BANK FOR INTERNATIONAL SETTLEMENTS

International Association of Deposit Insurers

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Introductory remarks

Hervé Hannoun

Deputy General Manager, Bank for International Settlements

Introduction

It is my pleasure today to welcome you to Basel. I would like to start by thanking IADI and Martin Gruenberg for the invitation to speak today. The theme of this conference – *Financial crises and the role of deposit insurance* – is indeed a timely and important one. Along with supervision and resolution, deposit insurance is one of the three key elements that form the financial safety net.

The critical role of deposit insurance was one of many lessons from the financial crisis. But there is a great diversity of deposit insurance arrangements. The 137 deposit insurance schemes worldwide can be roughly categorised into three separate models. On one end of the spectrum, there is the US model. This is a risk-minimising deposit insurance system that provides the Federal Deposit Insurance Corporation (FDIC) with a broad array of powers including both supervisory oversight and resolution capacity. On the other end of the spectrum is the so-called paybox model, which provides the deposit insurer with a more limited set of powers that facilitate the payment of claims to depositors. A third model exists along the continuum from the paybox model to an FDIC-type set of responsibilities. In this middle ground, additional powers are extended to the paybox model.

Despite this diversity in deposit insurance practices and the authorities that administer it, there is a common underpinning to all of the models: namely, that the existence of deposit insurance provides depositors with clarity, reassurance and confidence and thereby promotes financial stability. It facilitates the orderly payment of claims to depositors. As described in the Core Principles, the public policy objectives of a deposit insurance system are to contribute to the stability of the financial system and protect depositors.

Even when the deposit insurance systems have a narrow mandate – the paybox model – they still contribute to the two other components of the financial safety net, ie supervision and resolution.

In my remarks today, I will elaborate on three ideas that I think all deposit insurance institutions represented at this conference have in common:

I. First, deposit insurance forms an integral part of the global financial stability framework.

II. Second, deposit insurers play an important role in supporting a “back to basics” approach to banking supervision.

III. And, third, deposit insurers are key actors in bank crisis management and in bank resolution.

I. Deposit insurance forms an integral part of the global financial stability framework

The crisis revealed the importance of effective deposit insurance as a key element of the global financial stability framework. A loss of confidence among depositors was observed during the crisis. In response to this anxiety, some authorities increased the coverage of their jurisdiction's deposit insurance scheme or even provided an explicit blanket guarantee. These interventions came at a cost, in some cases a high cost. But, all in all, there were no widespread bank runs during the crisis. Authorities succeeded in their efforts to protect depositors. The adoption of higher deposit insurance coverage levels in many jurisdictions helped prevent the panic of debt investors from being transmitted to depositors. This highlights the powerful effect of deposit insurance on public confidence and financial stability.

Although there has been much progress in the area of deposit insurance, there are still differences among the various deposit insurance arrangements that could complicate cross-border resolutions. Cross-border issues were highlighted during the crisis, for example, in the Icelandic banking crisis. Some of the existing differences include coverage (deposits covered and the amount of coverage), payout times and payout funding (ex ante, ex post and hybrid). In this context, globally coordinated implementation of the Core Principles could help to narrow the gaps among countries.

The need for coordination is indeed another key lesson from the crisis. We should not forget that many countries had to expand deposit insurance coverage in an uncoordinated and disorderly way during the crisis, as reflected in the case of the issuance of blanket guarantees by the Irish authorities. This forced other European countries to enhance their deposit protection systems, and ultimately transformed Ireland's banking crisis into a sovereign debt crisis. It would be desirable to avoid this lack of coordination in future.

The development of the Core Principles was a key milestone in the direction of better coordination. The FSB's adoption of the Core Principles as one of its 12 key standards for sound financial systems marks deposit insurance as an integral part of the global financial stability framework.

I would like to express the BIS's appreciation of IADI's recent achievements under the strong leadership of Martin Gruenberg. IADI has become an important participant in the Basel process, a process which cascades from the Financial Stability Board (FSB), the overarching body in charge of coordinating efforts to maintain global financial stability. The BIS hosts not only the FSB's secretariat but also those of four standard setters: IADI itself, the Basel Committee, the Committee on Payment and Settlement Systems (CPSS) and the International Association of Insurance Supervisors (IAIS).

