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Public consultation on the revised version of the IADI Core Principles for Effective Deposit Insurance Systems

Dear Colleagues,

Ardhill Advisory greatly welcomes the opportunity to participate in the International Association of Deposit Insurers ("IADI") call for public feedback regarding the revised version of the IADI Core Principles for Effective Deposit Insurance Systems ("IADI Core Principles") launched on 12 May 2025.

We support the efforts of IADI members and its Secretariat to review the Core Principles in recognition of the significant changes in technology, bank failures and developments in resolution policy since 2014. We greatly welcome the IADI's attempt in revising the Core Principles to achieve a holistic approach to the financial safety net and effective coordination among deposit insurance, resolution, and supervision authorities.

This revision of the Core Principles comes at an important time following advances in the policy consensus over the last 10 years for ensuring orderly bank failure. The threshold for judging whether failed banks should be resolved rather than liquidated has fallen significantly since the 2008 financial crisis. International standards and domestic policy have developed on how the costs of resolution for large and small banks should be met. These policy standards attempt to consider bank funding structures, economic efficiency and the minimisation of risk to public funds. Regulators have predominantly relied on setting minimum loss-absorbing capacity or "LAC" requirements on large systemic banks, whilst there is an increasing recognition of the role deposit insurance funds play in meeting the costs of small and medium-sized bank resolution. The International Monetary Fund[1] has noted that using deposit insurance funds to meet resolution costs —rather than fund direct payouts of protected depositors — for smaller and medium-sized banks could result in a lower cost of bank failure for deposit insurers. The financial case for enhancing the use of deposit insurer funds in supporting resolution is further bolstered when combined with the growing understanding of the significantly higher proportionate costs to smaller and medium-sized deposit funded banks compared to larger banks of complying with LAC debt requirements.

We support this view that deposit insurer contributions towards resolution costs would always be equal to or lower than the costs incurred in a liquidation and payout of the same bank. This "lesser cost" safeguard aligns the interests of deposit insurers and industry levy payers as it would result in lower overall levies. In addition, this approach ensures seamless continuity of access for all depositors to their funds. Instead, liquidation can result in loss of access to protected deposits for 7 day or longer, and unprotected deposit balances are trapped in what is often a multi-year liquidation process. As a result, the IADI review of the Core Principles provides an important opportunity to advance the objectives of deposit insurers and enhance financial stability by clarifying that their funds can be used to meet resolution costs. In doing so, it will improve economic efficiency of regulation as well as proportionality for small and medium-sized banks.

This consultation response focuses on IADI's revisions to the Core Principles designed to address the role of deposit insurers in supporting orderly resolution of small and medium-sized banks. Changing global macroeconomic conditions increase the need to ensure proportionality, maximise economic efficiency in regulatory requirements and enhance bank resilience to stress. As a result, we believe that revisions to the Core Principles should be designed to clarify that deposit insurers *should* have a paybox plus mandate and the ability to use their funds to support *any* bank resolution costs for smaller and medium-sized banks subject to safeguards as an alternative to LAC requirements. Clarifying this role of deposit insurer will help ensure the continued relevance of deposit insurers in a world where depositors expect ever higher levels of continuity of access to their deposits that deposit insurers current payout processes cannot yet ensure when banks fail.

This report has been drawn up by Eamonn White, Director of Ardhill Advisory. With a background in public service and a priority to advance good public policy, the views in this report have been informed by work as a paid professional advisor. He works for international organisations supporting central banks around the world and to banks considering the institutional, distributional and commercial implications of policy options related to addressing the cost of bank resolution and optimising the role of deposit insurance funds in meeting these costs.

Introduction

In the current conjuncture of geopolitical fragmentation and de-globalization, financial regulators are having to navigate a delicate balance between safeguarding financial stability and economic growth,

[1] See IMF, Chapter VIII, "Sibling Rivalry in the Financial Safety Net: Governance Arrangements for Bank Resolution and Deposit Insurance" Feb 2025 - link.

particularly through their approach to bank regulation. Economic conditions have evolved significantly since the current IADI Core Principles were published in 2014, with many developed economies now experiencing declining productivity and slower growth. This is creating an increased focus on ensuring financial regulation is appropriately calibrated for the current macroeconomic conditions. Equally, we have seen significant economic turmoil related to the impact of the COVID crisis, rising and falling inflation, slowing global economic growth, the bank failures in 2023 and trade disputes which show that crises are no longer a "once in a generation" event. These events reinforce the importance of robust financial safety net arrangements. In this new policy making context, there is an even greater need to ensure that bank regulation is proportionate to the risk. Regulators must focus on implementing their requirements in the most economically efficient manner possible, while preserving financial stability and maximising bank lending capacity that supports investment, innovation and economic development.

