Deposit insurance and financial stability: old and new challenges

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Introduction

Good afternoon, ladies and gentlemen. Let me salute Katsunori Mikuniya, President and Chair of the Executive Council of the International Association of Deposit Insurers (IADI) and David Walker, IADI Secretary General. Allow me to start by welcoming you all to Basel. As you know, the BIS hosts the IADI Secretariat, as well as the secretariats of the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructure, the International Association of Insurance Supervisors and the Financial Stability Board. This allows for close interaction among experts working in different areas of regulation and financial stability, forming what is now known as the Basel Process.

Regulators have devoted much of the past 10 years to incorporating the lessons learned from the recent financial crises into new regulatory frameworks. While the objectives of specific regulatory reforms differ, the overarching aim is to ensure trust in the financial system.

In my talk today, I would like to discuss the channels through which effective deposit insurance schemes support trust. In doing so, I will revisit the specific goals of deposit insurance, and the benefits of reaching these goals. But I will also sketch inherent limitations and trade-offs. One well known trade-off stems from moral hazard, or weakening of market discipline. It is less appreciated that deposit insurance may actually attenuate some aspects of moral hazard.

Deposit insurance is an important pillar of trust. Yet it is most effective when it stands alongside other pillars of trust, such as banking supervision, resolution arrangements and ultimately the lender of last resort function of central banks. Current discussion on the establishment of a common deposit insurance scheme for the euro area – the European Deposit Insurance Scheme – provides an excellent opportunity to reassess the whole regulatory architecture. And the lessons from this reassessment are likely to be instructive beyond the euro area.

Effective regulation not only incorporates lessons from the past, but also adapts to structural changes in the financial system. Thus, looking ahead, deposit insurance needs to be reviewed continuously. Improvisation in the midst of a crisis can be a recipe for disaster.

Review of the basics

So let me start with a very basic question: what makes an insurance scheme effective in protecting *retail* depositors? Such schemes work if they are credible in assuring instant liquidity and assisting those who lack the time and expertise to monitor banks. Successful schemes are credible at all times. They serve to prevent self-fulfilling retail runs on otherwise viable banks. And they protect the depositors of a bank that fails for fundamental reasons.

But the pot of insured deposits is never backed 100% by cash in a vault. Thus, trust also requires a credible backstop by the government, beyond the funds readily available to the deposit insurance scheme. The importance of such a backstop became clear during the Great Financial Crisis, when public support of the banking system included the expansion of retail deposit insurance – for instance, from $100,000 to $250,000 in the United States. In other countries, such as Germany, all retail deposits were insured during the crisis. This expansion helped avoid a meltdown of the financial system and – even though the economic downturn was steep – prevented a collapse in consumption. It is in this sense that deposit insurance revealed its value during the crisis.

While deposit insurance schemes can ward off *retail* bank runs, they do not rule out runs on *wholesale* markets. During normal times, insurance schemes should not get in the way of a wholesale run on an individual institution, as this is part of healthy market discipline. But as the Great Financial Crisis worsened, the drying-up of wholesale funding markets put the entire system at risk. This forced many central banks to step in as lenders of last resort. At the same time, governments extended guarantees to wholesale funding and, in the United States, also to money market mutual funds.

Official liquidity assistance has evolved recently. As financial intermediation has shifted outside the banking sector, it has become important to carefully reassess the provision of liquidity support. Indeed, some post-crisis quantitative easing schemes targeted specific markets in distress. More structurally, some central banks expanded the scope of their lender of last resort coverage. The Bank of England, for example, started providing liquidity support to selected broker-dealers and central counterparties.[1] Similar arrangements are in place at the Bank of Japan.[2] A credible backstop to systemic liquidity issues supports banks and, ultimately, their depositors.

But we need to be careful when drawing parallels between deposit insurance schemes and the lender of last resort. Granted, both sustain trust in the financial system by reducing the risk of self-fulfilling runs. Even so, there are important differences. In principle, a lender of last resort seeks to address liquidity strains at viable institutions. This is an inherently difficult decision in the midst of a crisis, and needs to be at the central bank's discretion. Deposit insurance, by contrast, protects depositors of failing banks. And it is the rules-based nature of deposit insurance schemes that contains uncertainty. As such, last-resort lending and deposit insurance complement each other.

