Counting the cost of payout: constraints for deposit insurers in funding bank failure management[1]

Executive summary

Orderly bank failure management often requires funding beyond a bank's own loss-absorbing capacity and resources. For example, if liabilities exceed assets in a transfer of a failing bank's business to an acquirer, funds will be needed to facilitate that transaction. This is particularly relevant for banks that are predominantly funded by deposits, which do not reliably absorb losses in resolution. Industry-sourced deposit insurance funds (DIFs) are a potential source of such external funding. This requires the deposit insurer to be able to use its resources to protect insured deposits by funding measures other than payout.

Financial stability may benefit from broader use of deposit insurance funds in the management of a failing bank. Payout of the covered deposits of a failed bank protects insured deposits and helps maintain depositor confidence in the banking sector. DIF support for non-payout measures such as transfer transactions, bridge banks or capital and liquidity support under bank insolvency and resolution frameworks can achieve the same objective by minimising interruptions to depositors' access to their funds and, in addition, potentially offer wider benefits for financial stability. Those benefits stem from a broader range of failure management options for authorities which avoid the uncertainties and frictions of lengthy liquidation proceedings and achieve closure at a much earlier stage.

Nevertheless, there is a potential for tension between the use of DIF resources to fund bank failure management measures and a deposit insurer's ability to reimburse depositors. DIF resources should only be used in accordance with that DIF's mandate. If the deposit insurer's primary and perhaps only obligation is to protect insured depositors, DIF funding may only be provided to support measures that, at a minimum, protect insured deposits by ensuring continuity of access to deposits. Without appropriate safeguards, making DIF resources available to fund measures other than the payout of insured deposits risks a negative impact on the firepower of the DIF, and as a consequence on public trust in the DIF's ability to pay out depositors.

To manage that tension, jurisdictions impose constraints on the use of DIF resources. The way these constraints are framed and their effect on the amount of funding that may be available for measures other than payout varies. In some jurisdictions, the constraint is framed as a "least cost" requirement, meaning that DIF resources may only be used for the action that is assessed to be the least costly of all available options. Other jurisdictions cap the amount of DIF resources that may be used in an individual case, typically with reference to the cost the DIF would incur in payout, but within that cap do not require the least costly option to be adopted. The methodologies used to determine the least costly action or to calculate the quantitative cap also differ.

The elements that are taken into account when calculating the cost of payout vary significantly. In addition to the amount that would be required to pay out insured deposits, wider costs to the deposit insurer or DIF may be included. These include, variously, the operational costs of conducting a

[1] Bert van Roosebeke (bert.vanroosebeke@iadi.org), International Association of Deposit Insurers (IADI), Rastko Vrbaski (rastko.vrbaski@bis.org) and Ruth Walters (ruth.walters@bis.org), Bank for International Settlements (BIS), and Nicola Costa (Nicola.Costa@srb.europa.eu), Single Resolution Board (SRB).

The authors are grateful to contacts at the deposit insurers covered in this paper and to Jan Nolte and Danilo Palermo for helpful comments. Esther Künzi provided valuable administrative support with the paper. The views expressed herein are those of the authors and not necessarily those of the BIS, IADI or other Basel-based standard setters, or the SRB.

payout and liquidation; the "consequential" costs to the deposit insurer, such as borrowing or opportunity costs; and costs not directly arising from the case in question, such as the putative costs to the DIF of managing future bank failures that could be expected as a consequence of the systemic impact of a liquidation. Such costs may entail uncertainty, and the assessment requires judgment. That judgment may be guided by a framework that specifies, for example, expected asset values or time horizons for the purposes of estimating costs, but some degree of discretion to take account of case-specific circumstances is generally retained. As a result, cost calculations are inevitably complex.

Differences in how costs to the DIF are calculated help explain variations in outcome. The range of elements included in the calculation is one factor that influences the more likely outcome of the determination – DIF funding of payout or other measures. For example, the calculated cost of liquidation and payout may be comparatively high if the methodology recognises the costs to the deposit insurer of administering a liquidation and payout or future DIF liabilities in relation to subsequent bank failures that would be expected owing to the contagion effect of a liquidation. The inclusion of such broader costs in the calculation generally increases the scope for DIF funding for non-payout measures.[2] Conversely, a methodology based on a narrower range of costs increases the likelihood that payout will be determined as less costly for the deposit insurer. This is reinforced by certain forms depositor preference: the higher insured deposits rank in the creditor hierarchy, the more the deposit insurer can expect to recover reimbursed amounts by way of subrogation in liquidation. This lowers the net cost of payout to the deposit insurer and makes liquidation and payout a more likely outcome of cost-based decision-making.

Some frameworks incorporate flexibility by allowing constraints on the use of DIF funds to be overridden in specific, generally limited, circumstances. For example, some jurisdictions allow authorities to invoke an exception where necessary to contain a systemic impact that the lower cost options are considered likely to entail. Where the costs of payout are calculated narrowly and there is no exemption from the applicable constraint, the use of DIF resources to fund measures as an alternative to payout may in practice be limited, even if that ability is contemplated by the legal framework.

The ability to use DIF resources for non-payout measures, coupled with systemic exceptions, requires adequate funding. This is likely to entail backstop arrangements for public emergency funding to support the credibility of the DIF, even if private sources of funding are also available. In particular, systemic exceptions and public backstops appear to be linked. In the absence of systemic exceptions and public backstops, the ability to deal with systemic cases depends on the availability of special resolution regimes with their associated funding arrangements, including public backstops.

2 The impact will vary depending on the nature of the constraint on the uses of DIF resources and how the costs of non-payout measures are calculated.