

# The Fallacy of Deposit Insurance System Bail-in

42<sup>nd</sup> EXCO & High Level Seminar on  
Bail-In and Deposit Insurance System Interactions  
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Perbadanan Insurans Deposit Malaysia  
Protecting Your Insurance And Deposits In Malaysia

# Agenda

- 1 Background
- 2 Bail-in not a silver bullet
- 3 The Fallacy of DIS Bail-in
- 4 Conclusion

# 1

# Background



# The merits of bail-in of DIS needs to be properly assessed

- Bail-in of DIS is currently hotly debated and jurisdictions are considering its merits.
- EU BRRD provides that DIS will be liable to assume losses for the amount that it would have to bear in a liquidation. DIS will enjoy super preference over uninsured depositors.

## Considerations for EU supporting bail-in of DIS:

### 1. Getting access to pay-box DIS funds for G-SIFIs resolution where liquidation is not an option

Paul Tucker (former Deputy Governor, Bank of England), in his speech titled *“The role of deposit insurance in building a safer financial system”* at the IADI annual conference in London, in October 2012 said:

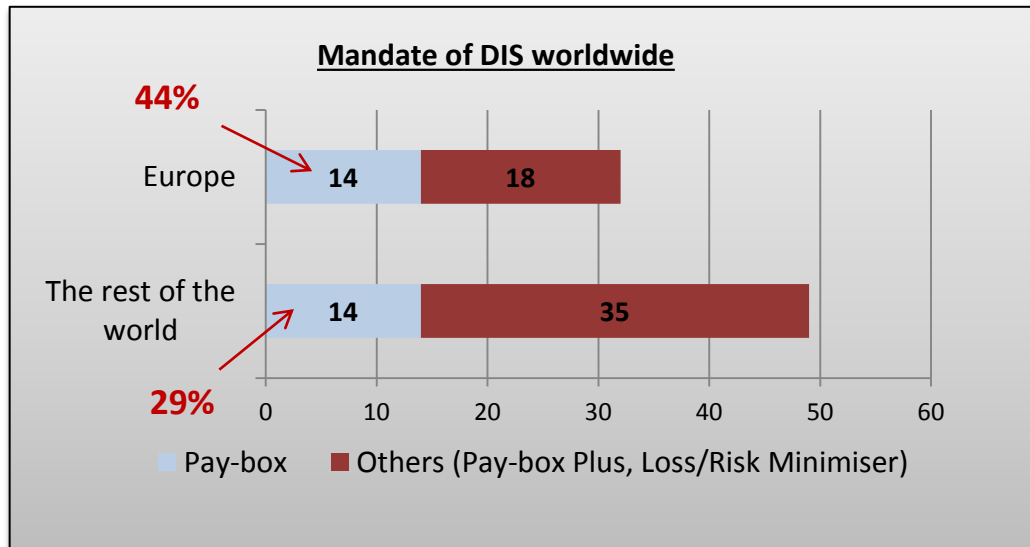
*“... we know from experience that liquidation and payout to insured depositors can be a seriously inferior way of handling the failure of some deposit-takers. That is because liquidation can entail a destruction in value, disruption to the provision of services, and other spillovers to the rest of the 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 purchasers). In resolution circles, this is known as “purchase and assumption” or P&A... 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 in 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 merits of bail-in of DIS needs to be properly assessed

## 1. Getting access to pay-box DIS funds for G-SIFIs resolution where liquidation is not an option (cont'd)

Europe has higher percentage of pay-boxes (44% with aggregate fund size close to USD 10bn) whose funds are not available for resolution. As such, bail-in of DIS provide access to these funds.