To this end, regulators are increasingly focused on clarifying and simplifying regulatory frameworks, calibrating regulatory requirements on banks, and reviewing regulatory policy thresholds as they apply to international standards applicable to smaller and medium-sized banks within the system. This is true for jurisdictions with open trade oriented economics and those with large financial centres. The overarching goal is to cultivate a regulatory environment that not only protects depositors and the financial system from shocks but also actively enables banks to support short and long-term economic growth and maintain competitiveness.

With respect to bank failure management, increasing global and regional economic uncertainty is reducing the risk appetite of resolution authority when considering the impact for financial stability objectives of discontinuity of access for depositors when small and medium sized banks fail. As a result, it is now recognised that it is appropriate for smaller banks that are systemic on failure to enter resolution rather than liquidation and we are seeing more evidence of such changes in authority risk appetite around the world. The Financial Stability Board has confirmed that smaller and medium-sized banks can also be systemic in failure, creating consequences for the financial system or the broader economy if they enter liquidation rather than resolution on failure[2]. The FSB also makes clear that such small and medium-size banks should have sufficient loss-absorbing and recapitalisation capacity available to support orderly resolution. Without this, a credible approach to meeting the costs of resolution defined in advance, there is a risk that resolution of these banks may impact on financial stability, risk continuity of critical functions, and public funds.

Many regulators have predominantly relied on LAC requirements to ensure that shareholders and certain unsecured creditors solely absorb the costs of bank resolution, and thereby protect stability, depositors and public funds. However, LAC compliance costs can be disproportionately high for smaller, predominantly deposit-funded banks. Smaller banks often rely solely on equity capital, the most expensive source of LAC resources, to meet LAC regulatory requirements. The higher compliance costs arise as smaller banks often do not issue the lower-cost unsecured debt instruments in the

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[2] See FSB, "The importance of resolution planning and loss-absorbing capacity for banks systemic in failure: Public statement" - link

capital markets at sustainable prices, which larger banks often rely on to comply with LAC requirements. For example, the impact of LAC debt on US banks is assessed to be c1% of Net Interest Margin ("NIM")[3] compared to a 9.0% - 12.5% reduction for smaller and medium-sized bank banks' NIM (see **Appendix 1** for assumptions underlying this cost comparison). This raises serious concerns about the economic sustainability of LAC debt requirements for smaller and medium-sized banks.

In addition, from a capital market perspective, it may not always be feasible or practicable for smaller banks to issue a meaningful amount of wholesale debt instruments with LAC features. Even if smaller banks can issue LAC debt instruments to comply with LAC requirements at the outset, they will likely be considered niche investments by investors given the scale of the banks, and the size of issuance, and as such, will be considered as less liquid investment increasing the price if issued at all and overall attractiveness to investors in the first place. Ultimately, these factors create questions about smaller bank's ability to maintain continuity of access to wholesale funding markets at sustainable prices on an on-going basis to continue to comply with LAC requirements. These features will be amplified at times of wider domestic and global capital market volatility which we are seeing today due to international trade disputes, geopolitical fragmentation and de-globalization. In such conditions, investors may withdraw from niche, less liquid debt markets and look for haven asset classes. Such structural aspects of capital markets create significant LAC debt refinancing risk for smaller and medium-sized banks.

This may force smaller banks to rely on equity to meet LAC requirements which is expensive. In addition, if banks can issue enough equity, it may not ensure their resolvability. Equity is the most powerful loss-absorbing instrument in going concern. As a result, it might no longer be available to support resolution costs by the time the bank fails. These challenges underscore the need for alternative financing methods to ensure smaller bank resolution is orderly i.e. use of deposit insurance funds.

<u>Bank Resolution Costs: Change International Policy for Smaller and Medium-Sized Banks</u>

A key consideration for authorities in determining whether to set LAC requirements on banks is their funding structure. If banks are entirely deposit-funded or have limited ability to issue additional capital or unsecured debt liabilities (loans or securities) as a source of loss-absorbing capacity, this may constrain a jurisdiction's ability to rely on LAC requirements as the sole mechanism for addressing the costs of bank resolution without requiring banks to issue new liabilities. Authorities need to understand the impact of such a new requirement regarding the market's ability to absorb such

[3] When the US authorities proposed that banks of USD 100 billion in assets issue long-term debt or comply with a LAC equivalent requirement, they estimated the marginal cost to those banks as equal to a c3bp of their NIM. In making this assessment, the US regulators estimate that the eligible external long Term Debt ("LTD") requirement would increase pre-tax annual steady-state funding costs for the analysis population by USD 1.5 billion in the incremental shortfall approach - this approach assumes that current reported principal amount of LTD issuance at covered entities is a reasonable proxy for the levels of such debt that would be maintained in future periods in the absence of the proposed rule. See link for more detail: https://www.federalregister.gov/d/2023-19265/page-64553

additional issuance and the impact such changes in funding structure on the viability of the bank's business model.

