FEDERAL DEPOSIT INSURANCE CORPORATION
STAFF PAPER

BUILDING CREDIBLE AND EFFECTIVE DEPOSIT INSURANCE SYSTEMS

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Introduction

In the last several years, jurisdictions around the world and the international regulatory community have made many changes to their regulatory frameworks in an attempt to respond to the causes and challenges of the 2008 financial crisis. It is, therefore, timely to identify some of these new regulatory tools and explore the role of deposit insurance in this post-financial-crisis environment, and to determine further efforts to ensure that deposit insurance systems around the world remain credible and effective.

New Toolkit

The financial crisis revealed a number of weaknesses and gaps in the regulatory system and, in particular, in the ability of government authorities to deal with widespread losses and the failure of a systemically important financial institution (SIFI) without exposing taxpayer funds to risk. This led to significant financial reform initiatives such as the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States and the Bank Recovery and Resolution Directive in Europe, as well as sweeping changes in global standards for deposit insurance, supervision, regulation, and resolution.

Deposit Insurance

The International Association of Deposit Insurers (IADI) updated its Core Principles for Effective Deposit Insurance Systems in November 2014. With the changes, IADI captured many of the lessons of the crisis and enhanced the effectiveness of deposit insurers and the financial safety net.

Supervision

The Basel Committee on Banking Supervision accomplished a series of post-crisis reforms that set higher requirements for loss absorption, established standards for higher-quality capital, and improved methods to measure bank risks. This work included a leverage ratio requirement, capital buffers to mitigate sources of systemic risk, and standards to measure and limit excessive liquidity and maturity transformation activities.

The U.S. federal banking agencies took further steps and strengthened the quality of regulatory capital, increased the level of risk-based capital requirements for all banks, and—importantly—established enhanced leverage ratio requirements for the largest, most complex banking organizations. They also finalized new rules that established requirements for liquidity and use of margin, and limited the use of the government's banking safety net to support proprietary trading.

Deposit insurers should be keenly interested in these developments—particularly those affecting capital requirements—because they affect not only the amount of risk that insured institutions take on, but the capital regulations also determine how much resources are available to absorb losses before a deposit insurer's guarantee is invoked.

Resolution

Also, post crisis, the Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system, and The Group of Twenty (G20) established "Key Attributes of Effective Resolution Regimes for Financial Institutions."[1] These attributes established international standards and best practices for countries as they develop and implement resolution frameworks designed to minimize financial distress and taxpayer loss.[2]

To support this framework, jurisdictions around the world enacted expanded authorities for the resolution of SIFIs—without causing systemic disruption or permanent recourse to taxpayer support. These developments also are of great importance to deposit insurers as the resolution regime defines the timing and the conditions that trigger the exercise of the deposit guarantees.

Among the new authorities is the process of bail-in, which is the legal requirement to impose losses on creditors of a failing or failed institution. Imposing losses may include writing down or writing off instruments, as well as converting creditor liabilities into equity interests in the institution (debt-to-equity conversion). This practice, then, introduces the need for sufficient unencumbered, uninsured liabilities at the entity subject to resolution.

To meet this challenge, regulators introduced a concept called Total Loss-Absorbing Capacity (TLAC).[3] The FSB issued guidance on TLAC in November 2015.[4] The new TLAC standard provides

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[1] The Group of Twenty (G20) is an international economic forum composed of 19 countries and the European Union.

[2] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 15, 2014.

[3] Financial Stability Board, Principles on Loss-Absorbing and Recapitalisation Capacity of GSIBs in Resolution: Total Loss-Absorbing Capacity (TLAC) Term Sheet, November 9, 2015.

[4] The Federal Reserve Board proposed a rulemaking which is broadly consistent with the FSB's TLAC Term Sheet: Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for

that each of the largest institutions have a minimum level of loss-absorbing capacity, including long-term debt and excess equity capital. It also requires that a significant amount of this TLAC be pre-positioned in material subsidiaries in foreign nations so that these entities can be recapitalized in resolution.

