Nout Wellink: Core principles for effective deposit insurance systems – where do we stand?

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Conference on The Core Principles for Effective Deposit Insurance Systems, Basel, 23 September 2009.

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Introduction

It is my pleasure to address this joint conference. As you know, the Core Principles for Effective Deposit Insurance Systems were developed jointly by IADI, the International Association of Deposit Insurers, under the excellent leadership of Marty Gruenberg, and the Basel Committee on Banking Supervision. These two bodies, together with the Financial Stability Institute, organised this conference in order to promote the Core Principles and to contribute to their implementation and further development.

Last July, the world commemorated the 40th anniversary of the man-on-the-moon. When Neil Armstrong set foot on the moon 40 years ago, he spoke the famous words "That's one small step for man, one giant leap for mankind". Last June, the Core Principles for Effective Deposit Insurance Systems were published. Admittedly, these are different works and I would not dare to put the Core Principles on par with the moon landing and the various countries' space programs. Nevertheless, the Core Principles are a milestone in regaining financial stability after the current crisis. The question is: where do we stand?

Recent events

The recent crisis that started in Summer 2007 reminded the wider public once again that banks are susceptible to problems of insolvency or illiquidity. Northern Rock was one of the first victims, following problems in the mortgage credit markets. Once its problems became publicly known, a classical bank run occurred with many customers queuing outside Northern Rock's branches to withdraw their savings. After the Northern Rock episode, the consensus emerged that deposit insurance systems with low levels of coverage, partial insurance and likely delays in repayment, are not effective in preventing a bank run.

One year later, in September and October 2008, this insight became topical once again. The financial turbulence, it was feared, could develop into an international financial crisis as severe as the Great Depression in the 1930s. In several jurisdictions, bank customers were reportedly shifting their deposits to the perceived safety of other banks or instruments. Policy makers had no choice but to respond. Some authorities stated publicly that all bank deposits would be safe or that deposit insurance coverage would be unlimited. Elsewhere, the maximum level of deposit insurance coverage was raised, at least temporarily, or co-insurance arrangements were withdrawn. In some countries without explicit deposit insurance arrangements, these were introduced. All measures were taken to regain and rebuild the public confidence in individual banks and the banking system. In the end, these actions were successful and retail bank runs were mostly avoided. These steps ultimately resulted in an enhanced appreciation of the importance of effective systems of deposit insurance in maintaining financial stability.

However, deposit insurance can not be seen in isolation. Deposit insurance systems are part of a wider financial safety net, together with the regulatory and supervisory framework and liquidity or capital support measures. Indeed, wholesale funding guarantees, capital injection plans and asset relief schemes for banks were also necessary as short term crisis management measures in the fight for financial stability. In the longer term, bank regulation and supervision will need to be – and are being – strengthened to restore stability. Yet another qualification regarding the policy actions on deposit insurance during the crisis, is that they were not always well co-ordinated across borders. One minister of finance clearly summarized the situation by saying that "One country's solution is another country's problem". I will come back to this shortly.

Supervisory policy responses

Let me first explain how the regulatory and supervisory framework will be strengthened. In this process, the Basel Committee plays a pivotal role. The Committee's strategic objective is to establish a clear road map for a future regulatory system that will reduce the probability and severity of a crisis like the current one. By developing a broad range of measures, we want to improve the resilience of banks and banking systems over time to future shocks. By phasing in these reforms over an appropriate time horizon, we seek to ensure that these measures will not impede the recovery of the real economy. The Basel Committee's oversight body – central bank Governors and Heads of supervision from 27 countries – recently agreed on quite a substantial package of reforms. These include:

- Raising the quality, consistency and transparency of the Tier 1 capital base;
- Introducing a leverage ratio as a supplementary measure to the Basel II risk-based framework;
- Implementing a minimum global standard for funding liquidity, and
- Creating a framework for countercyclical capital buffers.

In addition, the Committee's oversight body agreed to introduce a macro-prudential approach to bank supervision, which is aimed at the stability of the financial system. In this context, the Committee intends to reduce pro-cyclicality, for instance through countercyclical buffers in capital frameworks and more robust provisioning practices. Last week, the Basel Committee issued recommendations aimed at strengthening cross-border bank resolution frameworks.

Taken together, the recent and planned initiatives of the Basel Committee in response to the crisis, once implemented should promote a more robust banking sector and limit the risk that weaknesses in banks amplify shocks between the financial and real sectors. The Basel Committee's work is consistent with and supported by the initiatives of the Financial Stability Board and the G20, which will meet tomorrow and the day after tomorrow in Pittsburgh.

Core Principles

Another distinct response to the crisis is the Core Principles for Effective Deposit Insurance Systems, developed by the Basel Committee and IADI. The basic idea behind the Core Principles is that they are universally applicable. On the one hand, "they are reflective of, and designed to be adaptable to a broad range of country circumstances, settings and structures", as the Executive Summary notes. On the other hand, they "are not designed to cover all the needs and circumstances of every banking system", which would be very difficult indeed. "The Principles are intended to be a voluntary framework for effective deposit insurance practices." National authorities can adjust them and "put in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions".