Source : 2012 IADI survey results

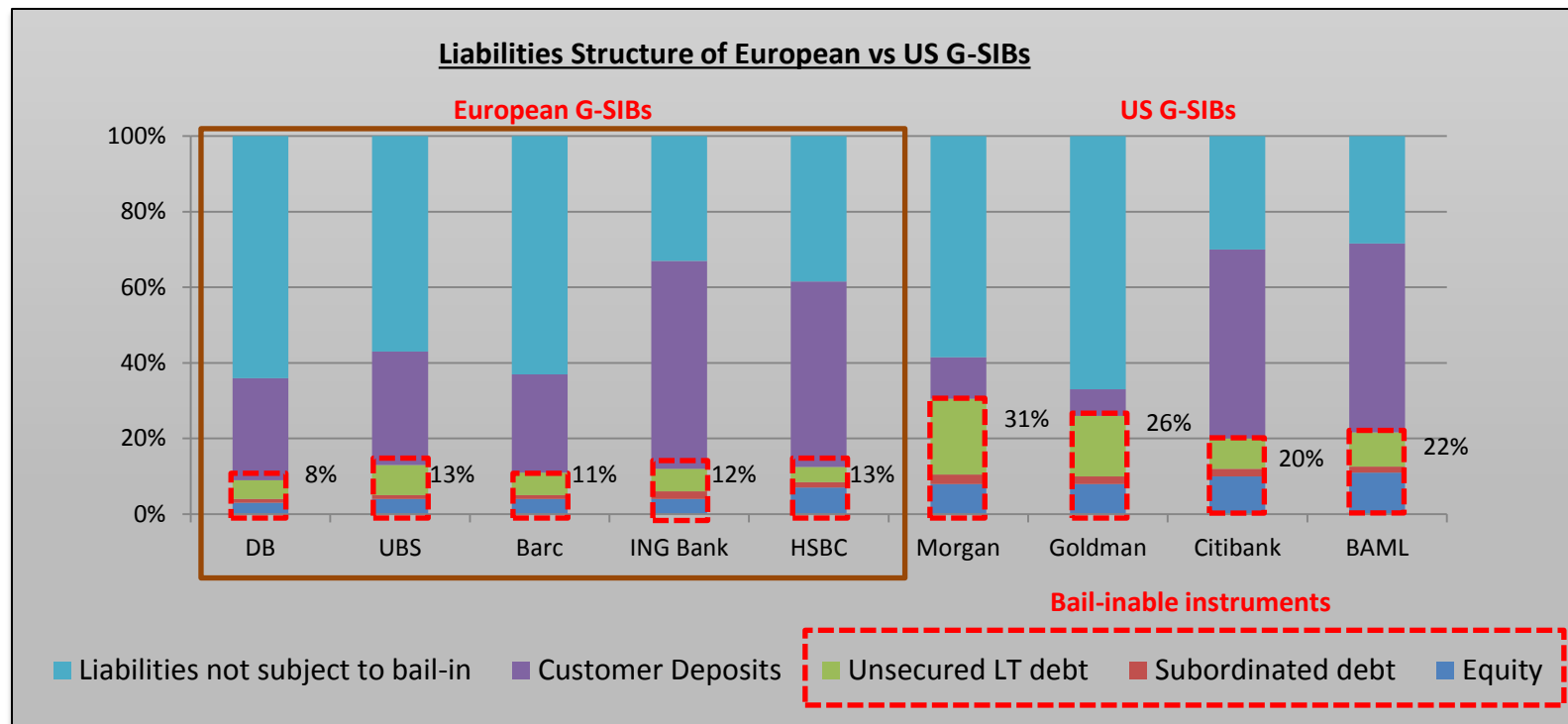
## Bail-in of DIS – Europe centric affair?



# The merits of bail-in of DIS needs to be properly assessed

## 2. Limited pool of bail-inable instruments outside of deposits

European G-SIBs have relatively lesser pool of bail-inable debts (8% - 13%). In order to make bail-in work, deposits being next in line would have to be bailed in. As such, DIS would need to step into the shoes of insured depositors to absorb losses as it would, under liquidation.



Note: All data (based on 2012 annual report) is reproduced from the FSB's CBCM workstream on Gone Concern Loss Absorbing Capacity Findings report dated 7 November 2013

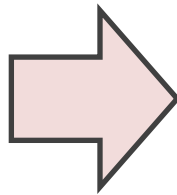
# 2

## Bail-in not a silver bullet



# Caution!! Bail-in alone may erode financial stability

- Bail-in needs to be carefully instituted together with a credible plan. Bail-in alone is not a silver bullet to resolve G-SIFIs!
- With or without bail-in, an effective resolution of G-SIFIs requires a comprehensive resolution strategy that ensures continuity of critical services, minimize systemic disruption and preserves customers' confidence.
- Solely undertaking a bail-in confirms that the G-SIFI is in trouble and triggers doubts of its health which undermines public confidence.