The goals of this resolution approach are to:

- assure that the failing firm can be promptly closed
- assure that critical services of the failing firm's operating subsidiaries can be maintained through resolution
- minimize the risk that host authorities would liquidate hosted operations to satisfy the claims of local creditors in a manner that is inconsistent with the home resolution strategy or adversely affects the ability to maintain the critical functions of the firm in resolution.

The Continued Need for a Robust Deposit Insurance System

Under a framework in which bail-in and TLAC provide a principle means to resolve firms, it follows to ask what role deposit insurance will play in the failure of a large firm. One view may be that deposit insurance is not necessary in a bank required to have TLAC, and that deposit insurance is relevant only for smaller institutions.

A view with which deposit insurers around the world should perhaps most concern themselves is that the very introduction of bail-in and its reliance on TLAC might affect depositor behavior and create uncertainties that could increase the likelihood of runs. This would be further complicated if deposits are part of TLAC.

Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies, November 30, 2015, to be codified at 12 CFR Parts 217 and 252.

Role of Deposit Insurance

At its most basic level, deposit insurance serves the goal of financial stability in three ways—protecting retail and other small depositors, minimizing the risk of depositor runs on banks, and mitigating the risk of contagion:

Protects retail depositors and small businesses. Deposit insurance within prescribed limits protects a significant proportion of retail depositors and small business owners, who are generally unprepared to assess the condition of the bank that they rely on for payments.

Minimizes the risk of runs. A bank run, characterized by the abrupt withdrawal of demand deposits by depositors, puts a significant strain upon the deposit-taking institution due to the asset-liability maturity mismatch. Because deposit insurance provides protection for insured deposits, even in the event of a bank failure, it reduces the incentive for retail depositors to run. Deposit insurance has an added advantage of reducing the chance of liquidity problems causing an otherwise healthy and well-capitalized institution to fail.

Mitigates contagion risk. Because deposit insurance mitigates depositor uncertainty, it also mitigates contagion risk. When a banking industry that lacks robust deposit insurance encounters asset problems, small depositors are unable to know which banks are safe. Without deposit insurance, depositors of *all* banks may fear financial losses and feel compelled to withdraw funds to safeguard them. This fear is as likely to cause a run on a healthy and well-capitalized institution as on a failing institution. Deposit insurance provides customers with the certainty that their savings are safe in any insured bank. Insurance reduces a customer's compulsion to withdraw funds in a panic, and, in doing so, promotes financial stability.

In the United States, deposit insurance has been a fundamental component of public confidence and financial stability for over 80 years and through three banking crises. These latest post-crisis tools outlined above are building upon that foundation of confidence.

Put simply, while bail-in and TLAC are designed to *assign* loss to select creditors as failure occurs, deposit insurance is designed to *absorb* loss for retail and small-deposit creditors and mitigate the tendency to run under conditions of uncertainty. Thus, in a world of bail-in and TLAC, deposit insurance also will be necessary to help provide the means of transition through resolution.

Deposit insurance eliminates loss for a minimum level of covered deposits, provides continuity of basic banking services, and mitigates the risks of runs and contagion. Insurance decreases the chance of failure for otherwise healthy and well-capitalized banks. Preventing the spread of runs and contagion contains a crisis. Authorities can then administer bail-in, focus on the source of the banking problem, and assure a more orderly resolution process.

The confidence provided by deposit insurance extends beyond depositors alone. A banking system supported by a strong core of federally insured deposits can withstand considerable stresses and strains. Also, uninsured creditors and other financial market participants can remain confident in our overall banking and payment systems.

Expansion of Deposit Insurance in the Crisis

The importance of deposit insurance was most apparent during the crisis that began in 2008. As Chart 1 shows, deposit insurance systems were enhanced and given expanded powers as countries came to realize its value in maintaining financial stability.

During the crisis, temporary government guarantees on non-deposit liabilities were put in place, including in Ireland, Korea, the United States, and Australia.[5] Coverage limits were increased across the European Union, in the United States, and in several other jurisdictions. Co-insurance systems—in which depositors must risk small losses because the deposit insurance covers less than 100 percent of a depositor's account balance—were largely removed because co-insurance increases the likelihood of bank runs. Sixteen countries had co-insurance in 2003, but only three still had co-insurance by 2010.

