

Financial Stability Institute



BANK FOR INTERNATIONAL SETTLEMENTS



FSI-IADI Seminar on Bank Resolution, Crisis Management and Deposit Insurance Issues

The role of the deposit insurer in bank resolution

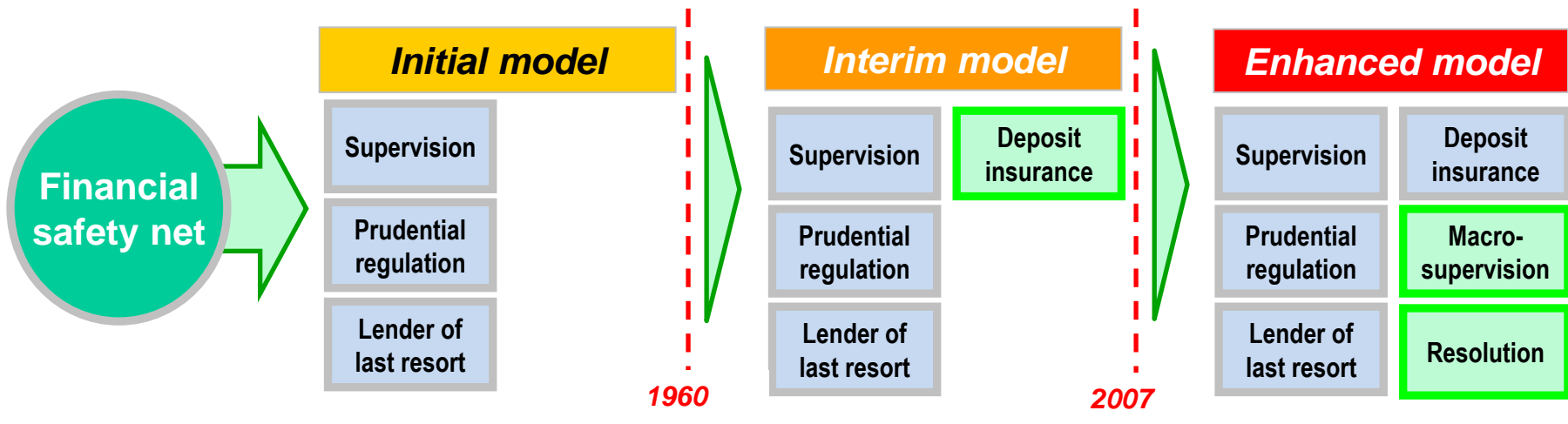
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**IADI President and Chair of the Executive Council
President of the Management Board, Bank Guarantee Fund, Poland**

Basel, 9-11 September 2014

- Crisis management and safety net evolution**
- Evolution of DIA role in crisis management**
- Resolution strategies**
- IADI Core Principles**
- Conclusions**

Financial safety net needs to address new risks identified after financial crises



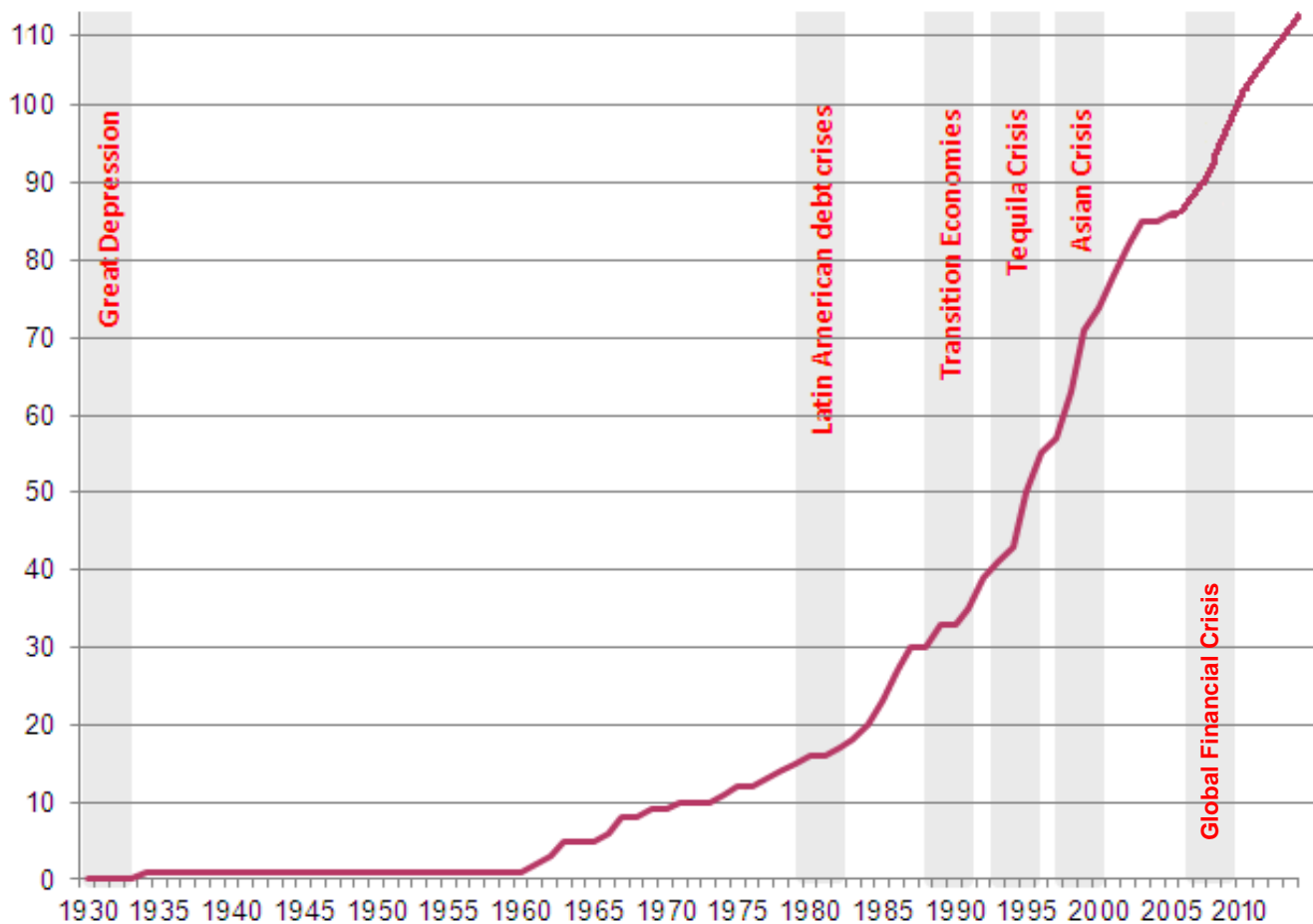
- The first DIA – FDIC established in USA in 1934 after the Great Depression
 - Number of DIAs growing gradually as a response to next crises
 - Most of the systems created after 1980 (*Latin American debt crises, Transition Economies, Tequila Crisis, Asian Crisis*):
- Number of countries with explicit DIA*:**

