Attitudes to deposit insurance have changed since the financial crisis and authorities in most countries now believe that almost all bank deposits should be insured. All schemes, even those in which deposits are uninsured, need to give customers virtually uninterrupted access to their banking facilities. There is clearly a need for credible funding arrangements and a clear basis for handling cross-border banks.

Before the financial crisis most OECD and other advanced countries, except Australia and New Zealand, had come to the view that limited explicit compulsory deposit insurance was necessary for retail bank deposits, where banks are defined quite widely. Of course there were wide variations in the nature of the schemes they applied and most other exceptions were in the direction of greater coverage. Now all of these countries have explicit and extensive deposit insurance. Implementing blanket guarantees of various forms is a normal reaction to a severe crisis. Confidence needs to be restored. This means a guarantee that the general public will not suffer loss from participating in the banking system — although such guarantees do not normally extend far into other financial instruments. In some countries, New Zealand and Australia included, the comprehensive insurance is temporary and the question now arises of what the permanent regime should be. Before the crisis Australia appeared en route for adopting the then consensus, while New Zealand was not exploring plans for insurance.

The experience of the global financial crisis has shown that much of traditional deposit insurance was poorly designed; the most striking deficiencies were observed in the United Kingdom and Iceland. The obvious deficiencies that need to be corrected are that, if schemes are to be effective, they must be able to pay out rapidly — as people are not willing to accept inability to access their funds for more than a few days, and the schemes must have ready access to enough extra finance to make their ability to pay out believable. There was no way that any comprehensive deposit insurance could have been possible in Iceland where bank liabilities were around 10 times GDP. The question then is: why did people accept such an obviously unviable system? The answer was, of course, that they did not expect banks to fail — or if they did fail, the expectation was that they would be bailed out by the taxpayer in some way or other (and they were right).

In much of Western Europe, bank failures were largely unheard of, or where they did occur, losses had been limited or rescues with or without recapitalisation were the norm. This time around the general perception has been vindicated. Few bank depositors have lost their deposits, whether or not the deposit insurance scheme could cope. The United Kingdom is perhaps the clearest example. Nationalisation (Northern Rock), government recapitalisation (RBS, Lloyds Group), and orderly resolution with the assistance of comprehensive deposit insurance (Dunfermline Building Society) have all been used. Where depositors in the UK branches of Icelandic banks found they would not be compensated (in the reasonable future) by the Icelandic authorities, the authorities stepped in and paid depositors out, seeking repayment from the Icelandic authorities when they could manage it.

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The experience of the global financial crisis has shown that much of traditional deposit insurance was poorly designed; the most striking deficiencies were observed in the United Kingdom and Iceland. The obvious deficiencies that need to be corrected are that, if schemes are to be effective, they must be able to pay out rapidly — as people are not willing to accept inability to access their funds for more than a few days, and the schemes must have ready access to enough extra finance to make their ability to pay out believable.

Some of the confusion at the international level stems from the fact that the history of deposit insurance in the United States has been relatively different. While deposit insurance in other parts of the world is a relatively new phenomenon, in the United States, where bank failures have been more frequent and the scale of losses (particularly in communities where the impact was concentrated, in the course of the Great Depression) was such that the need to act was politically essential. Federal deposit insurance was therefore introduced in 1935, following the collapse of the schemes run in various individual states. As a result, there was a major contrast between the US scheme — as comprehensively revised by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1989 — and many other countries. The United States had a proven scheme that was used and worked, and was able to cope with the present crisis. However, in general terms, the scheme was designed to deal with small numbers of failures in a framework of generally stable and well-run banks. There are many criticisms about the quality of prudential regulation in the United States and the system may well be softer than that in much of Europe and Australia. But nevertheless, the system works because the vast majority of banks can survive without intervention. Where there was intervention, the standard deposit insurance scheme could cope, even in the greatest crisis in 75 years. However, the problems with Citibank and Bank of America did require special intervention and, had Wells Fargo not been willing to buy Wachovia, that too would have required special intervention through what is known as the systemic risk exception.

The purpose of this discussion is to consider, in the light of the crisis, what is required for adequate depositor protection. Section 1 considers how extensive coverage should be. Section 2 considers what form payout should have, while Section 3 considers the necessary extent of funding. However, Section 4 focuses on the critical issue which relates to New Zealand, namely how to handle foreign-owned banks. While most countries have addressed the other aspects of the reform of deposit insurance, cross-border banking, particularly in Europe, remains a problem that is politically difficult to resolve.

Coverage

As part of the review of deposit insurance, the International Association of Deposit Insurers (IADI) and the BIS have drawn up a set of principles for insurance. The early sections cover the purpose of insurance and, as a consequence, the appropriate coverage. The principles suggest that there are multiple objectives and this means that policy will be a more difficult compromise. There are two main concerns. The first is that the ordinary person, who does not have the ability to monitor and manage risks, should have their ‘normal’ (transactions) deposits covered. The second is that deposit insurance should contribute to the maintenance of confidence in the system such that there are not retail runs on banks that are solvent — even if they are temporarily illiquid. These two requirements have different implications.