In the United States, where deposit insurance had been in place for 75 years at the time of the crisis, significant features were added to coverage as a means to increase depositor confidence and decrease the risk of flight. These included increases in insurance limits and, for some deposit classes such as non-interest bearing transaction accounts, temporary, unlimited coverage was provided.

[5] Asli Demirgüç-Kunt, Edward Kane, and Luc Laeven, Deposit Insurance Database, IMF Working Paper WP/14/118, International Monetary Fund, July 2014, 10.

Finally, it is noteworthy that 28 jurisdictions introduced explicit deposit insurance schemes between 2005 and 2015.[6] In Europe, the European Commission has proposed establishment of a European Deposit Insurance Scheme.

Retail depositors, businesses, and banks themselves have come to realize the importance of deposit insurance in maintaining core funding, business operational integrity, and broad confidence in the system. For example, Chart 2 shows how sharply deposits grew in the United States during the financial crisis. The growth rate was over 20 percent in 2008, which is more than double the long-run average. Moreover, Chart 3 shows that U.S. banks are relying less on volatile wholesale funding sources, such as repurchase agreements, or repos, that were used during and immediately following the crisis.[7] Instead, they have increased retail deposit-taking operations, from a low of 56 percent of liabilities in 2007 to 73 percent in 2015.[8]

Making Deposit Insurance More Credible and More Resilient

In a future crisis where bail-in is imposed, deposit insurance systems around the world must stand ready. Their ability to reassure nervous depositors, and minimize the chance of instability caused by runs, will be critical to governments that desire to resolve a SIFI without exposing taxpayer funds to risk. In achieving these goals, there are some key attributes of a credible and effective deposit insurance system that need to guide us forward.

Funding

The success of deposit insurance depends importantly on its funding and the reliance of that funding. This was recently highlighted in an update to IADI's Core Principles for Effective Deposit Insurance Systems.[9] There must be readily available funding to respond to problems and meet payout needs as they arise. Delays in payouts to insured depositors at the closing of a failed bank saps confidence in the systems and risks igniting its own crisis.

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[6] The number of jurisdictions is based on the IADI Annual Surveys and the World Bank Deposit Insurance Database of 2013.

[7] Wholesale funding decreased from 19 percent to 11 percent between 2003 and 2015 for all public U.S. commercial banks, according to FDIC staff analysis of SNL Financial data.

[8] Source: FDIC staff analysis of SNL Financial data.

[9] International Association of Deposit Insurers, IADI Core Principles for Effective Deposit Insurance Systems, Uses of Funds, November 2014, 29–31.

Thus, there needs to be a heavy emphasis on ex ante funding provided by the banking industry that benefits from deposit insurance. Further, this funding should be backstopped with lines of credit to assure the ability to pay all insured parties and maintain depositor confidence. Alternative arrangements—such as pay-as-you-go or ex-post assessments—increase the risk of payout delays, risk undermining confidence, and risk increasing the ultimate cost of failure. The result of these risks is a broad undermining of confidence in the system.

Capital Requirements and Prompt Corrective Action

Strong capital requirements for the insured bank are an essential part of any successful deposit insurance program. Equity capital holders are an important means for controlling risk-taking by bank management. Owners are not insured and, thus, they have every incentive to oversee the proper operations of the bank. Also, equity capital absorbs losses that would otherwise affect depositors, and it is an essential buffer protecting the deposit insurer from having to make excessive payouts, which would threaten the solvency of the deposit insurance fund. Thus, deposit insurers have a stake in how well banks are capitalized and play an important role in the ongoing debate occurring among Basel committee members and others about the appropriate capital requirements for banks.

In addition, a key mechanism to effectively utilize capital for risk and loss mitigation is a prompt corrective action framework.[10] The prompt corrective action framework in the U.S. system defines minimum capital ratios and imposes progressively tighter restrictions on an institution's activities once these minimums are breached.

