Financial Stability Institute | BIS

How to improve funding of bank resolution in the banking union: the role of deposit insurance

2021 Biennial IADI Research Conference "Navigating the new normal for financial stability, deposit insurance and banking resolution"

Fernando Restoy, Chair, FSI, BIS

11 May 2021

Views expressed are those of the presenter and do not necessarily reflect those of the BIS or the Basel-based standard-setting committees.

THE PROBLEMS WITH THE CURRENT FRAMEWORK

1. Inefficient insolvency regimes
2. Lack of consistency between the common resolution framework and national insolvency regimes
3. No effective mechanism for mid-sized (traditional) banks: the “middle-class problem” (Restoy (2018))

A key issue: lack of effective funding mechanism to facilitate orderly market exit

Source: Restoy, F (2018): "Bail-in in the new bank resolution framework: is there an issue with the middle class?", *Speech*, March.

THE EXISTING FUNDING MECHANISMS

1. Bailout
   - The most common instrument
   - … that is severely constrained in the new resolution framework
2. Creditor's bail-in
   - The cornerstone of the new resolution framework
   - … that justifies stringent MREL requirements
   - … even for banks with resolution strategies based on market exit through transfer transactions

THE EXISTING FUNDING MECHANISMS (cont)

3. National DGS
   - Usable under both resolution and insolvency
   - … but only up to estimated costs of paying out covered deposits in liquidation
   - … a very restrictive financial cap as covered deposits are “super-preferred”
4. Single Resolution Fund
   - Only available in resolution (banks meeting public interest conditions)
   - Limited to 5% of total liabilities
   - Require 8% minimum bail-in

THE ISSUE

1. The current approach consisting of:
   - Stringent minimum bail-in conditions
   - Stringent MREL requirements
   - Preparation of open bank bail-in as a preferred or backup strategy
2. … is internally consistent
3. … but constitutes a perverse equilibrium as it does not allow an effective funding of transaction strategies: the ones more suitable for small and mid-sized banks

THE SOLUTIONS

(following Restoy, Vrbaski and Walters (2020))

1. A comprehensive reform:
   - Modify financial cap for DGS funding
   - Adjust MREL requirements for (more realistic) transfer strategies
   - Modify conditions for access to SRF
2. Remove super-preference of covered deposits
   - … and replace it with a general depositor preference
   - This has a policy rationale
   - … and is more in line with successful experiences (US)

Source: Restoy F, R Vrbaski and R Walters (2020): "Bank failure management in the European banking union: What's wrong and how to fix it", *FSI Occasional Papers, no 15, July*

THE SOLUTIONS (cont)

3. Redefine MREL requirements for banks pursuing SoB strategies
   - Market exit (as in SoB) requires less funding
   - … SoB becomes more likely as available DGS support increases (see above)
   - MREL would, however, be needed
   - … and should be calibrated as to ensure sufficiency of assets to be transferred to the acquirer for it to accept assuming all sensitive liabilities (deposits)
   - MREL for SoB banks should crucially depend on the proportion of non-covered deposits over total deposits
4. Recalibrate minimum bail-in conditions for SRF access
   - Change philosophy: MREL should determine minimum bail-in, not the opposite

THE FINAL COMMENT

1. Funding reforms would make the distinction between insolvency and resolution less profound
2. Strong case for a centralisation of bank failure management and funding (including an EDIS empowered to support SoB transactions)
3. Less ambitious reforms may be practical to achieve political compromises…
   - Relax 8% minimum bail-in without changing the financial cap for DGS support
   - Relax financial cap for DGS support without changing conditions for SRF access
4. … but without a fully effective EDIS, the above partial reforms are likely to become insufficient