Covering the first objective entails an empirical assessment of the size of deposits, so that the large majority of deposits of ordinary depositors are fully covered. Take the case of the United Kingdom, for example. Even before the present crisis, the £35,000 limit covered around 95% of depositors fully, in the case of the failure of Northern Rock, and over 90% of retail deposits. (There was a specific problem with the UK’s insurance scheme in that it involved 10% co-insurance after the first £2,000, so that most people were not fully covered. As a result it was quite rational for anyone with over £2,000 in deposits to run on a bank at the first hint of trouble so that they could recover 100% and not 90% of the remaining deposit. Co-insurance is now a dead idea.)

The size of deposits will, of course, be endogenous as people will be influenced by the extent of insurance. Nevertheless, insurance of £35,000 per depositor per bank is likely to cover the vast majority of the population. Even in countries with five main banks, as in New Zealand, this would mean that any individual would be covered for up to $250,000 if the coverage for them in each bank were $50,000. Not many people who are not actively managing their savings and have little ability to sort out their risks would have holdings in excess of this. Hence the new ideas of coverage up to $US100,000 or $US200,000 provides a considerable excess on this criterion. Indeed encouraging people to hold financial wealth of up to $1 million in bank deposits — while enabling more stable finance for banks — could provide problems for capital markets.

The arguments for these larger amounts are based on concerns for financial stability rather than protection of naïve depositors. The larger coverage means a more costly process of providing insurance, as funding has to be commensurate. Assuming that insurance is funded through levies on the banks, this implies that there will be a higher tax on bank deposits.
Rapid payout

Perhaps the greatest lesson from the present crisis — given that co-insurance was unusual — is that unless the ability to pay out is virtually immediate, people will run on a troubled bank just to make sure that they do not face disruption in their payments and risk adverse evidence on their credit rating. This is not new. Kaufman (2007) explains this as the need to protect people against both credit risk and liquidity risk if runs are to be avoided. The US system has been designed so that this is possible and that one of two main payout routes can be followed. Either the deposits are taken over by another bank/owner or the depositors receive cheques from the insurer. In countries where cheques are no longer used, some means of issuing credits to an account with another institution is required. Even with transferring deposits to another bank, either the failing bank’s systems have to be operated by the new bank or a rapid and complex transfer between institutions has to take place with a very simple instruction issued to depositors about how to reactivate their accounts.

When the Bank of England first implemented its new arrangements under the Banking Act of 2009 in the case of the Dunfermline Building Society, the time for closure of the system while the transfer took place was only two hours. However, it required two months of careful preparation to get to this point. It is therefore inevitable that some means of keeping the bank’s payment systems going without interruption will be required, unless there is sufficient time, as the failing bank gets into increasing difficulty, to find another bank that will take on the deposits for an agreed fee from the deposit insurer. A bridge bank operated by or under the aegis of the deposit insurer is an obvious solution. The arrangements proposed for New Zealand (but not as yet implemented) of being able to write down the deposits and other claims on the bank within the value day while placing the bank in statutory management, might work as a substitute. In practice, however, changes are likely to be necessary.

Such speed means that it must be possible to identify insured deposits almost immediately, thus netting of liabilities would be impossible and detailed knowledge of the banks’ computer systems would be required. In the US special provisions are necessary to enable the FDIC to handle the largest banks in the required time frame.

Funding

As mentioned above, the insurer needs to have arrangements in place such that it can pay out or pay an acquirer of the deposits immediately. This implies that it either has to have adequate funds or that it can draw immediately without impediment on the necessary funds. The latter would normally imply the ability to borrow from the government until such time as a new levy can be imposed on the remaining banks, but recent innovations in contingent capital would also work. For example, the insurer could issue bonds whose servicing could be suspended in the event of a crisis. Clearly, any funding cannot be contingent on the agreement of the government at the time and must be a credible pre-commitment.

Cross-border banks

The above discussion relates to banks that fall largely within a single jurisdiction. Once banks run across borders there are complications to deposit insurance. Some of these are technical in the sense that depositors may be subject to different insurance benefits depending upon the country of registration of their bank. This will clearly affect competition in the country. In the European Union, a foreign bank can purchase extra insurance from the local insurer to bring its coverage up to the level of the local market. But if its home market already offers a higher level of insurance, it cannot reduce the insurance nor can its competitors top up their insurance to that level. Clearly, if New Zealanders could get a higher level of insurance protection by holding an account at a branch of an Australian bank in New Zealand, this could have severe competitive effects on the New Zealand and main Australian banks whose subsidiaries would be subject to the New Zealand system.