The interaction among these sister organisations has really been enhanced since the crisis and the BIS is proud to provide support. The joint writing of *The Core Principles for Effective Deposit Insurance Systems* by IADI and the Basel Committee in June 2009 illustrates the benefits of the Basel process of cooperation among the BIS-hosted standard-setting bodies. The Core Principles Methodology issued last January will be a useful way of assessing a country's compliance with the Core Principles. Self-assessment or external assessments (for example, through those carried out by the International Monetary Fund, World Bank and FSB peer review process) of the Core Principles will help deposit insurers and policy makers to identify the strengths and weaknesses in their systems. These continuous assessments will serve to strengthen every country's safety net.

II. Deposit insurers help promote a “back to basics” approach to banking supervision

Moving to the second component of the financial safety net – supervision – the Basel III framework reflects the need for a “back to basics” approach to bank regulation and supervision. Let me give you a few examples:

- Basel III raises the quality and quantity of capital with a fundamental tightening of the definition of capital and a greater focus on common equity.
- It introduces a simple leverage ratio that will act as a backstop to the risk-based measure. The Committee’s calibration work shows that bank leverage marked the difference, to a high degree of statistical significance, between banks that ultimately failed or required government bailouts during the crisis and those that did not.
- Basel III establishes a straightforward mechanism for building capital buffers in good times that can be drawn down in periods of stress. This is the countercyclical buffer. It also provides for a capital conservation buffer, which will help prevent inappropriate distributions of capital – such as dividends.
- Finally, it introduces global liquidity standards that will help ensure that banks effectively manage liquidity risk and maintain adequate liquidity buffers.

By nature, deposit insurers are supportive of a “back to basics” approach to banking supervision. They deal with small banks as well as big banks. They also deal with simple concepts and do not rely too much on the sophisticated models developed by big banks.

Deposit insurers tend to support strong capital buffers and low leverage as key protections for depositors. The strengthening of capital buffers and the introduction of a leverage ratio in the Basel III framework suggest that international standards are going in the direction of the back-to-basics approach that is widely supported by deposit insurers. Regarding the leverage ratio, let me highlight the importance of the Basel III commitment to move towards a binding Pillar 1 leverage ratio. Any step in the direction of a non-binding leverage ratio, as advocated in some European quarters, would signal that some large banks are still seeking to derail this key element of the global regulatory reform endorsed by G20 leaders. This, in turn, would ultimately threaten financial stability and the wallets of taxpayers, as risk-based ratios alone are vulnerable to gaming, as we saw in the run-up to the financial crisis.

Countercyclicality is another aspect of this approach. A countercyclical capital buffer is part of the Basel III framework for bank supervision. Countercyclicality is also a concept familiar to deposit insurers when setting the funding mechanism necessary to ensure the prompt reimbursement of depositors’ claims. Funding mechanisms can be ex ante, ex post or hybrid. An advantage of ex-ante funding is its countercyclical character: funds can be accumulated in good times as a hedge against future needs in bad times.

III. Deposit insurers are key actors in bank crisis management and resolution

Moving to the third pillar of the financial safety net – resolution – deposit insurers are key actors in bank crisis management and in bank resolution. They are involved in the policies that provide for the early detection of problems, timely corrective action and the resolution of troubled banks.

That said, the degree to which deposit insurance authorities are involved in bank resolution varies widely. In the United States, the FDIC is vested with legal resolution authority for insured depository institutions and also for systemically important financial institutions (SIFIs). In many other countries, the deposit insurance system is not in charge of bank resolution. However, because they are in charge of protecting insured depositors, deposit insurers are always involved in bank resolution in one way or another.

Resolution regimes for small banks work well on the whole. Resolution of SIFIs is more challenging, given the difficulty of unwinding massive and complex derivative books. Cross-border resolution of SIFIs is an even thornier task, given the territoriality issues and potential conflicts of interest between home and host authorities.

Effective cross-border bank resolution and deposit insurance

The Basel Committee issued 10 recommendations for effective cross-border bank resolution in March 2010, which the G20 leaders endorsed in June 2010.

The importance of an effective deposit insurance system was reiterated in this report. Recommendation 1 calls for prompt payment to insured depositors as a necessary feature of an effective resolution regime. Recommendation 3 urges national authorities to seek convergence of national resolution tools and measures including deposit insurance systems. I would like to emphasise that the implementation of these principles is key to facilitating an effective cross-border bank resolution. National authorities are responsible for narrowing the gaps across jurisdictions.