Most jurisdictions around the world have focused resolvability expectations including LAC requirements on their larger banks only e.g. G-SIBs, D-SIBs and some non-D-SIBs that authorities assess ex-ante cannot be placed into an orderly liquidation. This reflects their attempt to be proportionate and take a risk-based approach to prioritise those banks that present a risk to financial stability and public funds in the event of their failure and entry into liquidation.

Even if an authority decides not to set an ex-ante resolvability requirement like LAC requirement on a smaller bank, it does not mean that those smaller banks will not enter resolution in the event of failure. For example, in the United Kingdom in 2023, the Bank of England ("BoE") used transfer resolution tools on the UK subsidiary of Silicon Valley Bank which only has around GBP 8 billion of assets[4]. While such action demonstrates that well established authorities like the BoE may choose to use resolution tools to resolve even very small banks, the BoE does not impose ex-ante resolvability requirements on all such banks. Instead, the BoE only sets LAC requirements known as Minimum Requirement for Own Funds and Eligible Liabilities or "MREL" requirements on banks with assets in excess of GBP 15 billion in assets[5].

In the EU, only institutions classified as Significant Institutions ("SIs") are subject to automatic resolution MREL requirements. For example, recital (44) of BRRD II refers to the need to ensure sufficient loss-absorbing and recapitalisation capacity for Globally Systemically Important Institutions ("G-SIBs") and "significant institutions that are not G-SIIs". Under the Single Resolution Board's ("SRB") MREL policy, these firms are defined as "Top Tier Banks" with total assets exceeding EUR 100bn. In contrast, some Less Significant Institutions ("LSIs") are only subject to MREL requirements if a resolution plan is deemed necessary to ensure orderly failure as an alternative to liquidation. The U.S. recently consulted on a rule that would only impose loss-absorbing capacity requirements (i.e. long-term debt requirements) on its banks with assets in excess of USD 100 billion[6]. Under current US regulation, only banks with consolidated assets in excess of USD 250 billion are subject to a long-term debt requirement.

In fact, over the last decade, the majority of jurisdictions set LAC requirements on D-SIBs and G-SIBs only. This likely reflects the fact that such jurisdictions either have large pre-funded deposit insurers capable of ensuring the orderly resolution of non-D-SIBs without LAC (e.g. US, Canada) or are more comfortable using public funds in the event of bank failure (e.g. China, etc.). Those jurisdictions with no pre-funded deposit insurers (or limited access to sources of temporary liquidity) or who prefer to minimise risk to public funds tend to take a more conservative approach to LAC and require non-D-SIBs to meet the requirement (e.g. UK, EU, and Hong Kong).

[4] https://www.bankofengland.co.uk/news/2023/march/statement-on-silicon-valley-bank
[5] https://www.bankofengland.co.uk/paper/2021/the-boes-approach-to-setting-mrel-sop
[6] https://www.fdic.gov/sites/default/files/2024-03/2023-08-29-notice-dis-a-fr.pdf

However, there is increasing international policy discussion of the challenges for smaller, largely deposit funded banks who will be resolved on failure to comply with such LAC requirements. This is a challenge faced by both smaller banks in developed capital market economics and all banks in markets with less developed capital markets. As a result, many authorities are exploring how to increase their flexibility to rely on alternative financing methods to ensure smaller and medium-sized bank resolution is orderly. In the European Union, the Crisis Management and Deposit Insurance ("CMDI") directives are currently under negotiations among member states and consider increasing authorities' flexibility to rely on deposit insurer funds instead of LAC requirements as a means of ensuring smaller banks are resolvable. These live legislative proposals aim to facilitate the recourse to industry-funded resources (namely the national deposit insurers) as a source of funding to finance the resolution of small and medium-size banks in resolution[7].

