Deposit guarantee schemes: their role in resolution

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Building a better working world

When is a bank “safe to fail”?

Recap

- **No cost to taxpayer**

Assure continuity

- **Customers can conduct normal operations from start of next business day**

Limit side effects

- **No significant adverse effects on financial markets or the economy at large**

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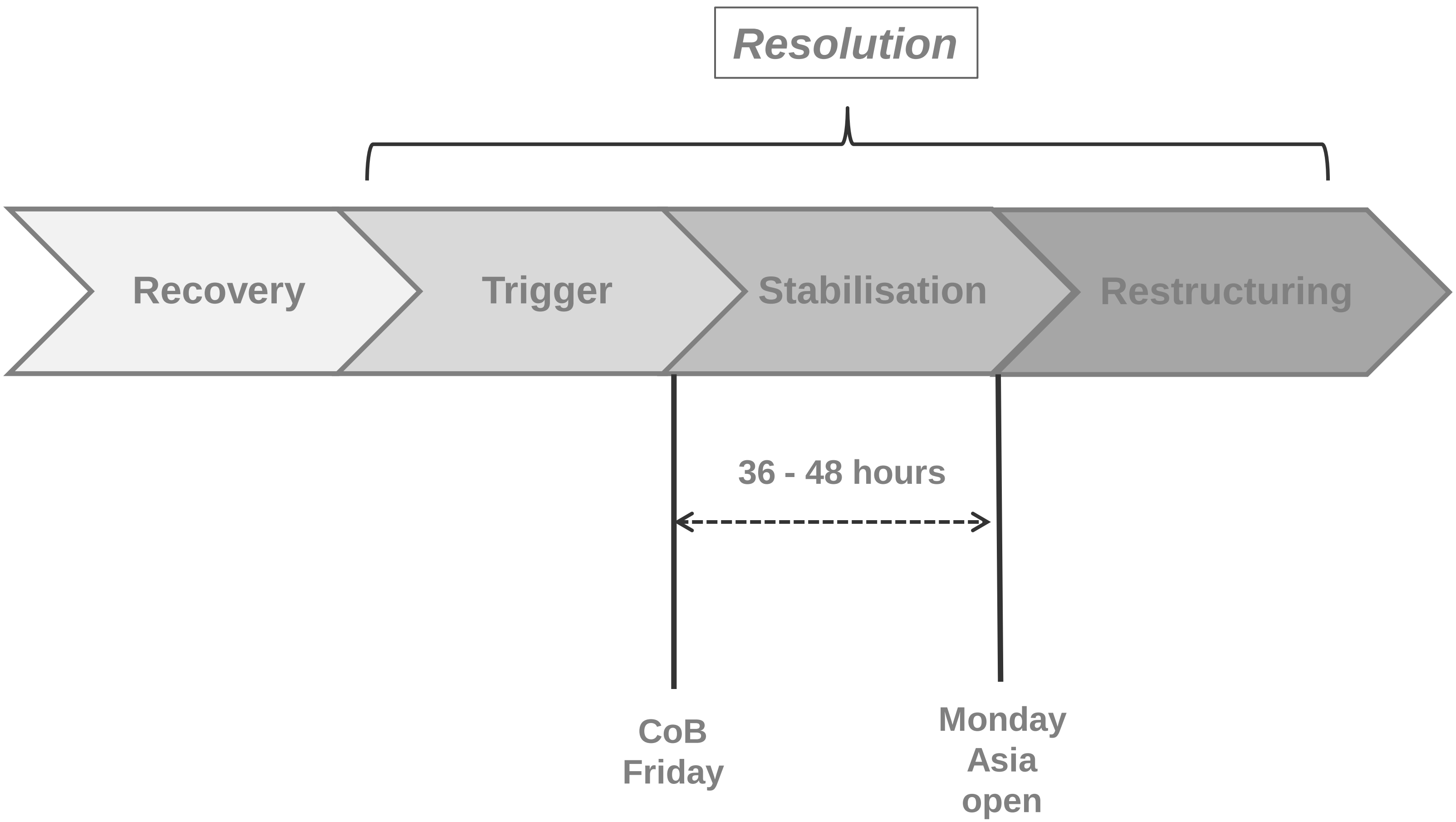
Resolution has three stages