**Bail-in is just an ancillary tool to the entire resolution package – It is not a *silver bullet*!**

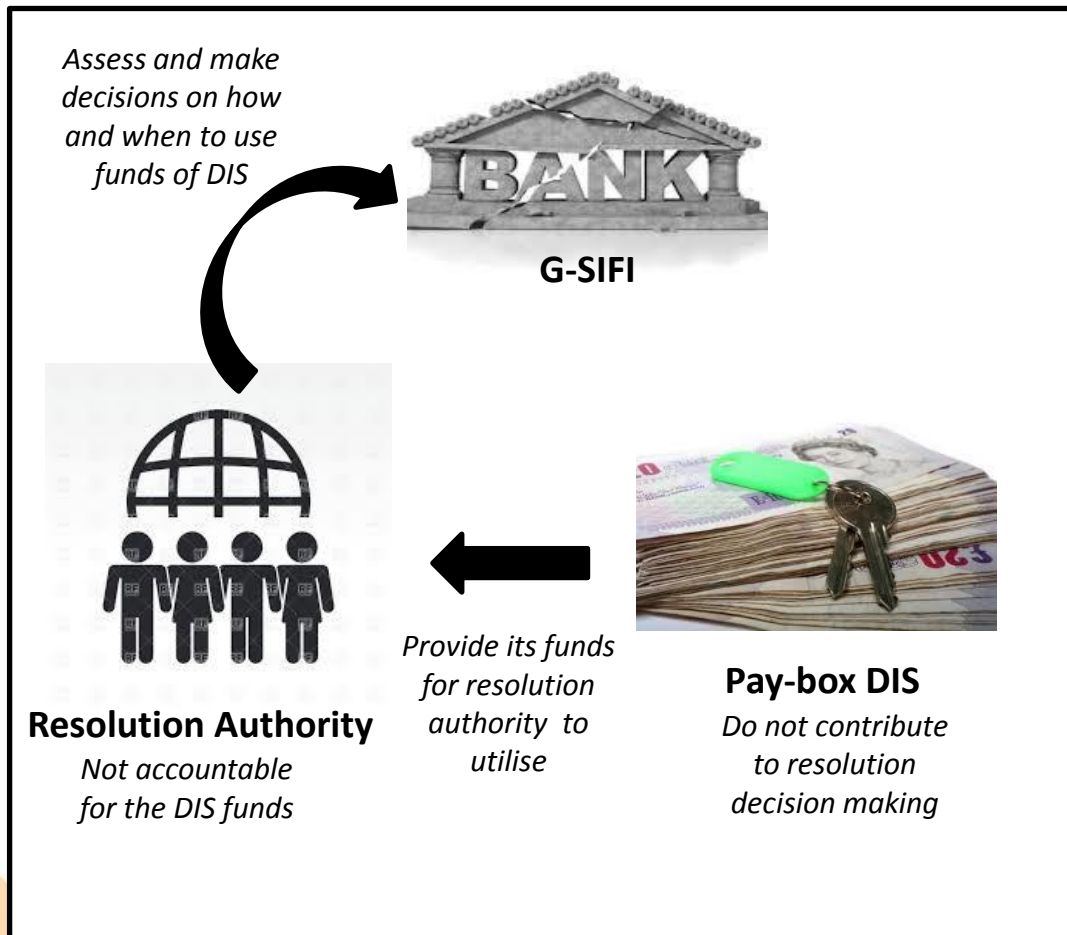


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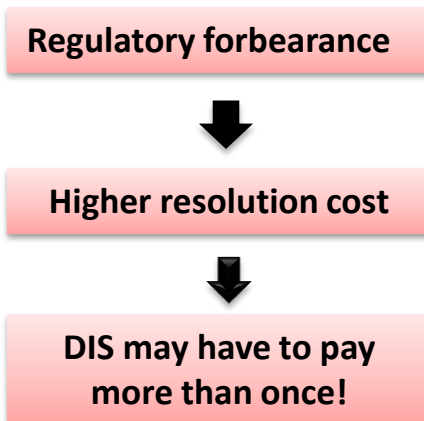
## The Fallacy of DIS Bail-in