In the U.K., the Government passed the Bank Resolution (Recapitalisation) Act[8] in May 2025 to provide new powers for the Bank of England as resolution authority to use deposit insurers funds to cover certain costs associated with resolving failing smaller banks. The UK Government has introduced these reforms to address the situations where it would not be in the public interest to place a smaller failing bank into liquidation, but such banks have not been subject to ex-ante LAC requirements or where equity used to comply with LAC requirements has been depleted. As a result, the UK resolution authority must access industry funds to cover resolution costs in over to protect public funds. Use of such deposit insurers funds would be limited to any costs associated with 1) a sale of the institution to a private sector purchaser, or 2) transfer to a temporary bridge bank. The credit rating agency Fitch has assessed the UK proposals as increasing depositor confidence and avoids MREL costs being imposed on these smaller banks which could be "disproportionate and weaken the banks' ability to compete"[9]. Following these recent reforms to enhance the role of deposit insurers funds in meeting resolution costs, the BoE subsequently launched a consultation in October 2024 on a new proposed approach to MREL for smaller and mid-tier banks. This new MREL policy reflects the Act's expanded role for deposit insurers funds to meet any transfer resolution cost for smaller banks. It proposes that UK banks with a transfer resolution strategy will not have a LAC requirement beyond normal prudential capital requirements. This could result in the threshold for banks subject to LAC requirement increasing from GBP 15bn in assets to over GBP 50 billion in assets. This represents a significant recalibration of this important regulatory requirement to increase proportionality to reflect the increased ability to rely on deposit insurer funds as an alternative source of financing to meet resolution costs.

Where other authorities are considering similarly increasing their ability to rely on deposit insurer funds as an alternative to LAC requirements for small and medium-sized banks, they need to consider the interaction between different resolution and deposit insurance statutory regimes. Both regimes are focused on ensuring bank failure is orderly and minimises risk to public funds. Close collaboration is needed between both resolution and deposit insurer regimes to put in place the statutory, policy

[7] See the European Council's negotiating mandate for the European Commission for these legislative reforms for more information - link

[8] https://www.legislation.gov.uk/ukpga/2025/15/enacted

9 See Fitch publication UK Small Bank Resolution Proposals Could Increase Depositor Confidence Mon 15 Jan, 2024 - link

and operational arrangements required to maximise the flexibility for authorities to rely on deposit insurer funds to contribute to resolution costs.

Ensuring deposit insurer funds can contribute to resolution costs - Preconditions

It is important for authorities to have the flexibility for deposit insurers to use their funds to contribute to the cost of resolution as a means of protecting depositors. However, there are a range of essential statutory, policy and operational preconditions to ensure authorities can rely on deposit insurer funds as a credible source of resources to meet smaller bank resolution costs instead of through LAC requirements.

To ensure the deposit insurers capacity to support resolution costs, the following statutory, policy and operational reforms are essential to maximise the flexibility of the resolution authority to leverage deposit insurer funds to ensure smaller bank failure is orderly and minimise the risk to public funds and costs to industry levy payers. These reforms should include at a minimum:

1. Deposit insurers with statutory "Paybox plus" mandate: Deposit insurer funds should be available to meet any resolution cost including the recapitalisation of banks as long as eligible depositors are protected, the failed banks' capital holders have been wiped out.

2. Deposit insurer contributions and "lesser cost" principles: The deposit insurer should be able to contribute to any resolution cost as long as it is at a "lesser cost" than the deposit insurer would expect to suffer in a hypothetical insolvency counterfactual valuation scenario net of recoveries. The "lesser cost" principle also means that the DPS has no approval role in assessing whether banks meet the conditions for entry into resolution or the choice of resolution tool as long as the wider safeguards are respected e.g. early consultation, protected depositors are protected, deposit insurer contributions are capped at an amount equal to expected net liquidation recoveries informed by agreed valuation methodologies subject to ex-post independent evaluation, and equity or other instruments of ownership of the bank in resolution are written down fully.

3. Update Statutory Creditor Hierarchy: Establishing "general depositor preference" will ensure the treatment of bank creditors in resolution and in insolvency is consistent[10]. Without this, in jurisdictions with high unprotected deposit balance, losses to the deposit insurer net of recoveries can be very small or zero. As a result, the deposit insurer may not be able to contribute to resolution costs while respecting the "lesser cost" principle, resulting in an increased risk to public funds and financial stability when banks fail.

[10] That is, deposit insurer protected and unprotected depositors would have equal ranking or be pari passu in the statutory creditor hierarchy over other creditors in the event of a bank's liquidation or insolvency. This is different from protected depositor preference which ranks protected depositors over unprotected depositors in the creditor hierarchy.

4. Deposit insurers fund sufficiency and target fund methodology: The deposit insurers should update its target fund methodology and backstop funding arrangements to reflect its expanded role in supporting resolution costs. This should also be reflected in updated calculations of bank ex-post contributions, target fund size and compliance timeline.

5. Authority crisis coordination: While the deposit insurer should have no approval role in the resolution authority's choice of resolution tools, there needs to be close coordination arrangements between the deposit insurer and resolution authority particularly on valuation analysis.