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Deposit guarantee funds and resolution funds fulfil separate purposes

Deposit guarantee fund

- Facilitates fulfilment of DGS obligation to pay off insured deposits in event bank goes into resolution.
  - Absorbs loss to DGS
  - Has claim on recoveries from estate of failed bank.
  - Meets limited liquidity needs
  - Has backstop from government
- Risk to DGS, is limited, if
  - Bank has layer of funding subordinated to deposits and subject to bail-in

Resolution fund

- Compensates creditors who become worse off than they would have fared under liquidation.
- Facilitates financing of resolution tools such as bridge bank and deposit transfer.
- May directly recapitalise failed bank.

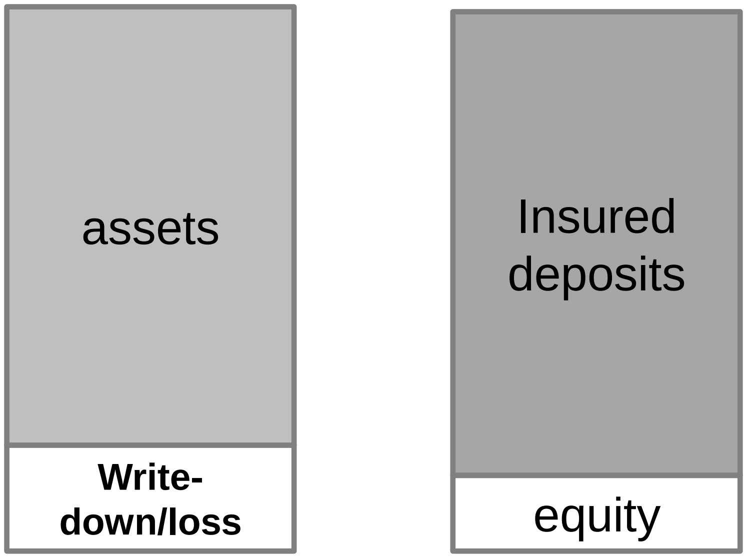
DGS and resolution funds provide means to absorb loss.
They do not provide on-going liquidity to the bank in resolutioin

Case 1: DGS is only creditor of the failed bank

If a bank funds itself entirely via insured deposits, at the entry of such a bank into resolution, the DGS assumes the rights of the depositors against the failed bank and becomes the only creditor of the bank.

In such a case, it is natural for the DGS to become the resolution authority of the failed bank. As the DGS is the only creditor, it is by definition acting in the interests of all the creditors.

Balance sheet at point of entry into resolution

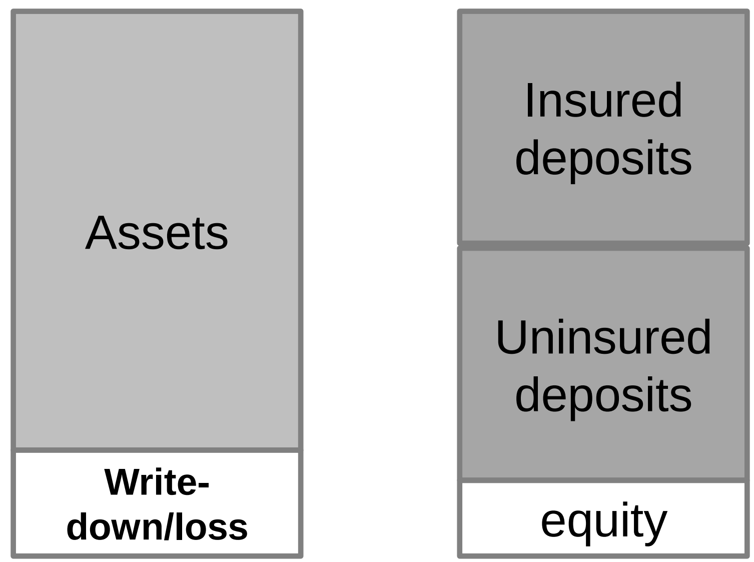


Case 2a: The bank funds itself via insured and uninsured deposits (pari passu with insured deposits)

If a bank funds itself via uninsured as well as insured deposits, at the entry of such a bank into resolution, the DGS only assumes the rights of the depositors against the failed bank. Although the DGS is not the only creditor of the failed bank, it is likely to be the single largest depositor.