Financial regulation: synergies with deposit insurance

Crises – except for those resulting from self-fulfilling runs – are not like meteor strikes. They stem from a gradual build-up of vulnerabilities. Here, prudential regulation steps in to ensure that deposit insurance schemes are called on only rarely.

The post-crisis regulatory reforms have made the banking sector stronger, which ultimately serves also to protect retail deposits. Regulatory buffers are part of both capital and liquidity regulation under Basel III. The countercyclical capital buffer contributes to greater loss-absorbing capacity in the case

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1 Access to the Bank of England's sterling monetary framework is subject to constraints. For one, only broker-dealers deemed critical to the stability of the UK financial system are eligible to apply for participation in the framework. See Bank of England, *The Bank of England's sterling monetary framework*, June 2015.

2 See, for instance, Bank of Japan, *Guidelines on eligible collateral*, 7 October 2014.

of a systemic event. The capital conservation buffer and global systemically important bank surcharges are there to absorb the losses of going concerns. And the Liquidity Coverage Ratio is intended specifically to help contain liquidity mismatches.

In addition, the Financial Stability Board has issued: (i) key attributes of effective resolution regimes for financial institutions; and (ii) minimum requirements for global systemically important banks' total loss-absorbing capacity.[3] Together with stronger Basel III minimum capital requirements, these measures have increased the pool of resources available to authorities for resolving or winding down a gone concern. These resources have been expressly calibrated to minimise the exposure of depositors and taxpayers to failing banks.

Clearly, effective resolution requires ongoing communication and coordination among supervisors, resolution authorities and deposit insurers. Even deposit insurers with a simple "paybox" mandate need to be involved in contingency planning in the run-up to a bank failure in order to ensure timely reimbursements of insured deposits. Notably, in many jurisdictions the mandate of the deposit insurer is much broader, and includes a direct role in managing bank failure as receiver, liquidator or resolution authority.

In this context, it is important to keep in mind that a smooth resolution means different things for different banks. While bail-in-able securities support the resolution of large banks, small and medium-sized institutions may simply be unable to issue such instruments. In fact, many of the smaller banks do not meet the conditions for use of resolution regimes. Forthcoming research by the Financial Stability Institute concludes that, in such cases, the deposit insurer, as the responsible authority under an administrative regime, may require a wider range of instruments, beyond conventional liquidation actions.[4] These are needed to protect deposits as well as to manage and sell the bank's assets in a way that minimises the cost to the deposit insurance funds and maximises value for creditors.

Turning to large and complex institutions, there will always be uncertainty about the benefits and costs of letting them enter into resolution. But deposit insurance itself can help reduce such uncertainty. By protecting small depositors and ensuring speedy payments, well structured schemes can shield authorities from political economy pressures to keep insolvent institutions afloat. This helps to reduce moral hazard.

The European deposit insurance scheme

Let me now turn to the European Deposit Insurance Scheme (EDIS). Recent developments in Europe provide important insights on how deposit insurance fits into the broader regulatory framework and the associated challenges. Specifically, the planned creation of a common deposit insurance scheme for the euro area is a key step towards the completion of the euro area's banking union. As such, the EDIS would complement the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), which have emerged as the regulatory response to the recent crisis. The SSM and SRM are fully operational now, although the Single Resolution Fund, which backs the SRM, is to build up gradually to reach its target level

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3 See FSB, *Key attributes of effective resolution regimes for financial institutions*, October 2014; and FSB, *Principles on loss-absorbing and recapitalisation capacity of G-SIBs in resolution – total loss-absorbing capacity (TLAC) term sheet*, November 2015.

4 See FSI, "How to manage failures of non-systemic banks? A review of country practices", *FSI Insights on policy implementation*, forthcoming.

only by end-2023.[5] In addition, there are also backstop arrangements with the European Stability Mechanism. In case the Single Resolution Fund is depleted by the failure of a large bank and that bank's sovereign has lost its access to capital markets, the European Stability Mechanism could step in as a lender of last resort.

The EDIS could prove instrumental for instilling trust in cases where the size of a national banking system overwhelms the public resources of the home country. It would also be useful when the political climate casts doubt on the equal treatment of all depositors in the event of a bank failure.

But there are important challenges on the road to EDIS implementation.