However, a far more difficult issue arises when the regulator of the bank in one country cannot control the exposure of their deposit insurance fund. For example, failure of a bank could be the result of weak supervision in another jurisdiction or the result of a decision to close by the supervisor of the parent. There is a concern over fairness for those who have to pay, if they are subjected to harsher supervision yet also have to pay in the event of failure. There is unlikely to be any route for compensation through the other country.

In addition, power over what can be done in the event of failure will be limited to the specific jurisdiction (even under the EU’s Winding Up Directive). Host country authorities will be very much subject to the decisions made in the home country. If a parent is closed, it may be difficult to keep the subsidiary running. Under the Special Resolution Regime in the UK, the administrator of the failed institution must continue to provide the necessary services to keep surviving parts of the bank operating until alternative arrangements can be made. Such requirements are not enforceable across borders. Only two routes seem viable to resolving this. One is to have a single federal level of jurisdiction which covers the whole
banking group. The other is to make sure that the parts of the bank are properly separable on a national basis so that each authority can make their own decisions. Australia and New Zealand are already managing the exposure by choosing the route of practical separability but many other countries around the world including the European Union have not resolved the problem.

Without separability, it seems likely that there will be inequity across borders unless there are some arrangements for cross-border payments. New Zealand, for example, could effectively free-ride on the Australian provisions for the parent and Australia could impose costs on the New Zealand taxpayer. The situation is complicated by the fact that the Australian authorities have made it clear that their four main banks will effectively not be allowed to fail. Thus all the New Zealand authorities would need to insure against is the prospect that the New Zealand subsidiary might fail while the parent survives. While there is no ‘source of strength’ requirement that ensures that this will not happen, reputation risk may mean that in practice such a failure is unlikely because of the knock-on effect it would have in Australia.

We could speculate on what would happen if Australia and New Zealand were to follow the single jurisdiction route, which would effectively entail a joint deposit insurance regime complicated only by the existence of two currencies, but such a prospect is a long way off.

Concluding remarks

Australia and New Zealand now need to decide how to handle deposit insurance after the present temporary measures expire. These measures reflect the crisis and are more generous than most countries thought necessary before the crisis. However, it seems as if most other countries will stay with a high coverage limit.

New Zealand has implicit insurance although, in practice, the arrangements to use bank creditor recapitalisation or other immediate routes to ensuring continuity of access to deposits have not been tried. It is clear from the crisis that people need uninterrupted access to their deposits if a run is to be avoided. This needs to be addressed right away.

While this implicit insurance exists for the larger banks through the insolvency regime, no such arrangements are in place for the smaller banks. Also, uninsured depositors would simply be caught up in the insolvency proceedings and could have no access to their funds for a substantial period, and it could be a long time before they would find out the extent of the final payout. Australia’s new scheme introduced in the crisis will continue but the coverage and other features are subject to review.

It would appear sensible for both countries to have a scheme that can handle the liquidity problems of depositors in small banks. However, implementing such a scheme for only part of the industry would be difficult unless it were to be funded by the taxpayer. Deposit insurance schemes normally cover the entire sector. This would imply an explicit scheme. In practice, this would pose few problems for Australia, where the scheme is already explicit, as it would only involve appropriate resolution rules for troubled small banks. New Zealand has a much greater problem as it only has implicit insurance for the depositors of large banks insofar as the Bank Creditor Recapitalisation scheme is not a reality. In the recent crisis it distinguished between small and large banks in the financing of insurance. The large banks had to pay whereas the small banks enjoyed a taxpayer-financed arrangement. This might well be the solution followed in the future since, typically, it is small banks that fail rather than larger ones, which creates an interesting moral hazard and potential liability.

Notes

1. Insurance in France, Italy and Norway, for example, covered almost all retail deposits.
2. The coverage has not been total as there have been losses for some people who made deposits through Guernsey and the Isle of Man and for public authorities.
3. Most of the major failures in the United States — AIG, Bear Steams, Fannie Mae, Freddie Mac, Lehman Brothers — occurred outside the banking sector and the scope of deposit insurance. Whether the US definition of what constitutes a bank that should be insured is appropriate is an issue beyond the scope of the present article.
4. See Mayes (2005) for an exposition of this mechanism that has not been invoked until the present crisis.
6. ‘The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and to protect less financially sophisticated depositors.’ (from Core Principles 1, p. 2, op. cit.).
8. The idea behind co-insurance was mainly that if depositors had something at stake they would pay much more attention to the behaviour of their bank and that the threat that they would exit if there was any suspicion of a problem would act as effective discipline on the bank to avoid running excess risks. However, in practice people do not monitor their banks and, in any case, it is likely that major retail banks do not expect to fail so the element of discipline is absent in practice.
9. The previous UK system related to net deposits.

References