Taking a closer look at the Principles themselves, they are intended as a basic reference for public authorities internationally. National authorities can use these Principles, either as a benchmark against which they can assess their own deposit insurance schemes or as a tool to implement or reform their deposit insurance systems. A comprehensive self-assessment should identify strengths and weaknesses in the existing deposit insurance system and form a basis for remedial measures, where needed. The Principles will also be used by the IMF and the World Bank in the context of Financial Sector Assessment Programs to assess the quality of deposit insurance. In order to facilitate such assessments, IADI with the support of the Basel Committee is currently developing a Core Principles Methodology. As part of these assessments, specific country circumstances can be more appropriately considered, in close dialogue with national authorities. Any assessment should aid the deposit insurer and policymakers in improving the deposit insurance system, as necessary. In short, the Basel Committee believes that the use and implementation of the Core Principles will provide a starting point for more advanced deposit insurance systems and contribute to enhancing financial stability. We have set off on this journey with this conference!

Future challenges

The more difficult question is how deposit insurance systems will develop. Unfortunately, the answer is still "up to the stars" – and I am not an astrologist. The events during the recent crisis, however, may indicate which issues may need to be addressed.

The first one is the optimal level of coverage, which comes down to the right balance between consumer protection and moral hazard. Clearly, the recent increases in the level of coverage during the crisis were necessary in order to protect consumers and to restore financial stability. But these measures have given rise to moral hazard, particularly when the coverage became unlimited. The perception may be that higher government guarantees will be available in future crises as well. The risk of moral hazard is explicitly recognised by the Core Principles, as well as the need to strike a balance in setting the coverage level. Meanwhile, many countries that increased their depositor protection during the crisis have announced or have planned to unwind the temporary protection measures. A notable exception is the EU, where the level of coverage was raised in October last year and will, most likely, soon be further increased. One might argue that the EU levels of coverage were too low previously. However, to the extent that the great majority of retail deposits in the EU will be fully covered, depositors will lose the incentives to critically assess banks' soundness and market discipline will be eroded. As this would be unfortunate from a prudential point of view, I invite the European Commission to substantiate the need for further increases.

Another important challenge to the Core Principles will be to better arrange the cross-border relationships between deposit insurance systems. Many banks increasingly operate internationally, but the safety nets are still organised along national lines. In a crisis affecting such banks, cross-border cooperation is necessary. However, there is very little experience of cooperation between deposit insurers. Similarly, there is little evidence that deposit insurance authorities have mutually well-understood plans for handling the failure of internationally active banks. In such cases, controversial issues are the distribution of responsibilities between the deposit insurance schemes, differences in legal arrangements, such as insolvency laws, as well as large cross-border liabilities.

Allow me, by way of illustration, to refer to the EU system once again. Clearly, in terms of market integration the EU's Internal Market is most advanced and may serve as an example worldwide. Under the home country control framework, the deposits of a bank and its branches in the European Economic Area (EEA) are covered by the deposit insurance scheme of the home country. The political reality is different, though. When a few Icelandic banks failed last Fall, the funds to cover deposits at these banks' foreign branches were not available and many host country authorities had to intervene, not only because of the so-called topping-up arrangement, whereby the host country provides additional cover. Although the latter will, practically speaking, soon disappear, the current European system of deposit insurance needs to be fundamentally reconsidered. A situation in which regular retail deposits in a country are not adequately covered should be avoided, not only in the EU, but worldwide.

In terms of the Core Principles, this means that further attention needs to be given to deposit insurance coverage for internationally active banks, as well as to the operational arrangements which should support it. The first issue in particular is a great challenge, indeed, even when banks are just doing well.

A final theme is the role of deposit insurance systems in the financial safety net and in crisis resolution. As we all know, the roles of deposit insurers may vary, but the key question, whether or not there is in fact a single “best” approach to safety net design, including one ideal model for deposit insurance and bank resolution, has not been resolved. Since banking systems differ, the role played by deposit insurance in ensuring financial stability, and the design of that and other elements of the safety net may differ. This institutional variety is allowed by the Core Principles, but the issue will remain on the agenda.

Summing up

Let me sum up. One of the lessons of the financial crisis is that deposit insurance is instrumental in recovering and maintaining financial stability. The Core Principles were a timely response to the crisis. They will act as a basic reference for countries to use in establishing or reforming their deposit insurance system. However, our experience with the Core Principles on Banking Supervision, as well as Basel II, is that truly effective Core Principles are not a static document, but a dynamic framework. It is not the document as such, but the process – of implementation, assessment and improvements – that counts. The Basel Committee – and, I am sure, IADI as well – stand ready to contribute to implementing these principles and improving deposit insurance systems everywhere.

When I started, I called the Core Principles a milestone. Milestones were a simple but effective device by which the Romans orientated themselves. But the Core Principles are more than that. I would rather consider them to be a Global Positioning System. They are not a product of rocket science, but they are useful and valuable, all over the world! I wish all of you a stimulating conference!