The Basel Committee recently conducted a survey to gauge progress in the implementation of its recommendations and has produced a stock-taking report. This report is scheduled to be published after the June Basel Committee meeting. In short, progress has been made in many jurisdictions but it must be said that renewed focus by national authorities on accelerating reforms is needed, especially in the cross-border context. This also applies to deposit insurance.

Improving the resolvability of systemically important financial institutions in the event of failure

Effective resolution regimes have come to be recognised as a critical component of any approach to addressing the too-big-to-fail problem, ie ensuring that the largest financial institutions can be either recapitalised as a going concern or wound down in an orderly manner without cost to taxpayers.

The FSB assigns a high priority to the design of regimes to ensure the orderly resolution of any SIFIs in the event of failure. This means that all SIFIs will be responsible for maintaining credible, actionable resolution plans ("living wills").

Each country should have a designated resolution authority responsible for exercising resolution powers over financial institutions. This authority may be the deposit insurance agency (as in the United States) or another state agency or a subsidiary of the central bank (as in the United Kingdom).

The aim of the resolution framework is to ensure that all financial institutions can be resolved safely, without destabilising the financial system and without exposing the taxpayer to the risk of loss, in other words without the government bailing out uninsured creditors.

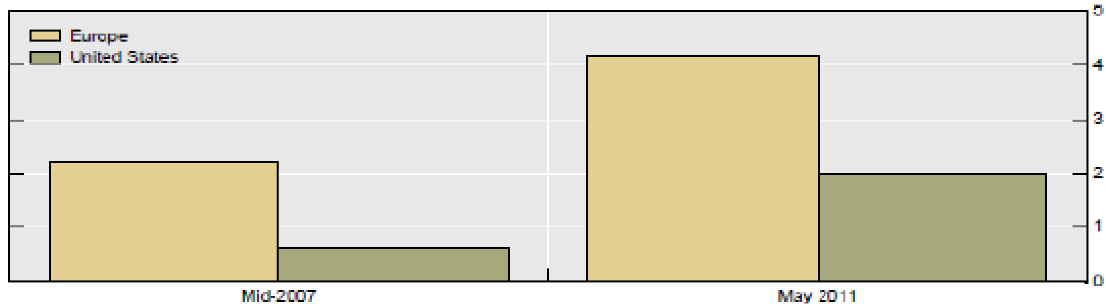
No bailout policy and market pricing: a conundrum

At the same time, I believe market pricing is currently showing us a conundrum. This relates to the aversion to taxpayer-funded bailouts of "too big to fail" financial institutions – as reflected in the dramatic change of perspective among policymakers between the G7 statement of 10 October 2008 at the peak of the crisis ("Take decisive action and use all available tools to support systemically important financial institutions and prevent their failure") and the declaration by the US President on 21 January 2010 ("Never again will the American taxpayer be held hostage by a bank that is too big to fail").

A crucial issue is whether financial markets have factored the "no bailout" policy into their pricing of risk related to systemically important banks – and whether credit rating agencies will alter their bank rating methodology, which currently takes into account not only the stand-

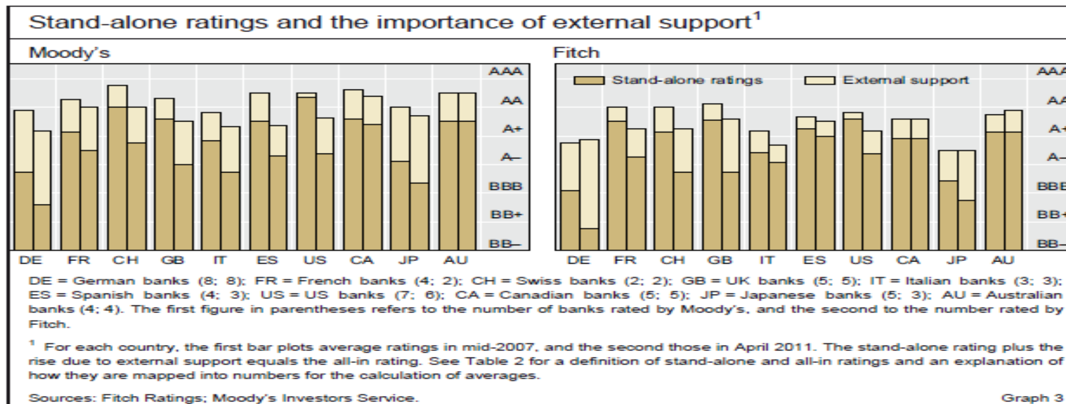
alone bank credit profile but also the effect of government support in times of stress. Typically this methodology leads to bank ratings that are several notches higher than where they would be without government backing. What is highly intriguing in this respect is that rating upgrades due to implicit official support have increased since 2007, as shown in this graph.[1]

Rating upgrade due to implicit official support[1]



[1] Rating upgrade is the number of notches that banks' ratings are increased based on the implicit expectation of official support.