Supervision

An effective insurance program must include a means to identify, measure, and manage risk. This applies at the time insurance is granted and as long as the insurance remains in force. While the FDIC is not the primary federal regulator of all FDIC-insured institutions, all FDIC-insured institutions are subject to the same, or very similar, regulatory framework, and the FDIC has backup authority should it become concerned with the condition of any institution it insures.

[10] Prompt Corrective Action was introduced through the Federal Deposit Insurance Corporation Improvement Act of 1991 and is codified at 12 U.S.C. § 1831(o).

Resolution Planning

Finally, the FDIC's history of resolution confirms that planning is essential for timely resolution of failed banks and payment of depositor claims. The financial crisis reinforced that lesson and brought about some additional authorities and requirements to help in the resolution of failed institutions and the payment of depositor claims. One such authority is the FDIC's role in receiving and assessing the quality of the resolution plans—the living wills—required of the largest bank holding companies.[11] The FDIC implemented a complementary resolution plan requirement for the largest banks operating in the United States.[12]

Conclusion

Jurisdictions, regulators, and deposit insurers around the world made many changes after the last financial crisis, including enhancing supervisory standards and expanding resolution authorities to include requirements for bail-in and TLAC. Deposit insurance systems have been enhanced and expanded since the crisis as well. Despite these improvements, deposit insurance systems around the world must be even better prepared for the next crisis. The success of deposit insurance in the future will depend on adequate funding arrangements, strong bank capital requirements and prompt corrective action, effective supervision, and planning for resolution of failed institutions.

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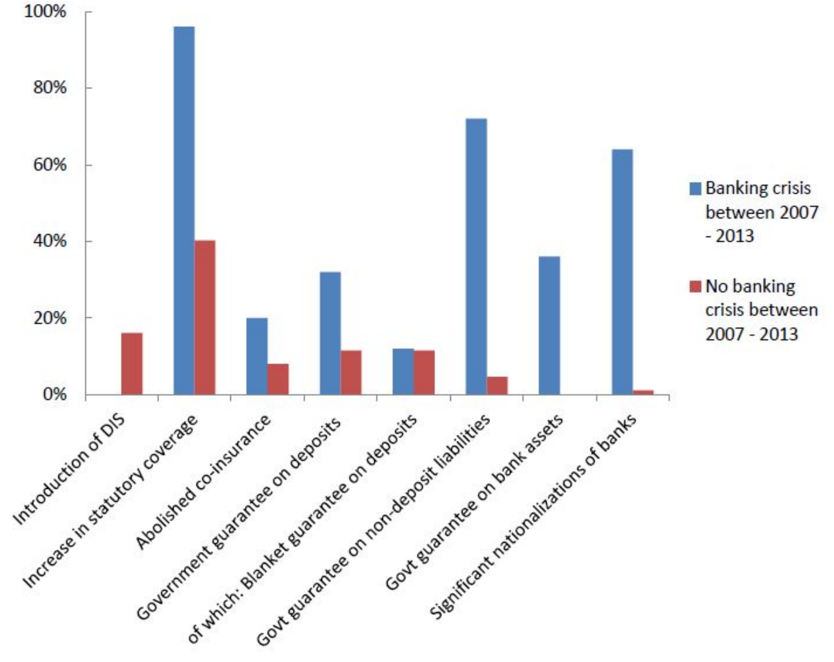
[11] The Dodd-Frank Wall Street Reform and Consumer Protection Act requires that bank holding companies with total consolidated assets of $50 billion or more periodically submit resolution plans to the Federal Reserve and the FDIC.

[12] The FDIC issued a separate rule that requires all insured depository institutions with greater than $50 billion in assets to submit resolution plans to the FDIC through the FDIC's traditional resolution powers under authority provided by the Federal Deposit Insurance Act, 12 U.S.C. § 1819(a) Tenth (12 C.F.R § 360.10 was added at 76 Fed. Reg. 58389, on September 21, 2011, effective January 1, 2012 and amended at 77 Fed. Reg. 3084, January 23, 2012, effective April 1, 2012).

