Paul Tucker: The role of deposit insurance in building a safer financial system

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, at the International Association of Deposit Insurers Annual Conference, London, 25 October 2012.

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It is a great honour to be the closing speaker at your conference today. I shall use the opportunity to update you on progress with the Financial Stability Board's work on the resolution of distressed financial institutions.[1]

Deposit insurance, stability and competition

Although it has rarely been centre stage in recent debates, deposit insurance in fact plays a key role in the international efforts to build solid foundations for global finance. Eighty-odd years ago the US introduced deposit insurance to underpin confidence in a commercial banking system that was threatening to unravel. In recent years, the UK has not been alone in learning the hard way that it is not enough simply to have a deposit insurance system. Retail depositors will run from a troubled bank if they are not confident that they will have access to their transactions balances quickly.

The general public need to know about the deposit insurance system, understand it, and be able to rely on rapid payout by the Deposit Insurer in the event of a bank's failure. With the encouragement of the Bank of England, the UK's bank supervisors – today at the FSA, from next year at a new Prudential Regulation Authority within the Bank – are requiring deposit takers to advertise prominently the availability and terms of deposit insurance, in every branch, on every ATM, on every key webpage.

Further, crucially, the UK's Financial Services Compensation Scheme will ensure they can deliver rapid payout, ideally within 7 days. This requires banks to hold more information about their depositors than it seems they would choose on their own. It is perfectly reasonable for society to demand this.

Once those conditions are met,[2] the deposit insurance regime has the potential to revolutionalise retail banking. By assuring retail depositors of safety, new banks should find it easier, other things being equal, to establish a deposit base, lowering barriers to entry into banking. Later I shall come to who pays for this: it isn't government and the taxpayer but the industry itself.

Deposit insurance and resolution

But we know from experience that liquidation and payout to insured depositors can be a seriously inferior way of handling the failure of some deposit-takers. That is because liquidation can entail a destruction of value, disruption to the provision of services, and other spillovers to the rest of financial system. Some of that can be avoided if, instead, we are able to transfer the insured deposit book and some good assets to another bank (or other

[1] Paul Tucker is chairman of the FSB's Resolution Steering Group. For an earlier update see Tucker (2012) 'Resolution: a progress report', a speech delivered to the Institute for Law and Finance Conference in Frankfurt. The Financial Stability Board will provide an official Progress Report to the forthcoming meeting of G20 Finance Ministers and Governors in Mexico.

[2] The same themes were emphasised in the FSB Peer Review on Deposit Insurance. http://www.financialstabilityboard.org/publications/r_120208.pdf

purchasers). In resolution circles, this is known as “purchase and assumption” or P&A. Bridge banks are often discussed in this context but they are not really another resolution strategy. Rather, they are a holding mechanism while a search for a buyer for part of the business is undertaken. So, under established practices in the USA and elsewhere, the basic non-liquidation resolution strategy has been to break up a bank into a good and bad bit; and effect a sale of the good and economically critical parts. In many major jurisdictions, including the UK, this is typically aided by an injection of resources by the Deposit Insurer, up to but not beyond what it would have expected to pay out to insured depositors in a liquidation. The most critical services – basically transactions deposits and payments – are thereby maintained.

Whether under “liquidation and payout” or “purchase and assumption”, uninsured depositors and other creditors, including bondholders, take losses after equity is exhausted. That includes the Deposit Insurer, which becomes a claimant creditor in the liquidation or administration of the rump of the business. It therefore stands to lose money if there is a realised loss that is not absorbed by more junior creditors. Any such loss is later recouped by the Deposit Insurer via a levy on the surviving insured banks.

It is important to underline that for banks funded by insured deposits, some of the costs of failure will fall on their peers. Over time, I suspect that that will increase pressure for a funded deposit-guarantee scheme with risk-based levies. That avoids defaulting banks getting off scott free, and has banks contributing to the deposit insurance system when times are good rather than only when under pressure.

I realise that I am telling this conference of deposit insurance agency experts things you already know! I am doing so because they are highly relevant to where I am going on the development of resolution strategies for coping with the failure of the world’s largest and most complex banks, and how Deposit Insurance might fit into that endeavour.

Resolution regimes for systemically important firms

The objective is, of course, to get to a position where public money is never used to provide solvency support for a failing bank, however large or complex.

To be clear, this is emphatically not just about preserving payments and transactions-deposit services. If we did only that, we will all be sitting around at some point in the future saying how appalling it was that a big dealer had failed and that they had had to be rescued in order to avoid a seizure in the capital markets.