# 1) DIS bail-in creates misalignment of incentives and accountabilities

## a) Lack of accountability over cost of resolution



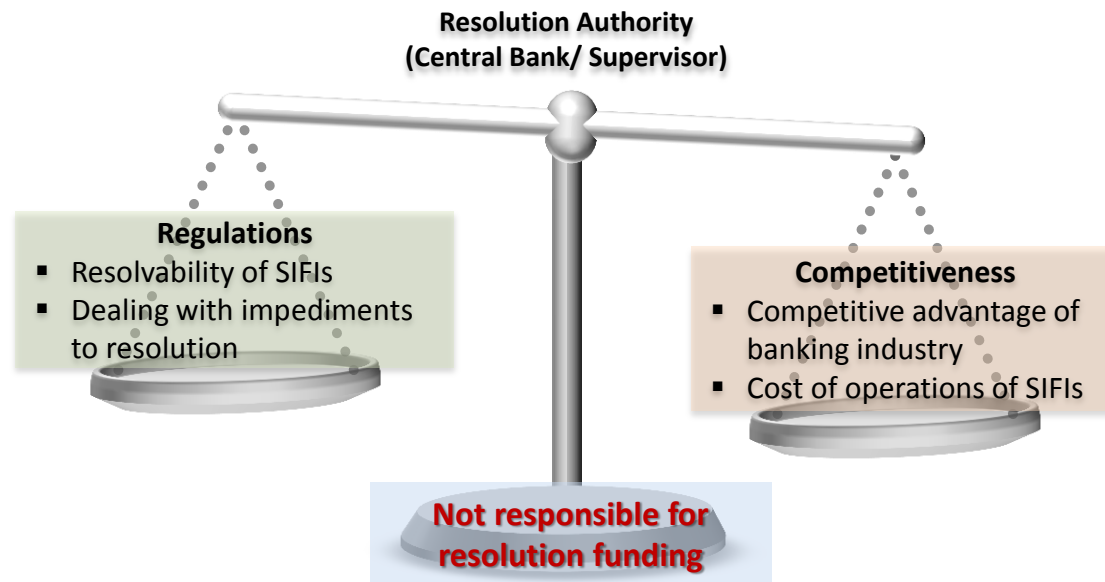
Bail-in of DIS creates moral hazard as authorities responsible over resolution decision is not accountable over funding of resolution. This promotes unhealthy governance.



# 1) DIS bail-in creates misalignment of incentives and accountabilities

## b) *Promotes sub-optimal policy and regulations in resolvability of SIFIs*

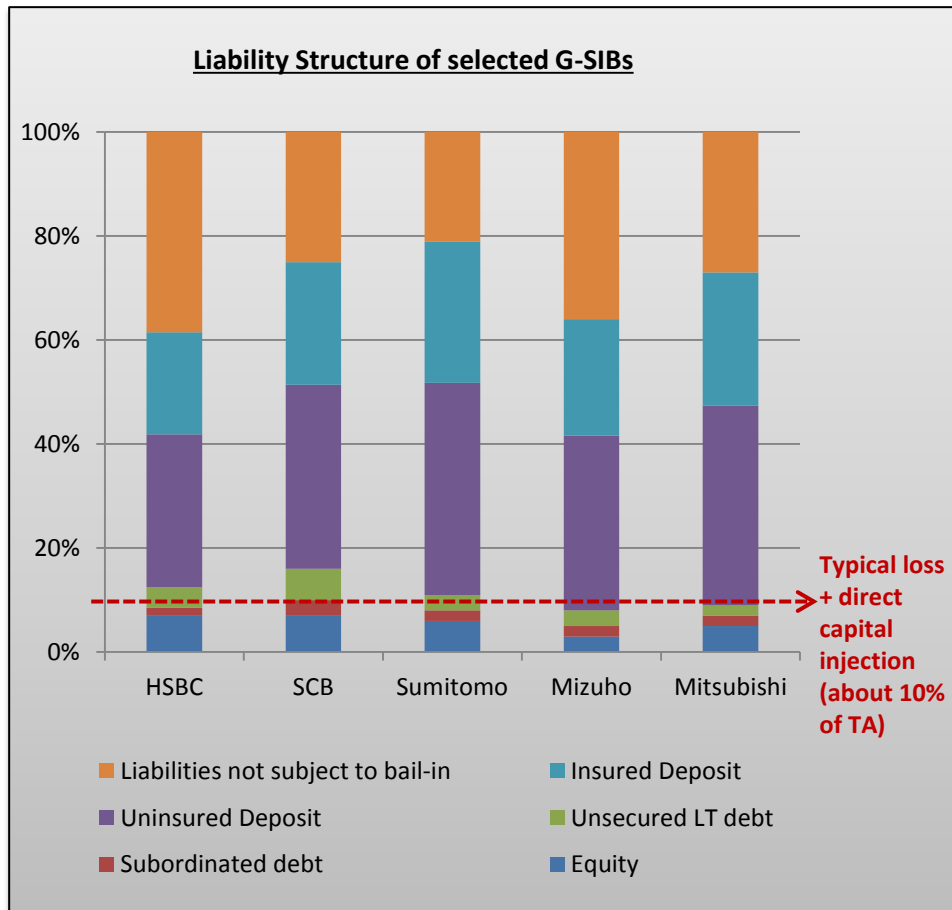
As part of structural reform to make SIFIs more resolvable, resolution authorities would need to strike a balance in the setting of policy and regulatory requirements for SIFIs. Key considerations include cost of operations and competitiveness, versus making SIFIs more resolvable and removing impediments to resolution.