As noted by the International Monetary Fund[11], the outcome of such reforms would be that the deposit insurer contributions towards resolution costs would be equal to or lower than the costs incurred in a liquidation and payout of the same bank. This aligns the interests of deposit insurers and industry levy payers as it would result in lower overall levies and adhere to the "lesser costs" principle described above. It also ensures that such contributions to resolution cost will be permitted for deposit insurer with a paybox plus mandate. This lesser cost principle ensures fairness in allocation of losses when banks fail and that all parties involved in the banking industry are treated equitably. It also recognises the shared interest of levy payers in preserving the stability of the wider financial system in the most proportionate manner. This financial case for ensuring that deposit insurer funds can support resolution costs is further bolstered when combined with the growing understanding of the significantly higher proportionate costs to smaller and medium-size banks compared to larger banks of complying with LAC debt requirements given their deposit based funding structure.

Delivering these reforms addresses the remaining critical policy gaps in the bank resolution and deposit insurer regimes, ensuring orderly resolutions for both D-SIBs and non-D-SIBs that are too large to be placed into an orderly liquidation if they fail. More importantly, by increasing the ability to rely on deposit insurer funds and rather than relying solely on LAC requirements to address bank resolution costs, they reflect the differences in smaller banks' funding structures and business models. They provide a more proportionate policy approach by minimising costs to smaller banks and industry levy payers without compromising authorities' financial stability objectives and enhance depositor protection. This new proposed framework not only ensures that both D-SIBs and non-D-SIBs can exit the market without destabilising the financial system but also maintains depositor protection and minimises risks to public funds, while minimising the cost to industry levy payers. All of this will help remove any market uncertainty about the treatment of such smaller banks in failure. It ensures the future relevance of deposit insurers as an important part of an effective financial safety net regime.

[11] See IMF, Chapter VIII, "Sibling Rivalry in the Financial Safety Net: Governance Arrangements for Bank Resolution and Deposit Insurance" Feb 2025.

ARDHILL ADVISORY

Response to IADI Consultation Question 2

Does the revision provide sufficient clarity on the interaction between deposit insurance and resolution to effectively achieve the public policy objectives of depositor protection and financial stability?

Please find below our answers to the relevant consultation questions as follows:

The revised Core Principles provide additional clarity on the interaction between deposit insurers and resolution authorities. Given that an important policy challenge when banks systemic in failure enter resolution related to how the costs of resolution will be addressed, the revised Core Principles provide greater clarity on the role of deposit insurer funds in supporting resolution costs. This offers authorities a credible alternative to LAC requirements to ensure the costs associated with smaller and medium-sized bank resolutions are met.

The IADI consultation paper also notes that it seeks to complement existing Basel/FSB policy standards for smaller/medium-sized banks in non-G20 jurisdictions more focused on the choice of liquidation versus transfer based resolution strategies when such banks fail. In particular the revised Core Principle 16 on the use of the deposit insurance fund in resolution makes the following positive clarification by:

- restating that deposit insurers may be used to support resolution measures which protect depositors, and these funds can be used to resolve of banks using a wider range of tools (transfer, bridge banks and bail-in resolution strategies) other than reimbursement of insured depositors - this should be an essential criterion under Core Principle 16
- detailing the conditions or safeguards for the use of the deposit insurer funds to manage the resolution of failed institutions including the deposit insurer being informed in a timely manner
- emphasising the importance of ex post independent valuation process to confirm the "lesser cost" principles or the net of insolvency recoveries safeguard has been respected.

However, we would recommend that the Core Principles are more explicit by requiring authorities to ensure they can use DPS funds to meet resolution costs for any resolution strategy. Under the current draft, this remains an option rather than a requirement. Any such requirement should be subject to the important safeguards outlined in the Core Principles e.g. all capital is wiped out first, there is a cap on deposit insurer contributions linked to an estimate of net recoveries under a hypothetical insolvency outcome, and this cap is informed by valuation methodologies agreed ex-ante by the resolution authority and the deposit insurer. In particular, the revised Core Principles 14 and 16, when read alongside the recent IMF paper on the coordination of resolution authorities and deposit insurers, make the case for greater clarity that the Core Principles require deposit insurers to have at a minimum a paybox plus mandate and for those deposit insurers to be able to use their funds to support resolution costs of small and medium-sized banks.

In addition, if the resolution authority is a separate independent agency from the deposit insurers, the revised Core Principles need to minimise any risk of duplication of institution specific roles and responsibilities where the deposit insurer is providing funds to support resolution costs. For example, as long as the safeguards on use of deposit insurer funds are respected (e.g. bank capital is wiped out, the "lesser cost" principles or net of insolvency recoveries cap is respected, and this is informed by robust valuation methodologies agreed in advance), the deposit insurer should have no approval role in assessing whether the conditions for entry into resolution are met or in the resolution authorities' choice of resolution tools.

