DEPOSITOR PRIORITY AND RIGHTS OF SET-OFF (NETTING)

Abstract

The ranking of depositors among the creditors of insolvent deposit-taking institutions, rights of set-off, and the collateralisation of claims vary between countries because of different legal traditions and different public-policy objectives. These factors can influence significantly the behaviour of the deposit insurer and other financial safety-net participants, deposit-taking institutions, and depositors and other creditors, and may affect the cost of providing deposit insurance or resolving troubled institutions.

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This paper, which was prepared by the Subgroup on Depositor Priority and Rights of Set-Off, discusses issues for deposit insurance systems that are associated with depositor priority, rights of set-off and collateralisation.[1] It is based primarily on the judgment of the members of the Working Group and the experience of various countries that have addressed depositor priority, rights of set-off, or collateralisation issues for deposit insurance systems. The paper also makes use of relevant literature on the subject.

Background

Frequently, the failure of a deposit-taking institution will result in a formal liquidation under the auspices of an official. In some cases that role is assumed by a deposit insurer or some governmental body, while in other cases an independent outside party, for example, a licensed professional, is appointed. A liquidator (by whatever title described) usually is charged with turning the insolvent entity's assets into cash and distributing the proceeds among claimants according to their ranking as determined by a country's statutory or decisional law.[2]

For the purposes of this paper, depositor priority describes the phenomenon of giving a particular category of depositor claims some superior right to share in the distribution of the proceeds of liquidation of the assets of an insolvent entity. Sometimes elevated ranking attaches to the nature or quality of the claim and sometimes it turns on the identity or status of the claimant.[3]

Collateralisation is defined to be the taking of a mortgage, pledge, charge or other form of security by a creditor over one or more assets of a debtor. Generally, whether a claim is collateralised will be a function of private bargaining, although that may take place in the context

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[1] The Subgroup is comprised of representatives from Canada (coordinator), Germany, the International Monetary Fund and the United States.

[2] The failure of a deposit-taking institution does not always involve a liquidation. A restructuring of the institution or its balance sheet may protect its creditors fully or at least provide them with more than they would receive in a formal liquidation.

[3] Priority is usually not something that creditors and debtors can create by private bargain but is a function of statutory law (for example, the priority afforded to domestic depositors in the United States) or decisional law (for example, the priority given to claims of "the Crown" by the common law of England and a number of countries that have inherited the English tradition). Parties can at times bargain to choose the form of their transaction so it will result in a type of claim that enjoys priority or, in the negative sense, they can bargain for subordination, so that the claim ends up with a lesser ranking than it otherwise would enjoy. Some countries allow "equitable subordination," under which a court may, for one or another of a variety of reasons (for example, to sanction perceived wrongdoing), move a creditor's claim down to a lower ranking than it otherwise would enjoy.

of statutory limits or requirements. Collateralisation can affect both the assets and the liabilities of a bank.[4]

The term set-off is used to refer to the situation where the claim of a creditor against an insolvent entity is to be deducted from a claim of that entity against the creditor. Typically, the effect of set-off is to extinguish the cross-obligations to the extent that they are in matching amounts. Set-off is, by nature, a form of netting, but the latter term frequently is used to describe arrangements where obligations are off-set in circumstances, or by means, that fall outside of the bounds of the law of set-off as traditionally understood.[5]

The laws regarding depositor priority, rights of set-off, and collateralisation can affect recoveries in the event of insolvency. In countries where the deposit insurer becomes subrogated to the rights of the insured depositors against the failed institution, the rules governing the allocation of assets in an insolvency can influence the behaviour of the deposit insurer significantly, as well as the financial safety-net participants, deposit-taking institutions, depositors and other creditors, and they may have a significant effect on the costs associated with providing deposit insurance.[6]

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[4] Legislation may restrict the persons to whom, the purposes for which, or the extent to which an institution is permitted to collateralise its obligations, or it may require that certain obligations be collateralised. Sometimes collateralisation arises from statute and sometimes collateralisation is mimicked as a means of providing priority (for example, where a statute provides that a certain class of creditors or claims is to be paid on a first-recourse basis out of a particular category of assets). In some countries, a claim against somebody can be a deposit with a bank that can be collateralised by taking security over the deposit, which can affect eligibility for deposit insurance coverage. The claimant can be the bank itself, in which case this can be viewed as a special form of set-off.