1947: 12 → 1999: 71 → 2014: 113

- The global financial crisis that began in 2007 revealed significant gaps in the crisis management framework:
- Supervision and regulation of financial firms in isolation in a purely microprudential perspective insufficient
 - **Lack of tools to wind down each failed institution in orderly manner**

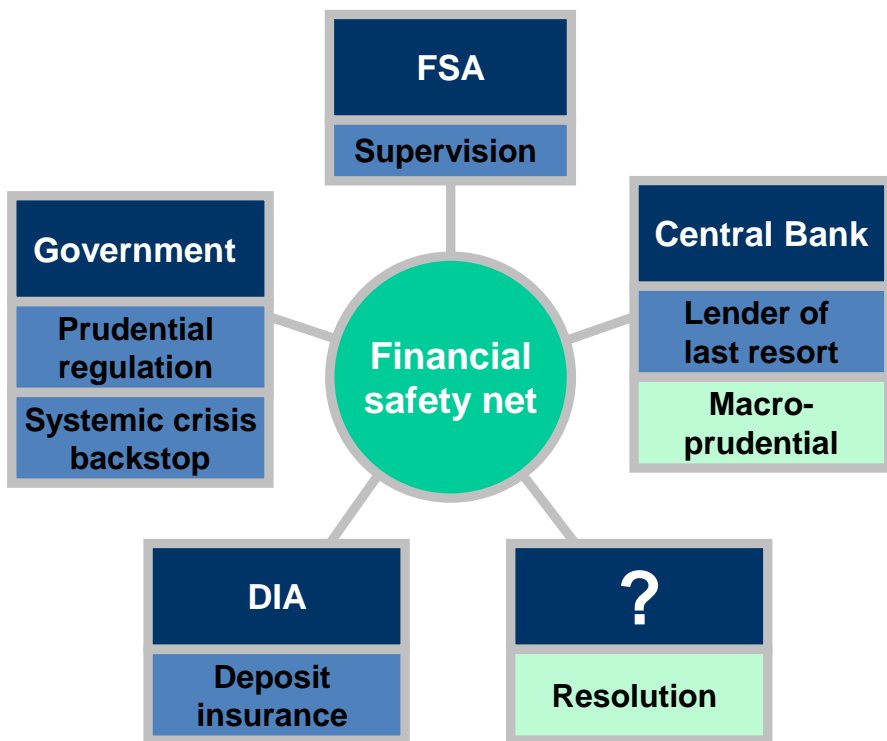
*Source: *Deposit Insurance Around the Globe: Where Does It Work?*, A. Demirgüç-Kunt and E. J. Kane (Boston College); IADI 2014