Continuing the same theme, we believe the reference to the revised Core Principles to only using deposit insurer funds for recapitalisation of banks in resolution in "exceptional circumstances" should be removed. Resolution regimes are designed to ensure flexibility to respond to the circumstances of bank failure guided by the resolution objectives to preserve financial stability, protect depositors and minimise risk to public funds. If the resolution authority expects to rely on deposit insurer funds to meet these objectives it is likely because it is a smaller or medium-sized bank that does not have LAC resources beyond prudential capital requirements. This is likely to be more acute in non-G20 jurisdictions. It should be for the resolution authority to determine the resolution strategy considering the context of the failure scenario without conditions being imposed by the deposit insurers. Resolution authorities may choose to manage the resolution of such firms through a combination of bail-in and transfer resolution tools – the former to imposes losses on any equity or other instruments of ownership, and the latter to transfer the stabilised bank to a bridge bank or private sector purchaser. The "exceptional circumstances" language risks amounting to a deposit insurer approval role on the resolution authority's choice of resolution tool in such circumstances which undermines the operational independence of the resolution authority and undermines the clarity of interaction between the deposit insurer and resolution authority. Given that the use of deposit insurer funds is capped and as a result results in a lower cost outcome for levy payers, it seems unnecessary to include any such conditions on the resolution authority use of deposit insurer funds.

Finally, the revised Core Principles discussion of creditor hierarchy and depositor preference (p20-21) should expand its description of the interaction of protected depositor preference under the statutory creditor hierarchy and the ability of a deposit insurer with a paybox plus mandate to contribute to resolution costs. In particular, statutory protected depositor preference can significantly constrain the ability of deposit insurers to support resolution costs in a way that respects the net of recoveries cap. For example, in jurisdictions with high unprotected deposit balances, losses in insolvency to the deposit insurer net of insolvency recoveries can be very small or zero because those unprotected deposit balances rank junior to the deposit insurer and absorb losses first, thereby protecting the deposit insurer from losses. While this might sound like a good position on first glance and protect industry levy payers from losses, if deposit insurer funds are expected to provide a source of loss absorbency needed to ensure small and medium-sized bank resolution is orderly, deposits and financial stability are protected, this preference of protected depositors can mean the deposit insurer is unable to contribute to resolution costs as it makes full recoveries in a hypothetical liquidation valuation. Obviously, this analysis ignores the financial stability implications of the significant balances of unprotected deposit balances made by for example national commercial depositors absorbing losses in insolvency. Instead, general deposit preference under the statutory creditor hierarchy is most aligned with maximum flexibility of the deposit insurer to contribute to resolution costs. That is to say, deposit insurance protected and unprotected depositors would have equal ranking or be pari passu in the statutory creditor hierarchy over other creditors in the event of a bank's liquidation or insolvency. Instead, establishing "general depositor preference" will ensure the treatment of bank creditors in resolution and in insolvency is consistent. As noted by the IMF in its paper "*Sibling Rivalry in the Financial Safety Net*", as bank resolution frameworks becoming more prevalent, depositor payouts can be expected to become less the norm of managing the orderly failure of smaller banks. Therefore, addressing any barriers to effective use of deposit insurance funds to support resolution costs will become increasingly important.

To facilitate the review by the IADI, illustrative textual changes to the reviewed Core Principles Core have been provided in **Appendix 2** to address the issues discussed above in response to consultation question 2.

Ardhill Advisory greatly welcomes the opportunity to participate in the IADI call for public feedback. We would be delighted to discuss the views expressed in this letter more fully with IADI staff if this would be helpful.

Yours sincerely

Eamonn White

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Appendix 1 - Assessing the cost implications of LAC debt requirements on small to medium-sized banks

In order to comply with loss absorbing capacity ("LAC") requirements non-D-SIBs may be required to issue new unsecured LAC debt instruments. This is because, other than Additional Tier 1 ("AT1")/Tier 2 ("T2") capital instruments, retail deposit funded banks typically do not access the senior unsecured debt markets for medium-term wholesale financing. As a result, smaller and medium-size banks may not have any significant levels of existing medium-term wholesale financing that can be restructured and refinanced at maturity as LAC-eligible instruments. Instead, their existing funding structure reflects the plentiful sources of deposit funding in the banking system. Therefore, such banks will need to issue the debt instrument with LAC features or AT1/T2 capital securities to fulfil LAC requirements. Given the high funding costs of AT1/T2 relative to unsecured LAC debt instruments, it is likely non-D-SIBs subject to LAC requirements will attempt to issue LAC senior unsecured debt instruments to fulfil the requirements.