[5] For example, many arrangements for the clearing and settlement of claims among multiple participants (such as the exchange between banks of customer cheques) rely on multilateral netting to reduce the number of payments required to be made at the end of a settlement cycle, so that A may satisfy an obligation that it owes to B by paying an obligation that B owes to C. There tends to be different views between common law and civil law systems over the issue of set-off. Common law jurisdictions generally regard it as “unfair” to require a party to pay its debt to an insolvent entity in full and receive only a fractional dividend on the insolvent’s debt to them. Many civil law jurisdictions view it as “unfair” to allow a debtor of the insolvent to avoid paying its debt by deducting the amount of a claim against the insolvent that is not fully recoverable. In practice, many jurisdictions that have historically barred rights of set-off in insolvency have adopted special rules permitting netting arrangements and the like for particular purposes, such as derivatives transactions.

[6] Subrogation of the insurance entity to the rights of insured depositors (or an equivalent arrangement, such as a requirement that depositors assign their claims in order to receive insurance payments) is an important feature of many deposit insurance systems. Subrogation allows the deposit insurer to “stand in the shoes” of the depositor when dealing with the liquidation of the deposit-taking institution. Under traditional legal principles in many jurisdictions, an insurer is not entitled to take over the rights of the insured unless and until the insured has been fully indemnified for their loss. Consequently, in jurisdictions with explicit, limited-coverage deposit insurance that principle usually is overridden by legislation enabling the deposit insurer to take over a depositor’s claim to the extent of the insured portion. In some cases, the insurer will rank equally with any remaining (uninsured) claim of the depositor. In contrast, in some systems the deposit insurer is entitled to use the depositor’s claim to recover the insurance payment before the depositor may recover on his uninsured balance (thus effectively placing the insured portion of the total deposit ahead of the uninsured portion). In most cases, the rights of the insurer as subrogee of the insured depositors against the failed institution rank no higher than the claims of the depositors would rank if they were not insured. An additional implication of subrogation is that the deposit insurer often will end up being a primary creditor in the liquidation, and so will enjoy a degree of influence or control over the conduct of the liquidator, which the depositors would be less likely to achieve by individual or collective action, given the comparatively small stake that each would have compared to the aggregate position of the insurance organisation.

Although collateralisation, depositor priority, and rights of set-off may not operate on the same basis and may have different sources, their economic effects may prove to be the same. In the simplest legal systems, the race between competing creditors may go to the swift. However, the state may intervene only so far as to adopt legislation placing all claimants against an insolvent entity on an equal footing in the distribution of assets. In other legal systems, determining the ranking of a particular claim or a particular creditor may be a matter of extremely fine discrimination, and perhaps considerable complexity.[7]

Depositor Priority: Approaches and Implications

Depending on the specific arrangement, the relative ranking of depositors can affect the behaviour, incentives and costs affecting a deposit insurer. For instance, a system that gives depositors high priority can allow depositors (and a deposit insurer if it is subrogated to the rights of depositors) to recover in full before other claimants are compensated.

However, depositor priority may not always reduce costs to depositors and deposit insurers. When depositors are given a higher ranking than other creditors, the potential loss exposure of the lower-ranking creditors may be increased. This, in turn, may increase the incentives for lower-ranking creditors to exercise more market discipline than otherwise would be the case. Non-deposit creditors can take actions to better protect themselves, including collateralising their claims, shortening their terms of maturity, or imposing additional charges.[8] However, much will depend on the types of non-deposit creditors, the actual ability of these creditors to collateralise their claims, and what is allowed in individual countries.[9] It is probably safe to say that only very large creditors of a bank would be in a position to collateralise their claims effectively in most cases.