NUMBER OF COUNTRIES WITH EXPLICIT DIA



Source: Demirguc-Kunt, Karacaovali and Laeven (World Bank 2005); IADI 2013

Functional developments require changes in the institutional framework

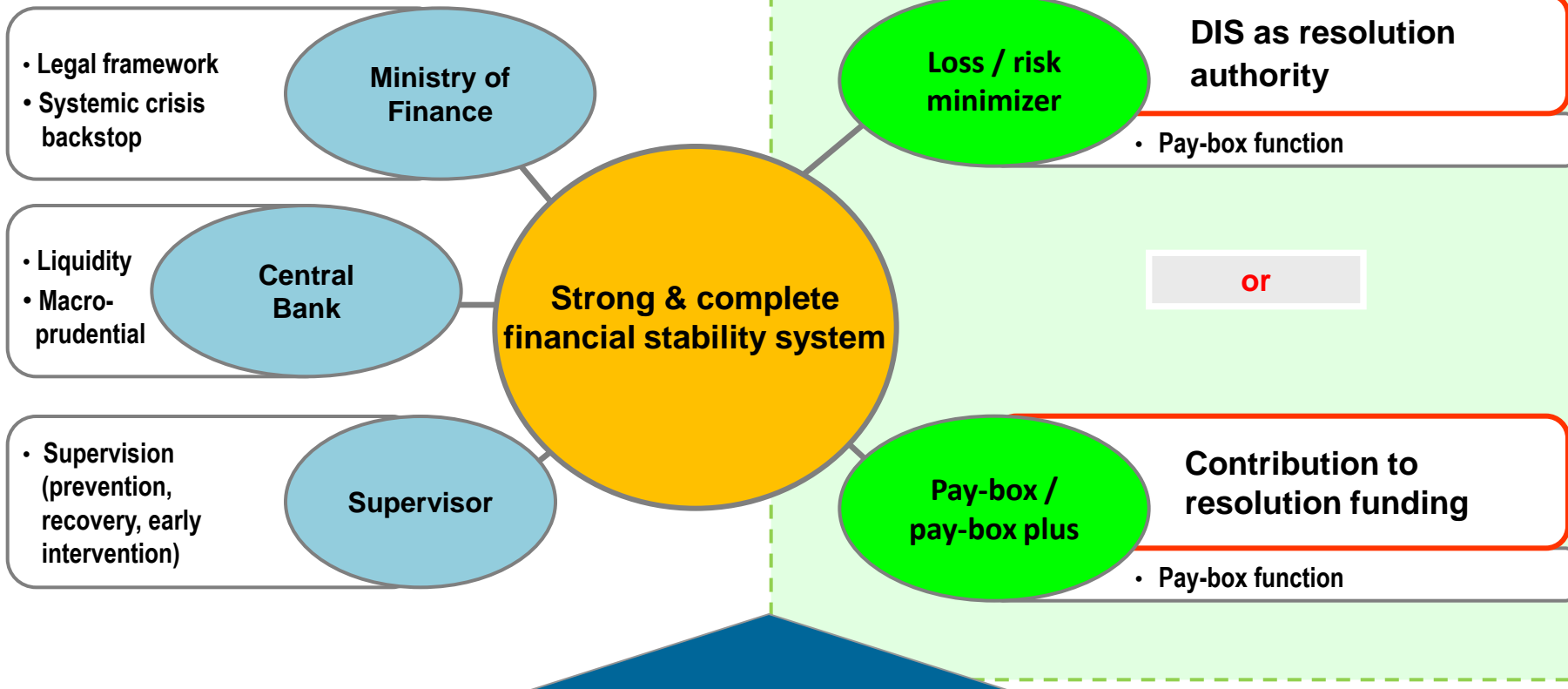


In some jurisdictions some functions can be combined (e.g. supervision exercised by Central Bank)

- Roles of financial safety net participants including deposit insurers evolve
 - In many jurisdictions powers assigned to DIA have been expanded significantly in last years
- However**
- There is no single international standard and the institutional approaches differ among jurisdictions

- Crisis management and safety net evolution
- Evolution of DIA role in crisis management
- Resolution strategies
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- Conclusions

DIA in resolution process



Change of role of DIA in the new crisis management framework

Successful resolution process ensures availability of covered deposits and consequently no guarantee conditions are fulfilled

Resolution tools substitute classic pay-out



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Resolution powers should include power to effect the closure and orderly wind-down (liquidation) of the whole or part of a failing firm with timely payout or transfer of insured deposits and prompt access to transaction accounts and to segregated client funds) [KA 3.2 (xii)]



Where eligible deposits at a failing institution are transferred within P&A or bridge institution tool in the amount equal to or more than the coverage limit, depositors have no claim under DGSD against the deposit insurer [BRRD Art.109(4)]



Transfer of deposits through closed-bank P&A transactions as one of the reimbursement options in the draft of revised Core Principles

[CP 15, p. 39, footnote 29]

Classic reimbursement of covered deposits predominantly in these cases:

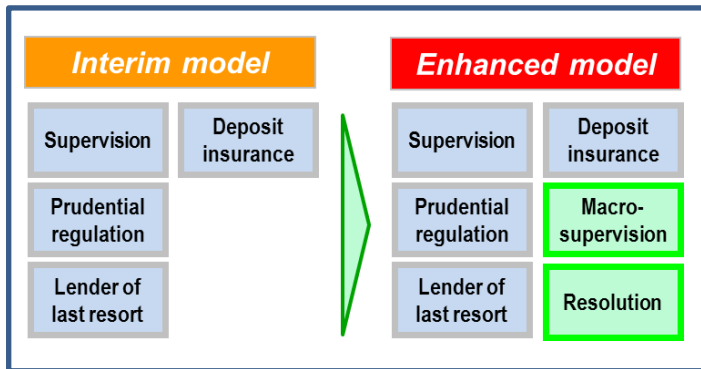
- **resolution not possible** (e.g. lack of potential acquirers),
- **an option for non-systemic banks which do not provide any critical functions and do not threaten financial stability if failed,**
- **resolution failure.**



Resolution tools substitute classic pay-out

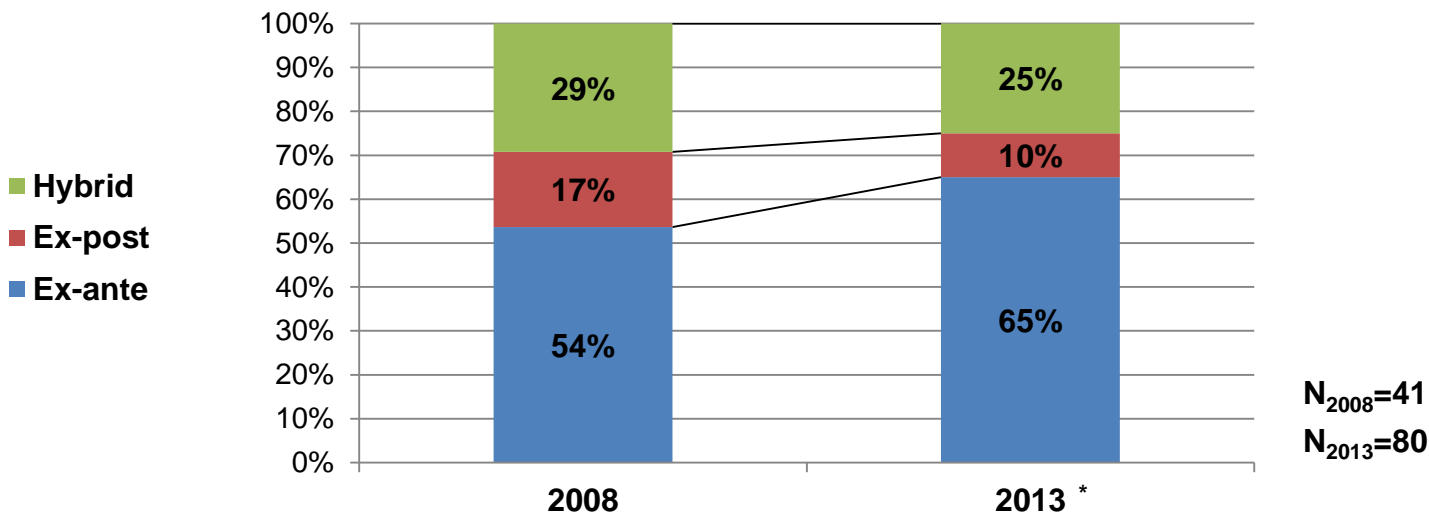


Involvement of DIA in financing resolution if provides prompt access to funds for insured depositors



Along with including resolution into the crisis management framework and extension of DIA mandate, the funding model of DIA evolves as the new functions require robust financing arrangements

Ex-post → *Ex-ante*



*Analyses cover data as at 31.12.2012

Source: Global overview of deposit insurance systems - 2013 IADI Annual Survey

Resolution tools could substitute classic pay-out



However

Resolution requires robust financing arrangements able to provide promptly needed funds in order to support the resolution process and ensure time efficiency



Resolution funds

still to be created in many countries

DIA funds

usually collected and available

Involvement of DIA funds in financing resolution

DIA = RA

- Flexibility, efficient funds management and synergies
- Mitigation of risk of forbearance
- Condition and incentives to apply least cost solution
- Resolution fund and DIA fund as complementary sources of funding (if separate)