In such a case, it is logical for the DGS to play a significant role in resolution. If the DGS does act as the resolution authority, it must do so in the interests of all depositors, not just insured depositors. Pari passu treatment should be preserved.

Balance sheet at point of entry into resolution

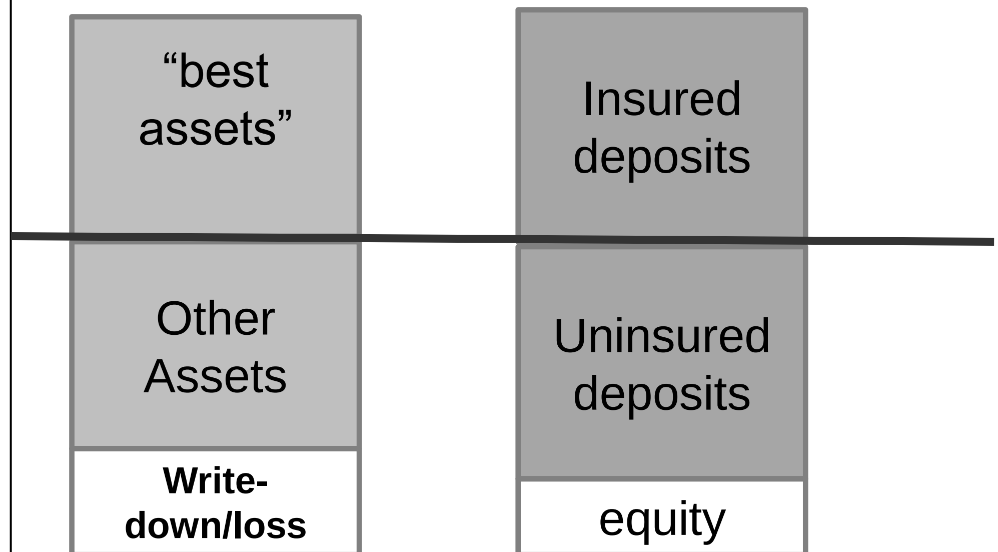


Case 2b: The bank funds itself via insured and uninsured deposits, but former have preference

If a bank funds itself via uninsured as well as insured deposits, at the entry of such a bank into resolution, the DGS only assumes the rights of the depositors against the failed bank. Although the DGS is not the only creditor of the failed bank, it is likely to be the single largest depositor.

If insured assets have preference, it is possible for the DGS to cherry pick the best assets from the estate of the failed bank put them against the insured deposits and transfer the package to a third party. The DGS is not necessarily the best representative of the interests of the uninsured depositors and need not be the resolution authority.

Balance sheet at point of entry into resolution



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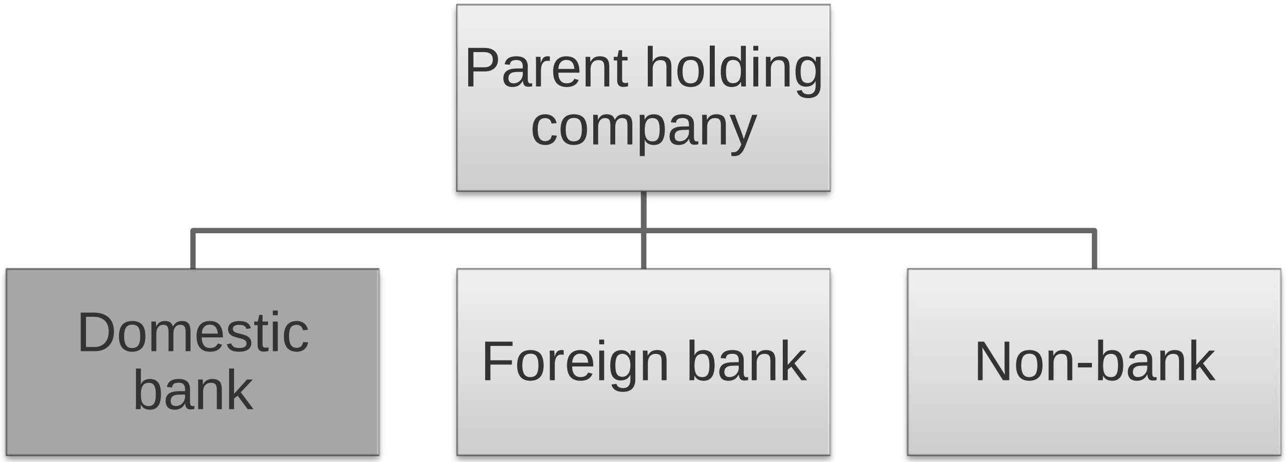
Case 3: the bank is a subsidiary of a parent holding company