So where are we on resolution regimes? It is worth saying upfront that we recognise that it is not easy for banks to assist the authorities in drawing up resolution plans when the full resolution legislation is not yet in place; it will matter enormously exactly what the legislation says. A year ago, the G20 Leaders endorsed an international standard – the FSB’s Key Attributes – that lays down what resolution regimes need to look like in the different jurisdictions around the world. It’s now a matter of countries putting those regimes into place. The US has largely done so through Dodd Frank. Europe is on the verge of doing so. It has a draft directive on recovery and resolution which seeks to implement the FSB standard very faithfully. This will be an enormous step forward. I think Asia will then follow that pattern, to the extent that it hasn’t done so already. The FSB’s Standards’ Implementation Committee currently has an exercise underway, led by Martin Gruenberg, Acting Chairman of the FDIC, and of course chair of the IADI, to review progress on legislating the Key Attributes. Their report is due to be published in the first quarter of 2013.

A broadly common statutory framework will help home and host authorities work together on resolution planning. To that end, Crisis Management Groups (CMGs) are now in place for nearly all global systemically important firms (or G-SIFIs as they are now commonly called), with the goal of reviewing firms’ proposed recovery plans and developing resolution strategies for them. *Firm-specific* cross-border cooperation agreements (or CoAgs) are also being developed, setting out roles and responsibilities of the home and host authorities, clarifying how they will share information, and how they will cooperate to implement their preferred resolution strategy. If home and host authorities are not going to cooperate, we need to flush that out ahead of time, rather than stumble into it in the moment of desperation. There's a good deal of cultural change entailed here. In the past, supervisors have sometimes seemed during peacetime to be more committed to cooperating than they have been prepared to live up to when it most mattered.

A forthcoming FSB consultation paper on developing resolution strategies

But we – the FSB – realise that more guidance is needed.

Although not of central interest to this audience, resolution isn't just about banks, and so we are planning to elaborate on how the Key Attributes should be applied to, for example, central counterparties, insurers, and the client assets held by prime brokers, custodians and others.

More relevant to today's conference, following the FSB's recent Plenary meeting in Tokyo we announced that in the next few weeks we will issue a consultative paper on resolution planning and, in particular, on resolution strategies.

The paper, drawn up by a subcommittee led by Christine Cumming of the New York Federal Reserve Bank, will cover three areas. The first is Recovery Triggers and Stress Scenarios used in recovery planning. Firms need to ensure that triggers are not linked mechanically to metrics that lag behind their true financial condition – a problem with some previous early-intervention frameworks. Recovery actions must start sufficiently early. But care must be taken to avoid markets overacting to the fact of such actions being taken. That is not easy.

Second, the consultative paper will outline a possible framework for national authorities to use when identifying the critical functions and support services of firms that need to be sustained in distressed conditions. What matters here is focusing on those services that are vital to the economy.

The third, and most important, area of consultation is about the development of Resolution Strategies and Operational Resolution Plans. This guidance aims to capture the main issues that authorities should address. It draws on two stylised approaches to resolution: a so-called "single point of entry" approach, under which resolution of a whole group is executed, primarily by the home authority and mainly at the level of the parent or holding company; and, secondly, a "multiple point of entry" approach whereby co-ordinated actions are taken by a number authorities along national, regional or functional lines. There is, of course, a spectrum between those two poles.

Identifying the resolution strategy that is most likely best suited to each specific firm is very important. The strategy must be relatively easy to understand – a strategy that cannot be explained concisely to top officials in central banks and regulators is not a strategy at all. But although authorities should try to identify a preferred strategy and should be as transparent as possible, I should caution that what turns out to be the best approach in the event of distress will depend on the circumstances. The suggestion of a "Presumptive Path", being aired by some in the market, is somewhat unrealistic, at least in its strongest form. Public authorities with statutory obligations to maintain stability cannot bind themselves to detailed strategies that in the event might not work as well as an alternative.

At the planning stage, whether a single- or a multiple-point-of-entry strategy looks more feasible will depend upon a group's organisational and financial structure. It is likely that some groups will need to adapt themselves in order to remove impediments to resolution.

Much of that will be case by case. But some general policies are also emerging. Here in the UK, the government is requiring the domestic retail banking business of the largest banking groups to be ring-fenced. And for the EU, Erkki Liikanen has produced an important report on the structure of banks which would involve essentially ring-fencing the trading business. Both of these approaches, which are similar in many respects, work with the grain of the FSB's approach to resolution.

Single-point of entry resolution: bail-in of the debt of the top company

The central principle running through this whole endeavour is that after equity is exhausted, losses should fall next on uninsured debt holders, in the order they would take losses in a standard bankruptcy or liquidation process. Although all resolution strategies have that effect, it is the particular focus of what has come to be called "bail-in". I should perhaps say that bail-in isn't about identifying a special type of bond that can be written down or converted. "Bail-in" is a verb not a noun. It's about giving the authorities the tools, the powers, to effect a restructuring of the capital and liabilities of a bank that isn't toxic all the way through; as such it will be recognisable to specialists as broadly akin to the US Chapter 11 system for business reconstructions, but speeded up for the exigencies of banking.