- Resolution authority not responsible for resolution funding will tilt the scale away from achieving more resolvable SIFIs.
- Bail-in of DIS creates misalignment that undermines the purpose of RRP and FSB's principle of making SIFIs more resolvable.

Resolution Authority should be made responsible over resolution funding so it can be accountable for achieving least cost resolution and to give stronger policy considerations to deal with resolvability impediments and make SIFIs more resolvable

## 2) Bail-in of DIS in a super depositor preference regime provides false comfort



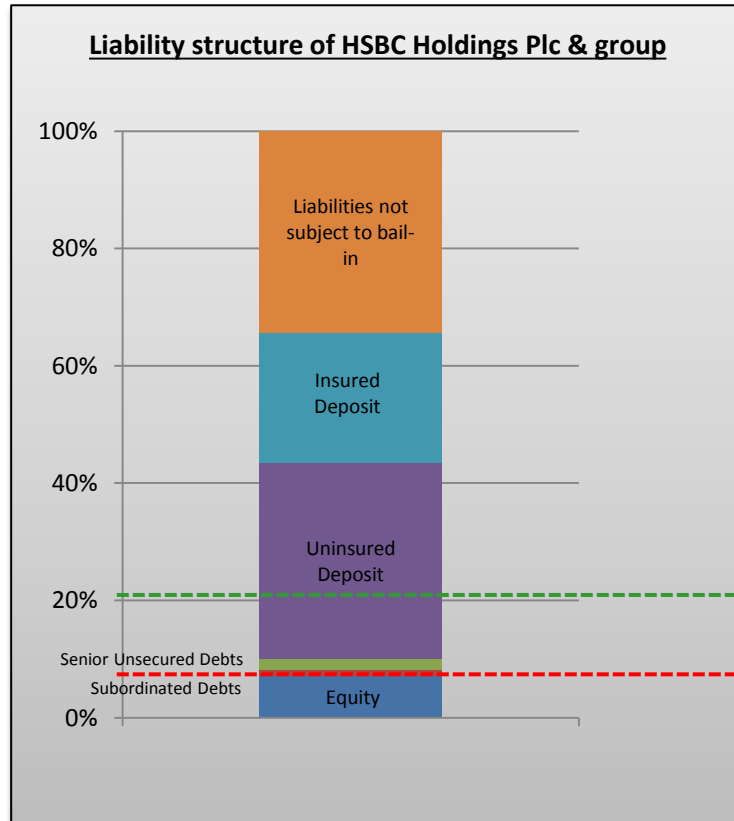
- Studies<sup>1</sup> have shown that historical gone concern loss absorbency needs of G-SIBs are up to about 10% of total assets
- The concept of “super depositor preference” creates **FALSE** comfort that DIS funds will be bailed-in but...
- In reality, the extent of losses will not reach the super depositor preference (insured depositors) level
- Thus bail-in of DIS is irrelevant!