The mutualisation principle of a supranational deposit insurance scheme gives rise to moral hazard issues not only at the bank level but also at the country level. If national authorities are not fully responsible for protecting retail depositors, they may reduce their oversight of banks and allow more risk-taking. This would make the banking system less stable. And if the reduction in oversight generalises, interlinkages between banks and sovereigns would undermine the credibility of supranational backstops.

The detrimental implications of such interlinkages are still fresh in Europeans' memory. For one, Italy and Spain experienced deposit flight during the sovereign crisis. To contain such a flight from Ireland, the country's government felt compelled to extend protection to all bank debt, both new and existing. This put pressure on taxpayers, who are also consumers, thus running against one of the key missions of retail deposit insurance. And Ireland's actions spilled over to other markets.

It is thus advisable that all countries seek to resolve legacy issues and address moral hazard now, before the EDIS has been put in place. In the spirit of arrangements for national resolution funds in the EU, moral hazard could be alleviated by institutionalising the burden-sharing by banks' shareholders and junior creditors. This would provide strong incentives to contain risk-taking, which would mitigate the accumulation of imbalances in tranquil times.

Resolving the outstanding issues would enhance the effectiveness of the EDIS. This scheme would then fully benefit from the diversification of risks across countries. In turn, such diversification would strengthen the resilience of the European banking system to localised stress.

Depositors in the age of technological innovation

Now what about technological innovations? To reflect lessons from the crisis, the IADI Core Principles were revised in 2014. The revision strengthened several key areas, including speed of reimbursement, deposit insurance coverage, funding and governance.

As deposit insurers seek to further increase the speed of reimbursement and to improve communication and coordination with other supervisory authorities, they will need to adapt to a changing financial landscape. Ideally, the adaptation should take place during periods of relative tranquillity, as crises are the worst times for improvisation.

Most recently, rapidly evolving technological innovations have accelerated the financial system's post-crisis transformation. Such innovations have given rise to fintech startups that often collaborate with, or are acquired by, banks. They have also paved the way for large technology companies ("bigtechs") to compete directly with banks.

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5 As of 30 June 2018, the Single Resolution Fund held €24.9 billion based on contributions from 3,315 institutions. The fund's target size was set to the equivalent of 1% of covered deposits in the euro area. The European Commission has estimated this to be €55–60 billion.

Technology enhancements hold the potential to further improve the efficiency of deposit insurance schemes. One example is data access, with improved IT structures at banks helping deposit insurers to gain access to relevant information in order to execute payouts more quickly. Another is communication, with new channels allowing deposit insurers to reach out directly to depositors of a failing bank. These improvements, while seemingly minor when considered individually, add to the credibility of insurance schemes and thereby support trust in the financial system.

Yet new technologies also involve challenges that may become quite visible to the general public. The fast flow of information and easy access to alternative products and web-based media may make deposits less sticky. A "one-click" migration of deposits has become extremely easy. This raises the bar for what constitutes a well structured deposit insurance scheme.

In addition, some bigtechs have started to provide bank-like intermediation, even though they cannot offer deposit insurance. Likewise, fintech firms are in a position to receive bank licenses – eg from the Comptroller of the Currency in the United States – without offering insured deposits.[6] Whether and how digital wallets and other e-money should be insured is still subject to debate. What is undisputed is that customers should be well informed of the extent to which they are – or are not – protected.

Concluding remarks

Let me conclude with some observations on what these developments imply for policy. Clearly, deposit insurance design needs to learn from the past. Notable progress has been made since the crisis. In the euro area, the introduction of the EDIS could prove to be a catalyst for financial integration, by completing the banking union, and for enhancing the regime for dealing with weak banks. More generally, deposit insurers have assumed an active role in resolution, strengthening the post-crisis financial system.

Deposit insurance also needs to preserve its flexibility to account for the ongoing technological revolution in finance. As the line between banks and non-banks blurs, there is an increasing likelihood that a crisis of confidence in the fintech sector could spill over to the traditional banking sector. For instance, if deposits at bigtechs reach a critical mass, lost confidence in their liquidity could put pressure on the overall financial system and undermine trust in all deposits. The importance of deposit insurance thus remains as relevant as ever.

Thank you very much.

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6 See Office of the Comptroller of the Currency, "OCC begins accepting national bank charter applications from financial technology companies", press release, 31 July 2018.