As a means of mitigating expected losses, non-deposit creditors may exercise early withdrawal. Early withdrawal can drain liquidity and exacerbate pre-existing problems. Given these considerations, a troubled institution's liability structure (and the changes it can undergo during times of financial stress) would play a role in determining the degree to which depositor priority lowers a deposit insurer's costs.

Depositor preference could lessen the incentives for depositors to exercise market discipline if they believe that the priority accorded to their deposits in an insolvency would prevent them from experiencing any losses. It also could lessen incentives for the deposit insurer or the supervisor to act promptly in dealing with problem banks, thereby potentially raising the costs associated

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[7] The degree of clarity in a nation's statutory or decisional law may influence significantly the bargaining power and behaviour of creditors and debtors. Precisely because there are "not enough assets to go around" in an insolvency, the decision to give particular creditors or types of claims priority, or to permit (or not) collateralisation, may produce an opposite (but not necessarily equal) reaction. In some countries, the law provides for specific time limits associated with the pursuit of claims by creditors, which can affect eligibility for deposit insurance coverage.

[8] Nevertheless, many countries impose limitations on the extent to which a bank can provide collateral for liabilities. Public-entity depositors often require highly marketable securities for collateral, even though these typically make up only a small portion of the assets of many large banks.

[9] It should be noted that in the case of many small banks, groups such as trade creditors can make up a sizeable portion of non-deposit creditors. These types of creditors may not be in a position to collateralise their claims.

with resolving a troubled institution. It has been suggested that depositor preference legislation in place in some countries has created incentives to liquidate rather than pursue other strategies, such as sales or mergers of troubled banks. However, although there may be some incentives pushing deposit insurers in these directions, it also has been observed that strong governance and accountability frameworks can offset these incentives.

Depositor priority arrangements also may have implications for financial-system stability. Some argue that giving depositors priority over key payments-system creditors, such as central banks or commercial banks, can raise the costs of capital (for example, unsecured debt may have to be priced at higher rates) and may lead to a higher risk of contagion. Others take the view that depositor priority has limited implications for capital costs and stability issues.

All of these actions potentially can offset the original benefit of priority for both depositors and the deposit insurance system. Empirical studies of the effect of such behaviour have been limited and there does not appear to be any clear evidence that depositor priority reduces or raises net resolution costs.[10] The final outcome of depositor priority on costs and the behaviour of stakeholders appears to rest on a wide variety of country-specific legal and economic factors.

Collateralisation: Approaches and Implications

The extent to which collateralisation is permitted or required can affect the ability of depositors to recover in the event of a bank failure, and, thus, can affect the incentives, behaviour, and costs of a deposit insurer. Some countries give depositors a priority that supercedes even the rights of secured creditors of a failed institution. In other countries, depositors, along with all other unsecured claimants, share only in the unencumbered assets of the insolvent entity.

There are trade-offs in allowing or requiring deposit-taking financial institutions to give security. Where there are limits on institutions doing so, there are implicit trade-offs in the choice of the types of creditors to whom, or the purposes for which, institutions are permitted or compelled to collateralise their obligations.

Collateralisation is used to facilitate commercial transactions, such as in the derivatives markets. If a financial institution is unable to collateralise its obligations, it may be forced either to pay risk premiums or be excluded from participation in a given market. In the simplest sense, unsecured creditors face diminished recoveries if a failed institution's assets have been encumbered. Further, there may be beneficial effects from a supervisory perspective, such as when a regulator would prefer the institution to hedge certain of its exposures with derivatives products. In many instances collateralisation is a two-way street—that is, party A must put up assets in favour of party B in order to receive security for party B's obligation to party A. If party A is financially strong there will be no harm to its unsecured creditors. It also may benefit from being able to transact on favourable terms with party B, while mitigating its credit risk.

