings in excess of this. Hence the new ideas of coverage up to \$100,000 or \$200,000US provides a considerable excess on this criterion. Indeed encouraging people to hold their financial wealth up to \$1million in bank deposits could provide problems for capital markets while enabling more stable finance for banks.

The arguments for these larger amounts are based on concerns for financial stability rather than protection of naïve depositors. The larger coverage is the more costly is the process of providing insurance, as funding has to be commensurate.

⁵ 'The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and to protect less-financially-sophisticated depositors.' (from Core Principle 1, p.2, op. cit.).

⁶ Mayes and Wood (2008) offer an exposition of the Northern Rock crisis and its implications for deposit insurance.

⁷ The idea behind co-insurance was mainly that if depositors had something at stake they would pay much more attention to the behaviour of their bank and that the threat that they would exit if there was any suspicion of a problem would act as effective discipline on the bank to avoid running excess risks. However, in practice people do not monitor their banks and in any case it is likely that major retail banks do not expect to fail so the element of discipline is in practice absent.

Assuming that insurance is funded through levies on the banks, this implies simply that there will be a higher tax on bank deposits.

2 Rapid payout

Perhaps the greatest lesson from the present crisis – given that co-insurance was unusual – was that unless the ability to pay out is virtually immediate, people will run on a troubled bank just to make sure that they do not face disruption in their payments and risk adverse evidence on their credit rating. This is not new. Kaufman (2007) explains this as the need to protect people against both credit risk and liquidity risk if runs are to be avoided. The US system has been designed so that this is possible so that one of two main payout routes can be followed. Either the deposits are taken over by another bank/owner or the depositors receive cheques from the insurer. In countries where cheques are no longer used some means of issuing credits to an account with another institution is required. Even with transferring deposits to another bank, either the failing bank's systems have to be operated by the new bank or a rapid and complex transfer between institutions has to take place with a very simple instruction issued to depositors about how to reactivate their accounts.

When the Bank of England implemented its new arrangements under the Banking Act of 2009 for the first time in the case of the Dunfermline Building Society, the time for closure of the system while the transfer took place was only two hours. However, it required two months of careful preparation to get to this point. It is therefore inevitable that unless there is sufficient time as the failing bank gets into increasing difficulty to find another bank that will take on the deposits for an agreed fee from the deposit insurer, some means of keeping the bank's payment systems going without interruption will be required. A bridge bank operated by or under the aegis of the deposit insurer is an obvious solution. The arrangements proposed for New Zealand, but not as yet implemented, of being able to write down the deposits and other claims on the bank within the value day while placing the bank in statutory management, might work as a substitute. In practice, however, changes are likely to be necessary.

Such speed means that it must be possible to identify insured deposits almost immediately, thus netting of liabilities would be impossible⁸ and detailed knowledge

⁸ The previous UK system related to net deposits.

of the banks' computer systems would be required. In the US it is requiring special provisions to enable the FDIC to handle the largest banks in the required time frame.

3 Funding

As mentioned above the insurer needs to have in place arrangements such that it can pay out or pay an acquirer of the deposits immediately. This implies that it either has to have adequate funds or that it can draw immediately without impediment on the necessary funds. The latter would normally imply the ability to borrow from the government until such time as a new levy can be imposed on the remaining banks but recent innovations in contingent capital would also work. For example, the insurer could issue bonds whose servicing could be suspended in the event of a crisis. Clearly any funding cannot be contingent on the agreement of the government at the time and must be a credible pre-commitment.

4 Cross-border banks

The above discussion relates to banks that fall largely within a single jurisdiction. Once banks run across border there are complications to deposit insurance. Some of these are technical in the sense that depositors may be subject to different insurance benefits depending upon the country of registration of their bank. This will clearly affect competition in the country. In the EU a foreign bank can purchase extra insurance from the local insurer to bring its coverage up to the level of the local market. But if its home market already offers a higher level of insurance it cannot reduce the insurance nor can its competitors top up their insurance to that level. Clearly if New Zealanders could get a higher level of insurance protection by holding an account at a branch of an Australian in New Zealand this could have severe competitive effects on the New Zealand and main Australian banks whose subsidiaries would be subject to the New Zealand system.