Sources: Fitch Ratings and FSB calculations.



Stand-alone ratings and the importance of external support[1]

DE = German banks (8; 8); FR = French banks (4; 2); CH = Swiss banks (2; 2); GB = UK banks (5; 5); IT = Italian banks (3; 3); ES = Spanish banks (4; 3); US = US banks (7; 6); CA = Canadian banks (5; 5); JP = Japanese banks (5; 3); AU = Australian banks (4; 4). The first figure in parentheses refers to the number of banks rated by Moody's, and the second to the number rated by Fitch.

[1] For each country, the first bar plots average ratings in mid-2007, and the second those in April 2011. The stand-alone rating plus the rise due to external support equals the all-in rating. See Table 2 for a definition of stand-alone and all-in ratings and an explanation of how they are mapped into numbers for the calculation of averages.

Sources: Fitch Ratings; Moody's Investors Service. Graph 3

This means that markets are still pricing in a large degree of public support for banks. This potential disconnect between the policy orientation (no bailout) and market pricing, as reflected in banks' CDS spreads and credit ratings, deserves thorough analysis. As I speak, Moody's and Standard & Poor's are both revising their approaches to measuring government support of banks, with the likely result of net downgrades. However, even with the revisions, the rating agencies will still be inviting market participants to price in prospective public support for banks – indeed, Standard & Poor's will explicitly pay attention to systemic importance in assessing such support. We must recognise that market participants will wait until they see cross-border resolution in action before they completely price in a "no bailout" policy and this might then have an impact on the respective levels of bank and sovereign CDS spreads.

[1] See also F Packer and N Tarashev, "Rating methodologies for banks", *BIS Quarterly Review,* June 2011

Sovereign and bank CDS spreads

iTraxx Europe CDS spreads
Five-year on-the-run; in basis points

Reducing the default probability of systemically important financial institutions by increasing their loss absorption capacity

Although substantial progress is being made in strengthening national resolution regimes and improving coordination on cross border issues, we need to be realistic about the feasibility of a global resolution regime that can cope with the failure of a global SIFI. It is therefore critical to reduce the probability of SIFI failures by increasing the loss absorption capacity of such institutions.

At the G20 Seoul Summit in November 2010, the leaders reiterated the importance of the work on SIFIs. Global SIFIs were defined as institutions of such size, market importance, complexity and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries. It was also agreed that global SIFIs should have loss absorption capacity beyond the minimum Basel III standards. Indeed, additional capital requirements for global SIFIs find their rationale in externalities that Basel III does not fully address.

To deal with the externalities of global SIFIs, the FSB and the Basel Committee are currently developing an assessment methodology for systemic importance that will identify global SIFIs. Based on their systemic importance, global SIFIs will be required to bolster their loss absorbency by holding a systemic capital surcharge or adding contingent capital.

In percentage of risk-weighted assets	Capital requirements							Additional macroprudential overlay	
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer	Additional loss-absorbing capacity for SIFIs*
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	Range	
Basel II	**2**			4		**8**			
Memo:	*Equivalent to around 1% for an average international bank under the new definition*			*Equivalent to around 2% for an average international bank under the new definition*					
Basel III New definition and calibration	**4.5**	2.5	**7.0**	6	8.5	**8**	**10.5**	0–2.5	Systemic capital surcharge

* Modalities to be defined.

I would like to underline that the Basel III capital requirements (the 7% common equity ratio, comprising the 4.5% minimum plus a 2.5% capital conservation buffer) should be seen as setting a minimum requirement; they are not a maximum. This is a fundamental point, which is the subject of an important debate at the moment in the European Union. It is important in our view to allow national authorities to set higher capital requirements than the Basel III minima. It is equally important to recognise the ability of supervisors, within each jurisdiction, to require additional loss absorbency for SIFIs in the form of common equity beyond the 7% common equity ratio established by Basel III.

To conclude, in the absence of a global resolution framework for the time being, the only reasonable course of action is to make SIFI failures less likely by imposing systemic capital surcharges.