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[10] Marino, James A., and Rosalind L. Bennett, "The Consequences of National Depositor Preference," *FDIC Banking Review* 12, no. 2: 19–38, 1999.

Collateralisation also is used to provide assistance for transaction arrangements that carry significant systemic risk. For example, deposit-taking financial institutions may be required to post collateral in order to participate in payment clearing and settlement systems and the like. Countries that encourage, or even require, participants to collateralise their obligations in these types of arrangements, have effectively decided that the value of eliminating, or at least minimising, credit risk to the other participants is worthwhile. Finally, collateralisation frequently is required as a condition for obtaining government accounts, such as tax, social benefit and other such claims.

When collateralisation is extensive, unsecured creditors have greater incentive to effect early withdrawals, shorten maturities or impose additional charges as a means of mitigating expected losses. Extensive collateralisation of a financial institution's assets also may impinge on the ability of a deposit insurer or a supervisory authority to assist a troubled depository institution. The ability of secured creditors to withdraw large blocks of assets from the control of a troubled institution could impede the ability of an institution to address its problems.

Rights of Set-off: Approaches and Implications

When rights of set-off are available or imposed in an insolvency proceeding, the net recoveries of creditors who also are debtors of the failed institution may be improved significantly. This, in turn, may diminish the recoveries of other unsecured creditors. Allowing or imposing set-off can reduce the number of individual creditors and debtors of the insolvent entity that will have to be dealt with in the liquidation. The subsequent reduction in administrative costs may provide some benefit to other creditors.

Various arrangements for the netting of claims increasingly are being used and being given legislative protection in the belief that doing so provides systemic benefits. For example, allowing the cross-obligations of the participants in systems for the clearing and settlement of payments to be netted, lessens the credit risk of the other participants in the event of the insolvency of one participant. This reduces the possibility of one participant's insolvency having a contagious effect on other participants.[11] Furthermore, a number of jurisdictions (including those generally opposed to set-off) have adopted laws to protect the operation of the close-out netting provisions found in the prevailing standard documentation for derivatives transactions. This enables participants in derivatives markets to effect transactions that might not be available to them if the contemplated netting was not assured, or at least to effect transactions on more-favourable pricing than would be the case if counterparties exacted risk premiums because of uncertainty over the availability of set-off in insolvency. The cost of netting by participants in derivatives markets are bourne by the other creditors if an institution fails.

Additional issues to consider regarding set-off include whether it should apply regardless of the status of the loan or whether it should apply only when the loan is due or in default. Set-off

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[11] Although set-off can be regarded as a tool to help reduce credit risk, it carries with it some legal risk in that netting contracts may not be legally enforceable in all the countries in which an institution operates and each type of netting has differing degrees of enforceability in the case of default. See, International Monetary Fund, *Orderly and Effective Insolvency Procedures*, (1999).

against a performing loan could result in a "call" on the loan to a viable business. As a result, many countries restrict set-off to cases where the loan is in default or has matured. Even in jurisdictions where set-off generally is accepted, there may be issues surrounding the extent to which set-off should apply. For example, if a liquidator is permitted, or required, to set the failed institution's obligations off against loans due to the institution that are in good standing, the result may be to diminish the value of that portfolio of loans as a realisable asset. As well, while the focus of insolvency law tends to be on the creditors of the failed entity, in the case of a deposit-taking institution there may be as many, or even more, borrowers whose arrangements might be disrupted.