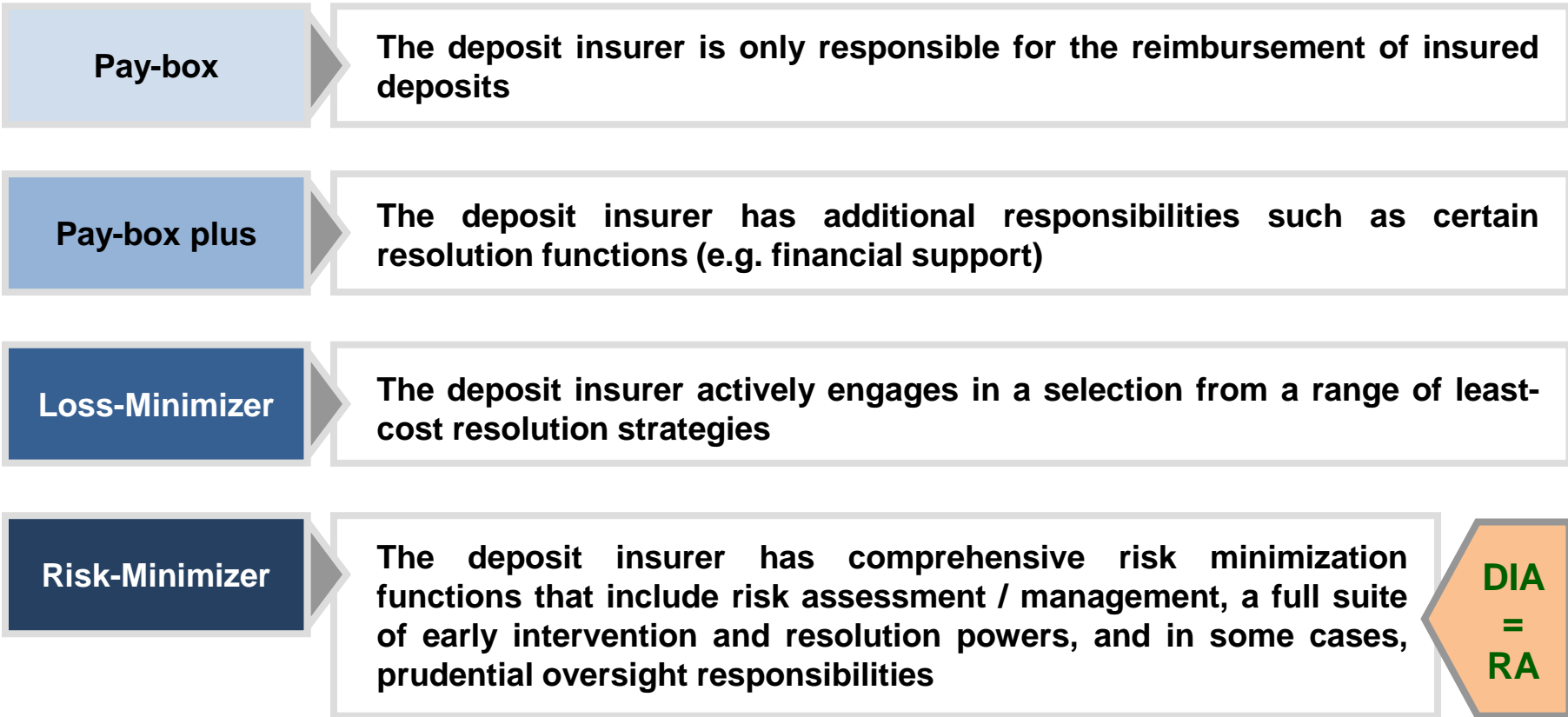
DGS ≠ RA

- Use of DIA funds as substitute to pay-out, **but**
- Appropriate **SAFEGUARDS** necessary to protect DIA interests

Whatever the applied institutional approach is, the evolution of a crisis management framework requires the evolution of DIA role and mandate

IADI Core Principles for Effective Deposit Insurance Systems, 2014

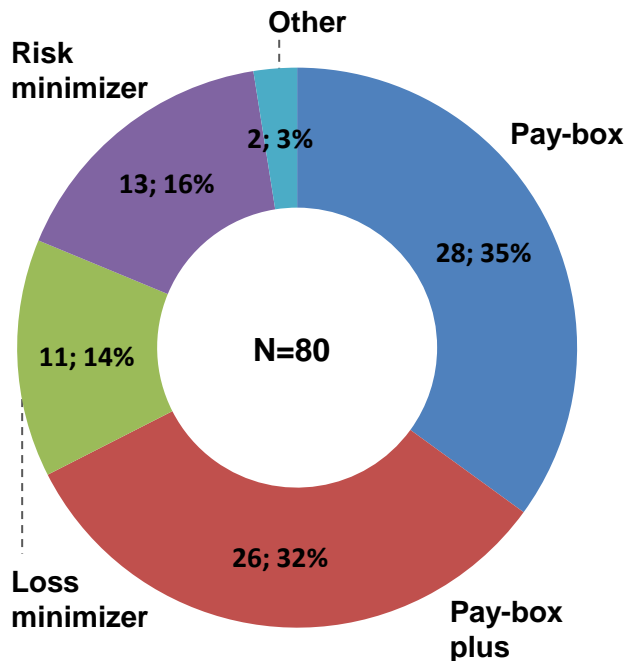
DIA mandates can range from narrow “pay-box” to those with extensive responsibilities, such as preventive action and loss or risk – minimization / management, with a variety of combinations in between. These can be broadly classified into four categories:



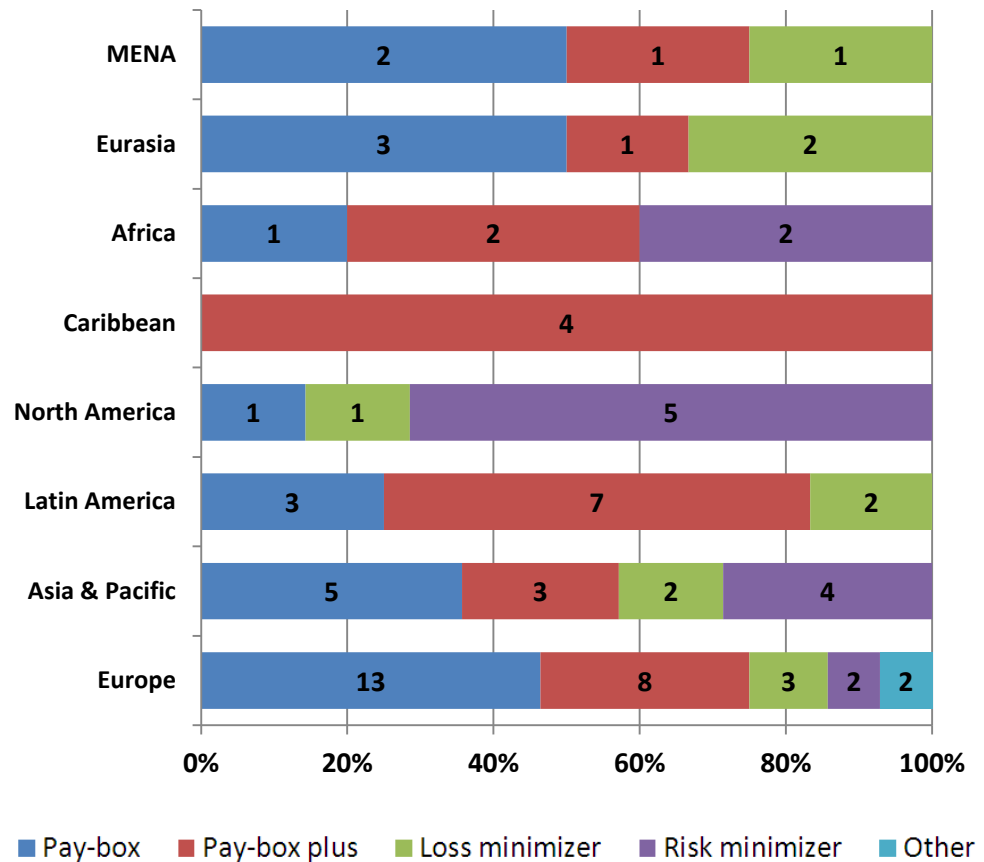
IADI Annual Survey 2013*

DIA mandate (declared)