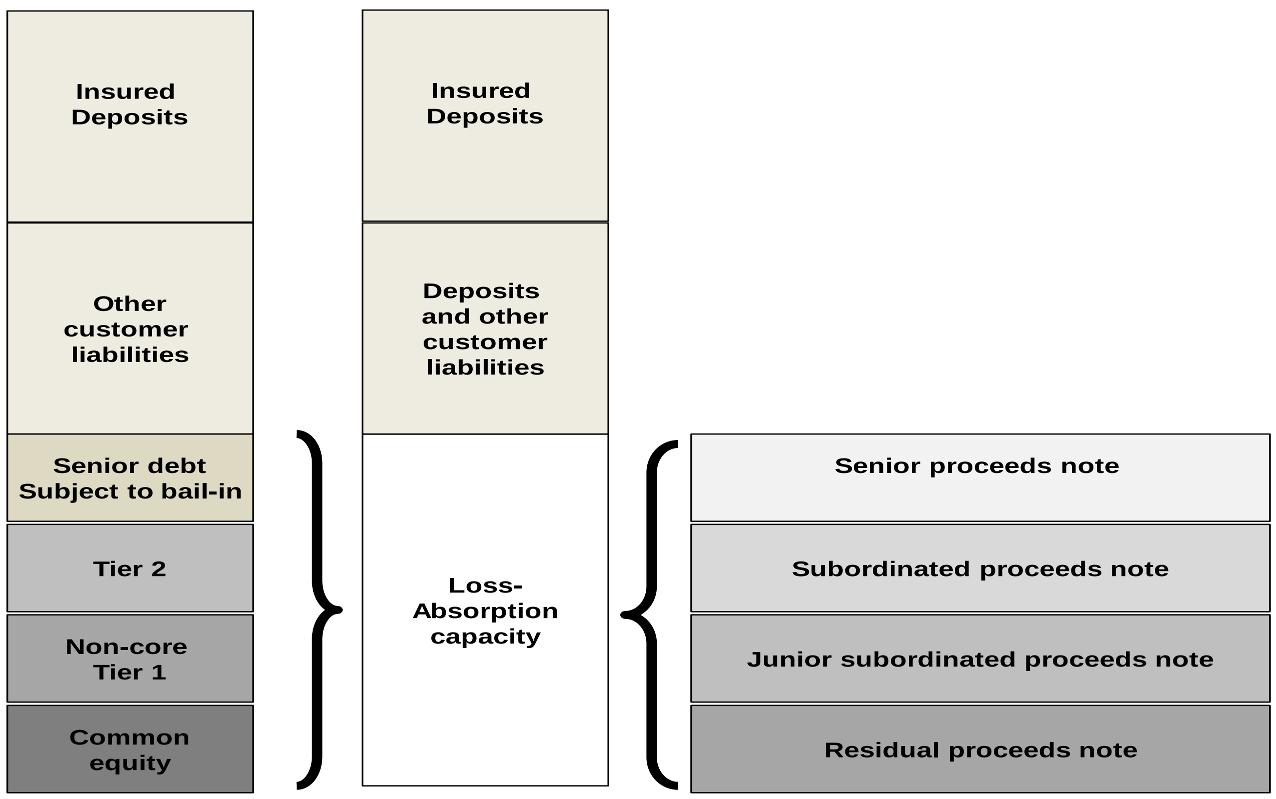
- **DGS's primary responsibility is to protect insured deposits issued by domestic bank.**
- **If DGS is the resolution authority, it may have a conflict of interest between its role as protector of insured deposits at domestic bank and role as resolution authority (where it should act in the interests of all creditors).**

Bail-in is the key to recap without taxpayer support

Recap

- **Bank must have minimum amount of investor instruments outstanding subject to mandatory bail-in immediately at resolution**
- **Resolution authority must have power to bail-in such instruments**