Bail-in is not unique in putting losses on bondholders. All resolution tools do that. The distinguishing characteristic of bail-in, as a resolution tool, is that it applies losses upfront based upon a valuation rather than at the end of a liquidation of assets. As such, it prospectively avoids an unnecessary destruction of value.

For those groups that issue debt from the holding company and downstream the proceeds to operating subsidiaries, it should be possible to bail in debt at the holding company and recapitalise distressed parts of the group. Where necessary, those distressed subsidiaries could be recapitalised by bailing-in – ie writing down and/or converting into equity – intergroup debt owed to the parent. The host authorities of those operating companies should in principle be prepared to go along with that kind of operation *provided* that the home country engenders the necessary trust and takes account of the need to maintain stability around the world not just in its immediate neighbourhood.

Deposit insurance schemes and bail-in: multiple point of entry resolution

We should not, however, assume a monolithic approach to resolution. It is not a case of one size fits all. What I have described could work for banking groups that issue plenty of debt out of a top company. It would not work so easily for groups operating commercial banks around the world that are funded to a very large extent from insured deposits. In a hypothetical extreme case, if they haven't issued bonds, then there would be no bond holders to bail in.

It has become fairly common to say that such groups should be resolved on a regional basis, ie broken up. Maybe. But even if that is correct, "break it up" hardly amounts to resolution plan. What happens to the broken-up parts? Under a "breakup" strategy, a plan is needed for all of the parts, both distressed and undistressed. That can't be a free for all. Indeed, it is worth underlining that, under the FSB Standard,[3] it is the responsibility of the home authorities of the group to ensure that a *group-wide* resolution plan exists. There is no ducking that. It removes an ambiguity that has quietly haunted banking authorities for decades, including in the UK.

Imagine an international commercial banking group whose operations in various jurisdictions are both big and complex. Good subsidiaries might be sold or floated off. But that won't be possible for the bankrupt parts of the group. The realisation of the assets via a standard liquidation of those subsidiaries would be liable to destroy a lot of value, creating disorder that could spill over to other jurisdictions and possibly globally. Such subsidiaries need to be

[3] FSB Standard Key Attribute 11.8.

resolved. That could be via bail-in of their bondholders and other creditors. But what happens if there are not enough bonds in issue to absorb all of the losses and recapitalise the operation? A way of cutting through that would be for each Deposit Insurer to be bailed in. Rather than a Deposit Insurer having to wait to discover its losses until the end of the process of a potentially destructive realisation of the bank's assets, it would hear up front how much it had lost. Its losses should be smaller that way. And it might gain a stake in a surviving business, which it could sell once conditions had calmed. This approach could, if necessary, be applied in different regions to different distressed subsidiaries of the group.

I must stress that in no way does any of this dilute the protection to insured deposits.

It puts losses to bondholders and also transfers them to the surviving parts of the various local banking systems standing behind each local Deposit Insurer. But, as I have outlined, so do other resolution techniques that draw up on the Deposit Insurers' resources. "Liquidation and payout" would entail much bigger losses for the Deposit Insurers and thus for other banks.

Work is underway on how to operationalise this strategy. It requires active cooperation amongst home and host authorities.

Recovery & resolution planning: making it happen

Indeed, a lot of work is underway, some of it publicly, some of it with firms, some of it quietly in the background. This is top level stuff. It isn't about writing 3,000 or 30,000 page essays. It is at its heart about a few regulators getting together with the top management of the firms and saying this is what we would plan to do to you if the only alternative was liquidation, and working out how to operationalise that strategy. That is something the key countries, the key governments, have every reason in the world to co-operate on. In the FSB, we are putting in place a process where the most senior officials will talk to each other to reassure themselves on the resolvability of globally significant firms. From that will follow detailed operational planning, and requirements to remove impediments to executing resolution strategies.

And flipping from my global hat to my domestic hat, at the Bank of England we have been working closely with the FDIC on how we would operationalise resolution strategies in a cross-border setting.

You shouldn't doubt that this will happen. Don't listen to siren voices who question our capability or will.

Financial protectionism and the FSB agenda

Which brings me, in conclusion, to a broader point. The international authorities are committed to maintaining global finance – global capital markets, the free flow of capital across borders. We are not trying to create a new order that incorporates financial protectionism. On the contrary: the balkanisation of finance would cut against the extraordinary historical changes towards a much more globalised real economy.

But allowing a fragile financial system to persist would also be a threat to globalisation. In fact, it has to be recognised that around the world domestic authorities have been putting in place defensive measures, mostly below the radar of commentators, over the past few years. This comes back to the use of public money. A world in which public money is used to bail out banks or dealers, is a world in which balkanisation is likely because the authorities that deploy public money are accountable to domestic tax payers – people with votes in their jurisdiction – and to nobody else. But by delivering the FSB's global agenda – not only on resolution, but more widely – we will significantly reduce, if not remove, the need for some of those balkanising tendencies. By making finance safe and orderly failure possible, I think we can take off the stage the most basic force towards balkanisation. The stakes are high.