For the purposes of illustrating the cost implication of substituting cheaper deposit funding with more expensive LAC senior debt, it is assumed that unsecured LAC debt instruments have a margin funding cost increase of c5%. It is also assumed that the average cost of deposit funding is 2.7% relative to c7.5% for unsecured LAC debt instruments. The impact of margin cost of complying with LAC requirements is calculated by estimating the costs of the additional eligible LAC resources required based on an assumed LAC requirement of c25% Risk Weighted Assets ("RWA")[12]. This minimum LAC requirement is compared against an assumed existing Total Capital Adequacy Ratio (CAR) of the banks of c18.5%. As a result, the net increase in interest expense is the coupon rate/interest rate of LAC issued (which is around 7.5%) minus the average customer deposit cost of the banks and further multiplied by the amount of LAC required. The interest expenses for LAC debt assumed for the purposes of this analysis is similar to the non D-SIB banks issue price of MREL in UK and Europe[13].

Based on these assumptions, the marginal funding cost increase for smaller banks is equivalent to a reduction of 15% in Profit and Loss ("P&L") and 13bps in NIM. If we assume that such banks have a NIM that ranges between 1.6% to 2.2%, the impact of the compliance cost of LAC represents a 9.0% - 12.5% reduction in NIM for these smaller banks.

To help understand the materiality of the NIM implications of LAC requirements for such banks, when the US authorities proposed that banks of USD 100 billion in assets issue LTD or comply with a LAC equivalent requirement, they estimated the marginal cost to those banks as equal to a at c3bp of their NIM[14]. That analysis assumed that those US banks have an average NIM of c3%. Therefore, the impact of LAC debt on the US banks is only around 1% of NIM compared to a 12.5-9% reduction for smaller banks' NIM.

[12] Given the purpose of LAC is to ensure continuity of critical functions in resolution which requires restoring compliance with minimum capital requirements, LAC requirements are typically equal to twice minimum Capital Adequacy Requirements - Pillar 1+Pillar2A, which is assumed to be 12.5% for the purpose of this analysis.

[13] EU non-D-SIBs MREL coupons are at Mid-swap MS + 200bbps, in a mixture of EUR and GBP (no USD issuance)

[14]The US regulators estimate that the eligible external LTD requirement would increase pre-tax annual steady-state funding costs for the analysis population by USD 1.5 billion in the incremental shortfall approach - this approach assumes that current reported principal amount of LTD issuance at covered entities is a reasonable proxy for the levels of such debt that would be maintained in future periods in the absence of the proposed rule. Link: https://www.federalregister.gov/d/2023-19265/page-64553

Appendix 2 - Revised IADI Core Principles - Illustrative Proposed Textual Changes

Proposed drafting changes to the IADI Revised Core Principles to reflect the points raises in this consultation responses are outline below in blue and strikethroughs.

Principle 2 – Mandate and powers

The mandate and powers of the deposit insurer support the public policy objectives of the deposit insurance system and are formally specified and publicly disclosed.

Essential criteria

1. The mandate and powers of the deposit insurer are formally and clearly specified in legislation and publicly disclosed. They are consistent with stated public policy objectives of the deposit insurance system.

2. The mandate clarifies the roles and responsibilities of the deposit insurer and is aligned with the mandates of other relevant financial safety-net participants.

3. The powers of the deposit insurer support its mandate and enable the deposit insurer to fulfil its roles and responsibilities, including to support other financial safety-net participants.

4. The powers of the deposit insurer include, but are not limited to:

a) assessing and collecting premiums, levies, or other charges;

b) reimbursing insured depositors (via a payout or by supporting bank resolution);

c) managing its fund and its use;

d) obtaining timely, accurate, and comprehensive non-public information needed to fulfil its mandate directly from its members, from third parties holding the relevant information on behalf of a member, or from other financial safety-net participants;

e) compelling its members to comply with their legal obligations to the deposit insurer, or requiring another financial safety-net participant to do so on behalf of the deposit insurer;

f) entering into formal agreements with other financial safety-net participants regarding cooperation, coordination and information sharing in business-as-usual times and in times of crisis;

g) setting operating budgets, policies, systems, and practices; and

h) entering into contracts to execute its mandate.

Principle 14 – Failure resolution

A resolution regime ensures the effective resolution of failing insured deposit-taking institutions in a manner that ensures the continuity of critical or systemically important financial services, protects insured depositors against losses, minimises disruptions in their access to insured deposits, and contributes to financial stability.

Essential criteria 20

1. The resolution regime provides for a broad range of powers and options to resolve an insured deposit-taking institution that is no longer viable and has no reasonable prospect of becoming so. It includes options that facilitate the continuity of the critical or systemically important financial services and deposit-taking functions and liquidation options that provide for the orderly closure and wind-down of all or parts of the business of the insured deposit-taking institution.