Chart 1

Increase in Depositor Protection, 2007 to 2013

% of countries with an explicit deposit insurance scheme (DIS)

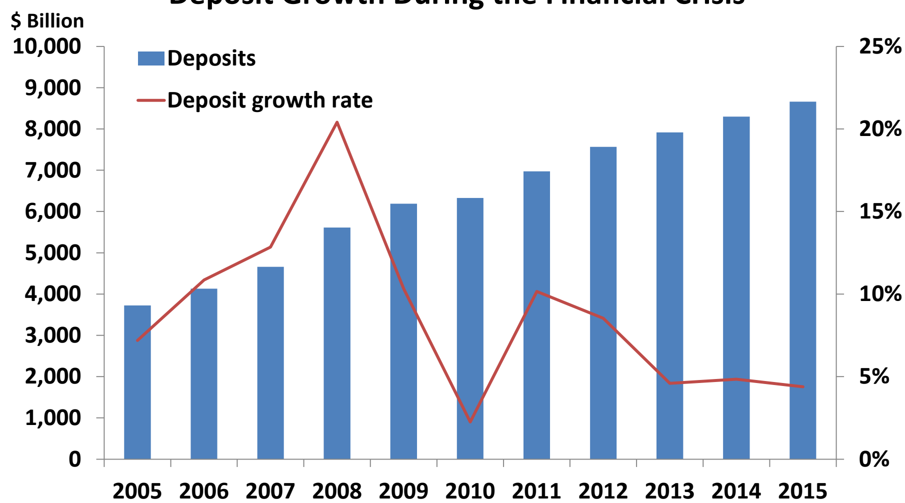


Source: International Monetary Fund

Note: The vertical axis shows the percentage of countries that bolstered deposit insurance schemes (DISs) in relation to each of the attributes shown on the horizontal axis.

Chart 2

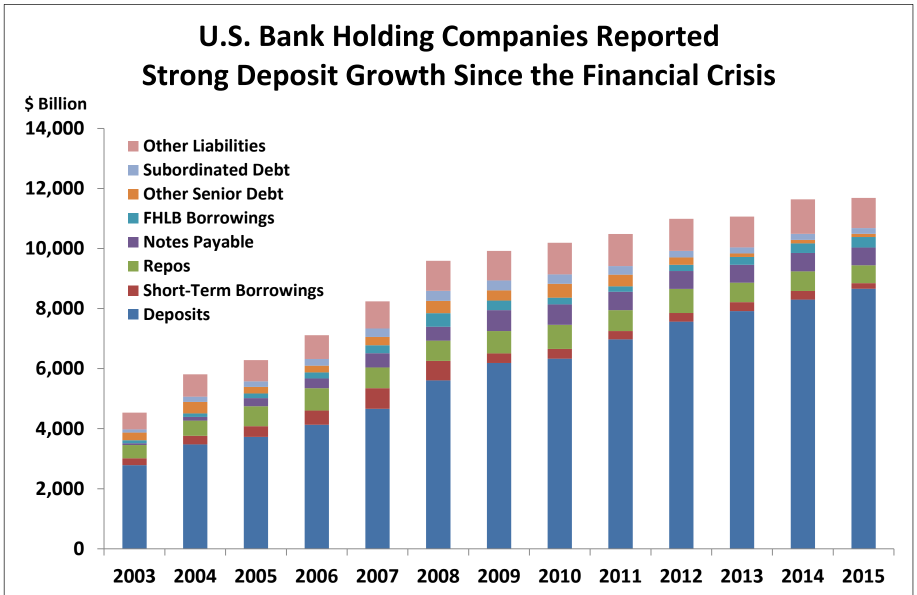
U.S. Bank Holding Companies Reported Strong Deposit Growth During the Financial Crisis



Source: SNL Financial.

Note: Consolidated public U.S. bank holding companies for commercial banks, savings banks, thrifts, and mutuals.

Chart 3



Source: SNL Financial.
Note: Consolidated public U.S. bank holding companies for commercial banks, savings banks, thrifts, and mutuals.