Note: All data (based on 2012 annual report) is reproduced from the FSB’s CBCM workstream on Gone Concern Loss Absorbing Capacity Findings report dated 7 November 2013. Assume 60% of customer deposits are uninsured.

<sup>1</sup> Source : FSB’s CBCM workstream on Gone Concern Loss Absorbing Capacity Findings report dated 7 November 2013



### 3) Bail-in of DIS in a super depositor preference regime undermines financial stability



- Where the losses are significant and requires deposits to be bailed-in, the uninsured deposit must be bailed-in first in a super depositor preference regime => worse than the effect of co-insurance => **bank run!** e.g. Northern Rock and Cyprus
- Further, where uninsured depositors are bailed-in, beware of unintended consequences – high net worth foreigners becoming controlling shareholders, e.g. Bank of Cyprus

Assume **loss is 20%** of total assets, under super depositor preference, the uninsured deposits must be bailed in first

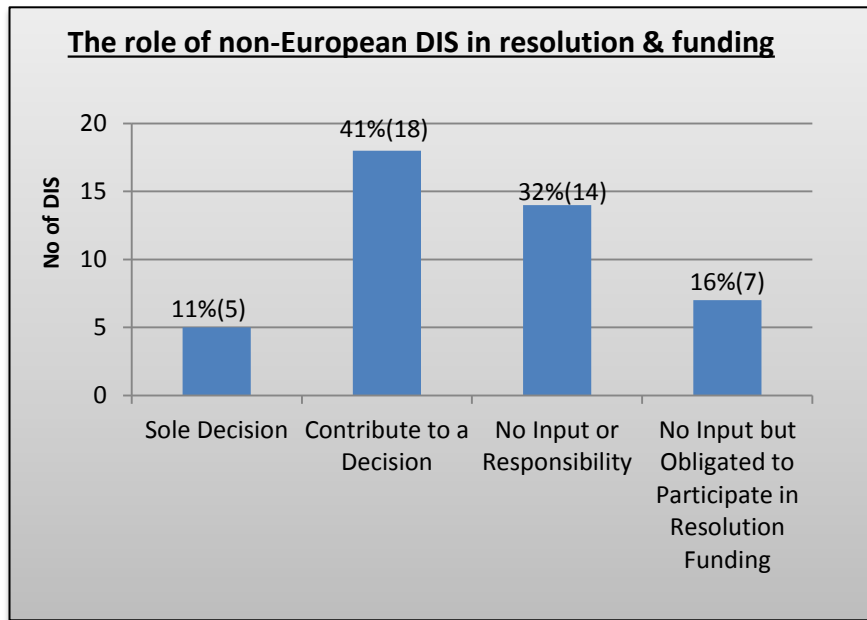
Assume **loss is 10%** of total assets, there is sufficient bail-inable instruments to absorb losses. Hence, there is no need for DIS to be bailed-in



Note: All data presented is based on 2013 Annual accounts.

Included in liabilities not subject to bail-in are derivatives, trading liabilities, interbank deposits, HK currency notes in circulation, liabilities under insurance contracts, etc. Assume that 60% of customer deposits is uninsured.

## 4) Pay-box DIS are not mandated to fund resolutions other than depositors reimbursement as such they should not be bailed-in



Note : Based on 2012 IADI survey results and adjusted to exclude 5 non-European DIS which responded in the "Others" category.

- 52% (23) of non-European DIS provide input or participate in the decision for the resolution of failing bank. **Hence bail-in of DIS is irrelevant as they are already required to fund resolution.**
- 32% (14) of non-European DIS do not contribute to any resolution decision or provide resolution funding. **They should not be bailed-in as they are not mandated to fund resolution in the first place.**
- The issue of DIS bail-in do not apply to at least 84% of non-European DIS.

**The issue of DIS bail-in is not significant and less applicable for non-European DIS.**

# 4

# Conclusion

## In a resolution of SIFIs, bail-in is not the silver bullet, and DIS bail-in is a fallacy with no relevance

- Executing bail-in without a comprehensive resolution plan will undermine public confidence.
- Bailing-in of DIS provides false comfort and undermine financial stability.
- Jurisdictions that are considering DIS bail-in should take note of its adverse implications.
- To promote effective governance and alignment of incentives, there is a need for agencies accountable for resolution to be responsible over funding the entire cost of resolution.





# Thank you

## Q&A