However, what is far more difficult is when the regulator of the bank in one country cannot control the exposure of their deposit insurance fund. For example, failure of the bank could be the result of weak supervision in another jurisdiction or the result of a decision to close by the supervisor of the parent. There is a concern over fairness for those who have to pay if they are subjected to harsher supervision yet have to pay in the event of failure. There is unlikely to be any route for compensation through to the other country.

Secondly, powers over what can be done in the event of failure will be limited to the specific jurisdiction (even under the EU's Winding Up Directive). Host country authorities will be very much subject to the decision of the home country. If a parent is closed it may be difficult to keep the subsidiary running. Under the Special Resolution Regime in the UK, the administrator of the failed institution has to continue to provide the necessary services to keep surviving parts of the bank operating until such time as alternative arrangements can be made. Such requirements are not enforceable across borders. Only two routes seem viable to resolving this. One is to have a single federal level of jurisdiction which covers the whole banking group. The other is to make sure that the parts of the bank are properly separable on a national basis so that each authority can make their own decisions. Australia and New Zealand are already being managing the exposure by choosing the route of practical separability but many other countries round the world including the EU have not resolved the problem.

Without separability it seems likely that there will be inequity across borders unless there are some arrangements for cross-border payments. New Zealand for example could effectively free-ride on the Australian provisions for the parent and Australia could impose costs on the New Zealand taxpayer. The situation is complicated by the fact that the Australian authorities have made it clear that their four main banks will effectively not be allowed to fail. Thus all the New Zealand authorities would need to insure against is the prospect that the New Zealand subsidiary might fail while the parent survives. While there is no 'source of strength' requirement that ensures that this will not happen, reputation risk may very well mean that in practice such a failure is rather unlikely because of the knock on it would have in Australia.

We could speculate what would happen if Australia and New Zealand were to follow the single jurisdiction route, which would effectively entail a joint deposit insurance regime, complicated only by the existence of two currencies, but such a prospect is a long way off.

5 Concluding remarks

Australia and New Zealand need now to decide how to handle deposit insurance after the present temporary measures expire. These measures reflect the crisis and are more

generous than most countries thought necessary before the crisis. However, it seems as if most other countries will stay with a high coverage limit.

In practice Australia has implicit insurance while the arrangements to use bank creditor recapitalisation or other immediate routes to ensuring continuity of access to deposits have not been tried in practice. It is clear from the crisis that people need uninterrupted access to their deposits if a run is to be avoided. That needs to be worked on right away. While it exists theoretically for the larger banks through the insolvency regime in New Zealand no such arrangements are in place for the smaller banks and uninsured depositors would simply be caught up in the insolvency proceedings and could have no access to their funds for a substantial period and a long time before they find out the extent of the final payout.

It would thus appear sensible for both countries to introduce a scheme that handles the liquidity problems of depositors in small banks. However, implementing such a scheme for part of the industry would be difficult unless it were to be funded by the taxpayer. Deposit insurance schemes normally cover the entire sector. This would imply an explicit scheme. In practice this would pose little problem for Australia as it would replace an implicit scheme by an explicit scheme and would enable the government to place the burden on bank depositors rather than the taxpayer although the overlap between the two groups is substantial. New Zealand has a much greater problem as it only has implicit insurance for the depositors of large banks insofar as the Bank Creditor Recapitalisation scheme is not a reality. In the present crisis it distinguished between small and large banks in the financing of insurance. The large had to pay whereas the small enjoyed a taxpayer financed arrangement. This might well therefore be the solution followed in the future. Since typically it is small banks that fail rather than larger ones, this creates an interesting moral hazard and potential liability.

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