2. The period of time during which insured depositors are without access to their insured funds is minimised.

3. Where responsible for exercising resolution powers, the deposit insurer's powers are clearly defined and sufficiently broad. Where multiple financial safety-net participants are responsible for resolution, the legal framework provides for a clear allocation of objectives, mandates, and powers of those participants, with no material gaps, overlaps or inconsistencies. To support orderly resolution where not the resolution authority, deposit insurers should have a "paybox" plus statutory mandate.

4. Where responsible for exercising resolution powers, the deposit insurer has the operational independence, expertise, transparent processes, sound governance, resources, and the operational capacity to exercise those powers consistent with its mandate.

5. Resolution procedures follow a defined creditor hierarchy in which equity or other instruments of ownership take first losses and insured depositors are excluded from sharing losses.

6. Where responsible for exercising resolution powers, the deposit insurer is protected against legal action that could constrain its implementation of, or result in a reversal of, resolution related measures taken within its legal powers and taken in good faith. The legal remedy for successful legal challenges is limited to financial compensation.

7. Where responsible for exercising resolution powers, the deposit insurer is guided by clear objectives, as well as cost and benefit considerations.

8. The deposit insurer does not discriminate against depositors on the basis of their nationality or residency status in the resolution process.

Principle 16 – Use of the deposit insurance fund in resolution

The conditions for the use of the deposit insurance fund to manage the resolution of failed insured deposit-taking institutions are clearly set out in law and publicly disclosed.

Essential criteria

1. The deposit insurance fund can ~~may~~ be used to support reimbursement and other resolution measures which protect depositors.

2. Where there are multiple funds in the financial safety-net available for resolution funding, their respective roles and use cases are set out in law and publicly disclosed.

3. Where a deposit insurer is not the resolution authority, its legal framework should ~~may~~ provide the option for use of its funds for resolution of member institutions other than reimbursement of insured depositors. This use is subject to clear and formal terms and conditions, which include at a minimum the following:

a) the deposit insurer is informed in a timely manner of the resolution and ~~involved in the~~ resolution decision-making process from an early stage;

b) the deposit insurer confirms that the conditions set out in the legal framework for the use of its funds for non-reimbursement purposes are met;

c) the resolution measure limits the risk of exposure of the deposit insurer to contribute additional funding in respect of the same obligation;

d) net contributions from the deposit insurer for the resolution of member institutions do not exceed the estimated net costs the deposit insurer would otherwise have incurred in a reimbursement of insured depositors in a liquidation, net recoveries of expected; and gross contributions do not exceed total insured deposits in the failed insured deposit-taking institution;

e) the use of deposit insurance funds is subject to an ex post independent audit to review compliance with the terms and conditions and criteria for the use of the funds in resolution;

f) deposit insurance funds can be ~~are~~ used to contribute to ~~for~~ the recapitalisation of resolved insured deposit-taking institutions ~~only in exceptional circumstances and~~ if equity or other instruments of ownership are written down fully to absorb losses.

Principle 17 – Financial safety-net cooperation, coordination and information sharing

The deposit insurer is part of a formal framework within the financial safety-net for cooperation, coordination, and information sharing. The framework sets the individual and joint responsibilities of the financial safety-net participants and how these participants discharge these responsibilities in a coordinated and cooperative manner.

Essential criteria

1. The framework for cooperation, timely and ongoing sharing of confidential information and the coordination of actions between the deposit insurer and other financial safety-net participants is

effective, explicit, and formalised through legislation, regulation, memoranda of understanding, legal agreements, or a combination thereof.

2. The deposit insurer has in place rules for the protection of confidential information that impose adequate confidentiality requirements on its current and former employees and agents that receive or have received confidential information. The rules provide for effective sanctions and penalties for breach of confidentiality requirements.

3. The deposit insurer shares and receives appropriate information in line with its respective roles and responsibilities on a timely basis and before material supervisory actions are taken in respect of insured deposit-taking institutions. This includes information on the funding structures of insured deposit-taking institutions and on supervisory actions that relate to concerns about the solvency, performance, or viability of an insured deposit taking institution.

4. In cases where the deposit insurer is not the resolution authority, appropriate cooperation, coordination and information sharing arrangements are in place between the deposit insurer and the resolution authority that address:

a) collaboration in the orderly resolution of a problem insured deposit-taking institution; and

b) if the deposit insurance fund can be used in resolution other than for reimbursement, the timely sharing of relevant confidential information needed in order to inform the resolution authority's decision on the choice of the resolution action and its ~~to~~ determination~~e~~ whether the conditions for the use of the deposit insurance fund are met.

5. Where multiple deposit insurers operate within the same jurisdiction appropriate cooperation, coordination and information sharing arrangements among those deposit insurers are in place.