Bail-in via stay on investor capital



Liquidity is key to assuring continuity

Assure continuity

- Super senior on basis of bank's unencumbered assets
- Banks will need to maintain and report "sources and uses" collateral budget and arrange for pledge
- Central bank(s) will need to put in place framework for such a facility

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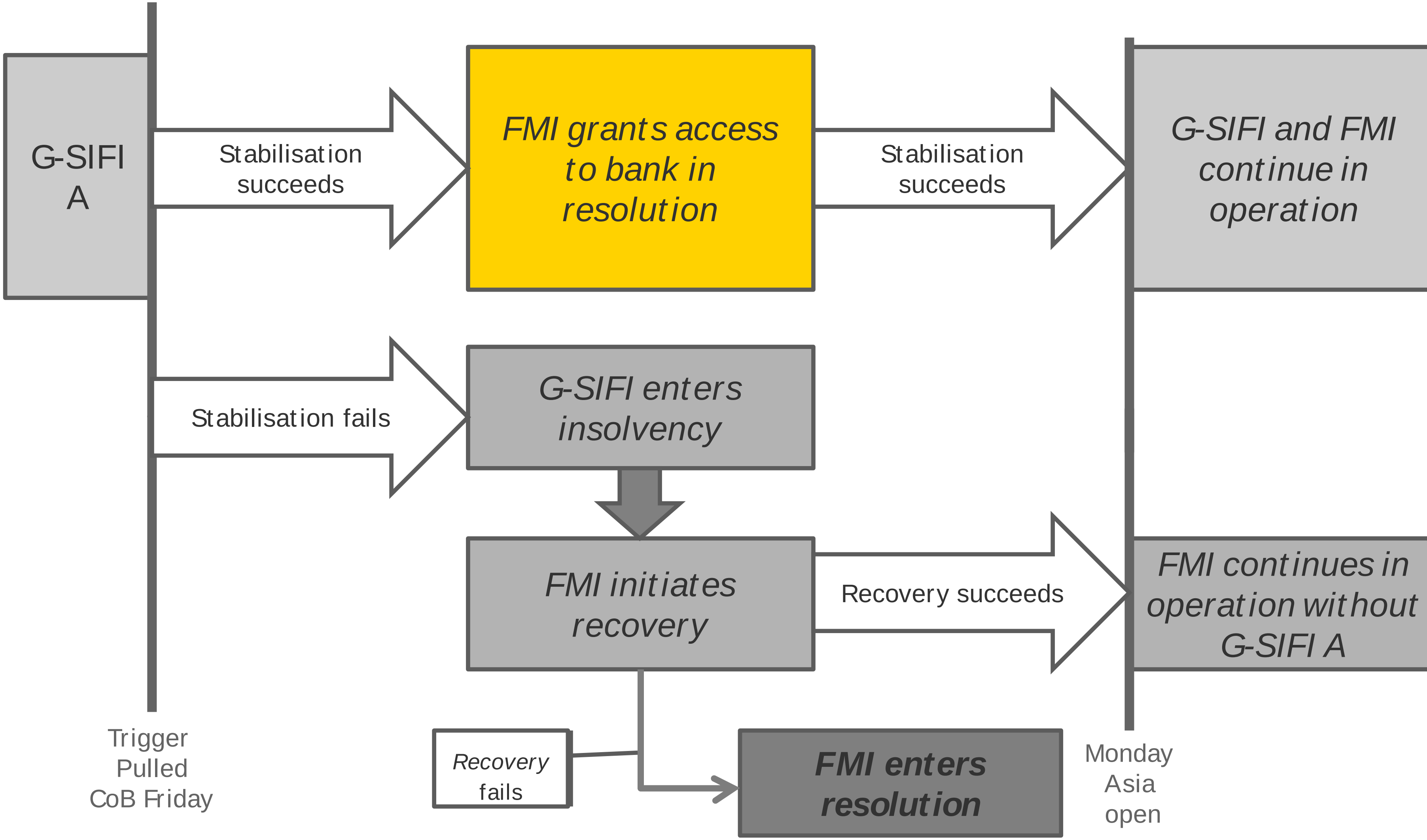
To limit side effects FMUs need to remain robust

