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The expanding role of deposit insurance in the financial safety net architecture

By Jerzy Pruski | Published: 27 January, 2014

Deposit guarantee schemes are vital to maintaining retail customer confidence in the banking system and it is logical to give them a greater role in bank resolution.

The recent financial crisis demonstrated the importance of modernising and updating the traditional safety net model. The rapid cross-border expansion, growth and consolidation of financial institutions in the past 20 years has brought important economic benefits, but also created financial strains and regulatory inefficiencies. These strains culminated in the 2008 to 2009 global financial crisis. The impact of the crisis was to highlight the central role of depositor protection in stabilising expectations and the importance of a coordinated response to the crisis that includes all safety net players.

The safety net framework revolves around the dual objectives of prevention and early intervention of failing institutions, and the resolution, restructuring and depositor protection of failed institutions. The global crisis pointed to limitations in both supervision and resolution in many jurisdictions. Differences in the design and effectiveness of depositor protection regimes were also evident.

An important lesson from the crisis was the need to strengthen available resolution tools. The traditional framework was found to be ineffective for dealing with global financial institutions. Such institutions were too big for private sector recapitalisation and public sector solutions relying on taxpayer-funded recapitalisation or liquidation and bankruptcy were both extremely costly and placed an enormous burden on the economy in the form of accumulated debt.

In response, the Financial Stability Board (FSB) proposed Key Attributes of Effective Resolution Regimes criteria, which introduce specialised resolution tools for large complex institutions. These tools introduce new funding options involving the conversion of creditor claims to equity (bail-in) and the development of specialised resolution regimes for a wide range of financial institutions including insurance companies, fund managers and securities firms.

Maintaining trust

Another important lesson is that the deposit insurer has a far greater role in maintaining financial stability than previously recognised. Three important trends have been identified for the depositor. First and foremost, the deposit insurance community played a central role in weathering the recent financial storm by encouraging private confidence in the financial system and preventing bank runs. This trust in the financial sector stabilised expectations and gave authorities time to implement restructuring measures. In recognition of this central role, the deposit insurance community has been making important enhancements in basic design features, including significantly shortening the reimbursement period, increasing coverage ratios and building strong ex-ante funding for deposit guarantee schemes.

A second emerging trend is the expansion of traditional mandates of deposit insurers from just depositor payout to include resolution responsibilities, system oversight and loss- or risk-minimising functions. This evolution was noted by the FSB in its Thematic Review on Deposit Insurance Systems as well as by the International Association of Deposit Insurers (IADI) annual survey, which found that, by 2012, nearly 70% of deposit insurers had some resolution powers.

The third trend is the inclusion of the deposit insurer in public sector systemic oversight and strategic functions. The deposit insurer has a unique perspective. As the institution responsible for managing private resources held in the deposit insurance fund, the insurer has a strong focus on least-cost-resolution options and ensuring that any restructuring results in a safe and sound financial institution that is viable in the medium term. In this way, the deposit insurer offers a counterweight to pressures for forbearance.

Increasing role

The increasing role of deposit insurers has been acknowledged by the Core Principles for Effective Deposit Insurance Systems, jointly developed by the Basel Committee for Banking Supervision and IADI. This has been further affirmed by the inclusion of the core principles into the FSB compendium of 12 Key Standards for Sound Financial Systems and their application by the International Monetary Fund and the World Bank in Financial Sector Assessment Programme reviews. Also, a project fast approaching completion is an update of the core principles, incorporating past experiences and lessons from the current financial crisis.

Against this background, an active and challenging European discussion on the development of the EU Bank Recovery and Resolution Directive, the Deposit Guarantee Schemes Directive and banking union should be closely watched.

Given these developments, it would be worth considering a more formal framework of robust deposit insurance institutions equipped with broad resolution powers, taking into account the scope of best practices developed in other non-European advanced financial markets. Under such an institutional setting, the overall financial cost for both the deposit insurance system and resolution framework would be reduced given the synergies between the two functions. This argument has been highlighted in the draft proposal of the EU resolution directive.

There are overwhelming analytical and practical arguments in favour of incorporating deposit insurers into the financial safety net. This is already the case in some but not all countries. Likewise, it would be advisable to consider the pros and cons of different institutional models existing in developed and emerging markets, while discussing the establishment of a new regulatory crisis management framework in Europe. Such models are characterised by the strong position of deposit insurers in the financial safety net, an increasing number of which are being equipped with resolution powers.

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