Overall results



Results per region



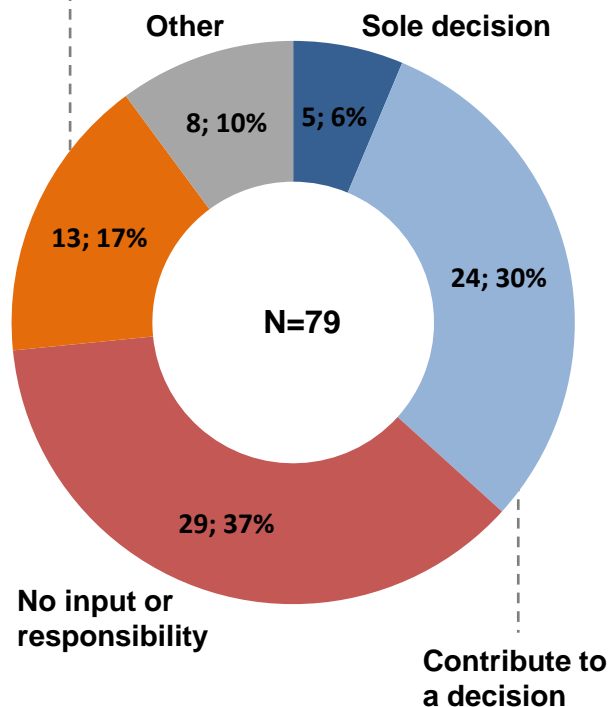
*Analyses cover data as at 31.12.2012

IADI Annual Survey 2013*

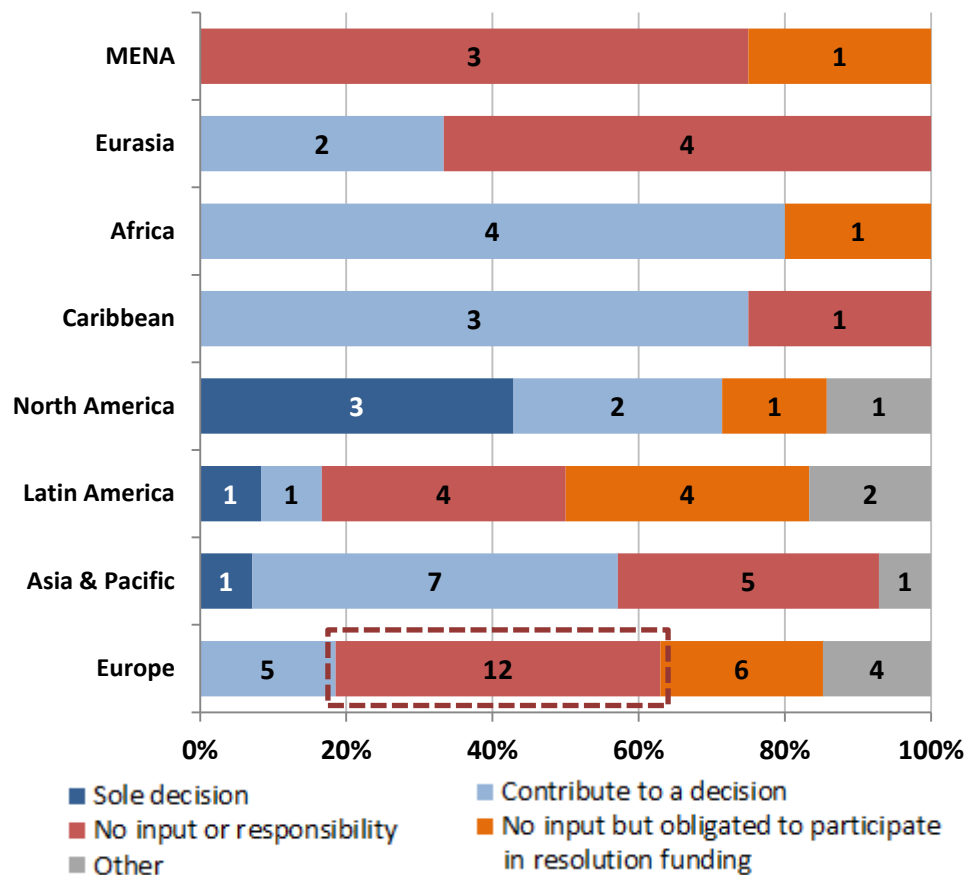
DIA input in the decision on resolution (declared)

Overall results

No input but obligated to participate in resolution funding



Results per region



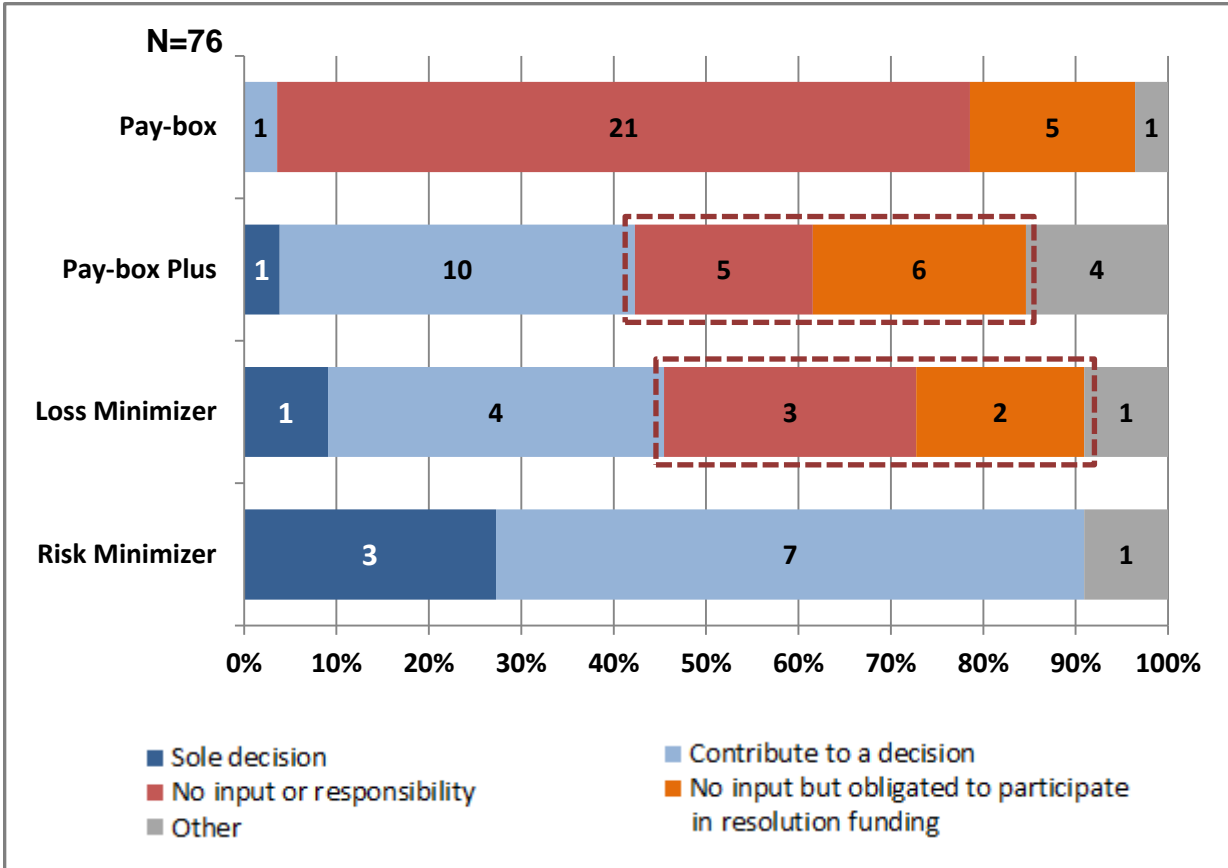
*Analyses cover data as at 31.12.2012



As a consequence of BRRD DIA role in resolution in EU Member States will change significantly