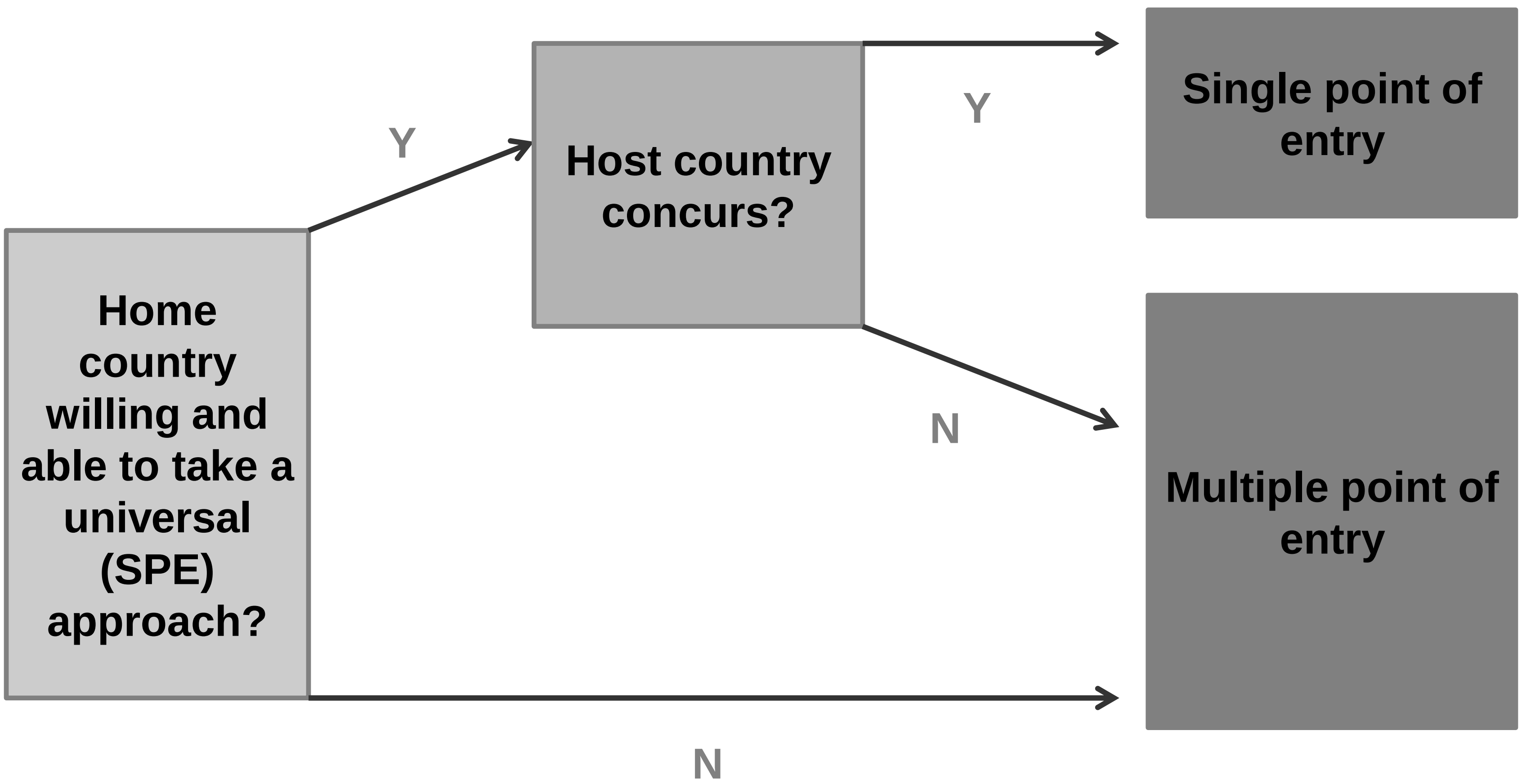
Limit side effects

- FMIs remain robust
- No close out of derivatives; no liquidation of repo collateral
- Client assets stay intact

FMIs need to remain robust



International issues:
Single point of entry approach requires concurrence of home and host



Does USA want universal (SPE) approach where it is home, and territorial approach where it is host?

Banks cannot be made failsafe

but

they can be made safe to fail.

Thank you

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