For example, suppose that an individual has a $10,000 deposit with the bank and a $100,000 residential mortgage from the bank payable in blended monthly instalments over five years. If the $10,000 deposit is to be set-off against the mortgage debt, is it to apply to the first $10,000 owing on the mortgage after the date of failure, or the last $10,000 owing at maturity of the mortgage, or spread in some fashion over the monthly payments falling due between the date of the failure and the maturity of the mortgage? If the deposit is not insured, the borrower in this example may place far more value on being able to effectively "recover" his $10,000 deposit in full than on having his mortgage loan paid in accordance with the contractual schedule. On the other hand, if the $10,000 is insured, the borrower may well prefer his or her loan payments to remain on the original schedule.

The latter example illustrates that co-ordination issues can arise between the rules of set-off and the operation of a deposit insurance system. For example, suppose that a depositor with $100,000 of deposit insurance coverage has a deposit of $150,000 and a loan of $75,000 from a troubled bank. If set-off is not available, the depositor will receive $100,000 from the insurer, will have to pay his or her $75,000 loan in full and will obtain on the $50,000 uninsured portion of the deposit only such fractional dividend as may be paid by the liquidator. Both the depositor, for his or her $50,000 claim, and the deposit insurance organisation, for its $100,000 claim, will share, along with all other creditors of the failed institution, in the value of the asset represented by the depositor's $75,000 loan.

Suppose, instead, on the same facts, that set-off is available. The issue will then arise whether set-off ought to be effected before or after calculating the deposit insurance payment. To put the same matter another way, there will be an issue whether the deposit insurance is to be paid on the gross amount of the deposit or only on the net amount remaining after set-off. So, if the deposit insurance system requires the insurer to pay $100,000 to the depositor as a gross basis, he or she will be left with a $50,000 uninsured balance and a $75,000 claim for set-off against that balance. In the end result, the depositor will obtain full recovery of his or her $150,000 deposit and be left owing a $25,000 loan balance to the failed institution. On the other hand, if set-off is taken first, then the $75,000 loan will reduce the $150,000 deposit to a net $75,000 and the deposit insurer then will pay $75,000. In this example, the depositor will achieve complete recovery of his or her deposit and complete satisfaction of their obligation as a borrower. The deposit insurer will pay less than under the first variant—although the difference is not entirely black and white, since under the first variant, while paying $100,000 instead of $75,000, the deposit insurer would share, along with other creditors, in the asset represented by the depositor's $25,000 loan balance owing to the liquidator. One might say that in the first variant the deposit insurance applies to the “first” $100,000 of the deposit and in the second variant it applies to the “last” $75,000.

This example illustrates that countries setting out to design a deposit insurance system must consider the effects of netting. Policymakers must decide either how to tailor the coverage to achieve whatever might be the desired effect, in light of the degree to which rights of set-off operate on the insolvency of deposit-taking institutions, or whether to give the deposit insurer a somewhat different position than creditors generally enjoy.

Conclusions

There is a great deal of variation between countries in the ranking of depositors among the creditors of failed institutions. These differences can be attributed to different legal traditions as well as different public-policy objectives. The particular ranking of depositors, along with the rules governing the availability of set-off or collateralisation, as established by a country’s legal system, usually are not subject to change by the deposit insurance system.

The ranking of depositors can influence the incentives and costs affecting a deposit insurer. Systems providing for depositor priority in the event of insolvency have the potential to lower costs for a deposit insurer. However, this may be offset to a large extent, depending on the ability of other creditors to obtain collateral for their claims, initiate early withdrawal of funds and take other measures. There also may be reductions in incentives to exert market discipline from those receiving the benefit of priority.

Depositor priority arrangements also may have implications for the stability of the payments system and the financial system, although it is not clear the extent to which they can influence capital costs, the effectiveness of payment systems, or the risk of contagion.

Rights of set-off can vary significantly from one country to another. Some countries stress the importance of set-off, while others take a less favourable view, believing that it can contribute to unequal treatment.

If set-off is to be allowed in the case of depositor claims, restricting the set-off application to instances when the loan or other obligation owed by the depositor to the failed institution is due or in default may provide better conditions for the resolution of the failed institution.