IADI Annual Survey 2013

DIA mandate vs. input in the decision on resolution



To protect DIA interests their role in decision-making process should be enhanced

Ongoing need to promote and implement IADI Core Principles

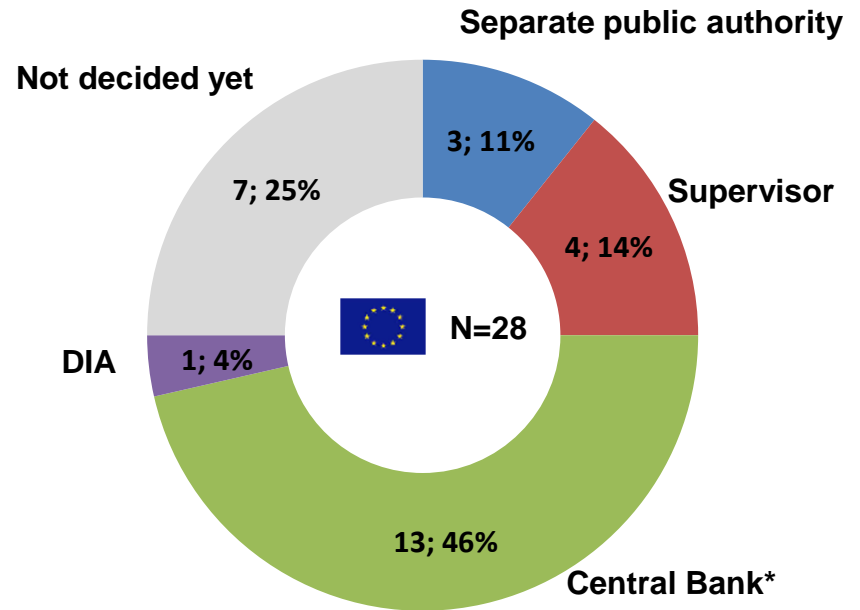


Article 3 of BRRD

- RA shall be a public administrative authority or authorities entrusted with public administrative powers,
- RA may be:
 - Central banks,
 - Competent ministries,
 - Other public administrative authorities or authorities entrusted with administrative powers,
- **Exceptionally** RA may be competent authority (supervisor), but structural arrangements shall be in place to ensure operational independence and avoid conflicts of interest,
- Independence between the resolution function and the supervisory or other functions required.



Intended resolution authorities after BRRD implementation



*includes jurisdictions where supervision is done by central bank

Source: BFG's elaboration on the basis of EU FSC and EBA data.

International standards allow use of DIA funds to finance resolution proceedings

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EU

General rule

DIA funds listed as one of several potential sources to provide temporary financing to facilitate resolution (KA 6.3)

DIA **obliged** to contribute to financing resolution up to the net cost of pay-out if resolution ensures depositors continue to have access to their deposits (BRRD; art. 109)

Limited list of activities that can be financed from financial arrangement (resolution fund) (BRRD; art. 101)

Cross-border dimension

Resolution plan for G-SIFI should identify all potential sources of resolution funding, including, where relevant, from national DIA and resolution funds.

Where DIA funds are available to contribute to resolution, a mechanism **shall be found** to require DIA to contribute to resolution of holding company (RRP; p. 4.6)

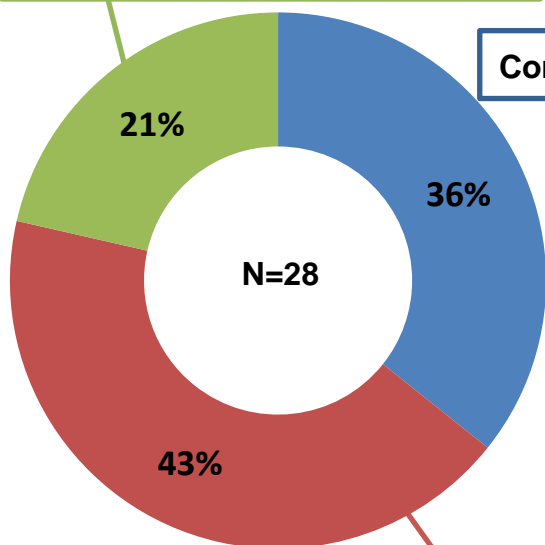
In case of a group resolution, a resolution college shall draft a financing plan including inter-alia contributions that DIAs would be required to make (BRRD; art. 107)

- Use of DIA funds to finance resolution is very likely even in non-EU countries as in many jurisdictions resolution funds are still to be established,
- At the same time the rules of use of DIA funds are not clear, particularly in relation to the MREL component and cross-border group resolution.

IADI Survey on Bail-in Implications for DIA and Funding (2014)

Role of DIA funds in financing resolution proceedings other than pay-box

It is **forbidden** to use DIA funds to finance measures other than reimbursement of covered deposits in liquidation (pay-box)

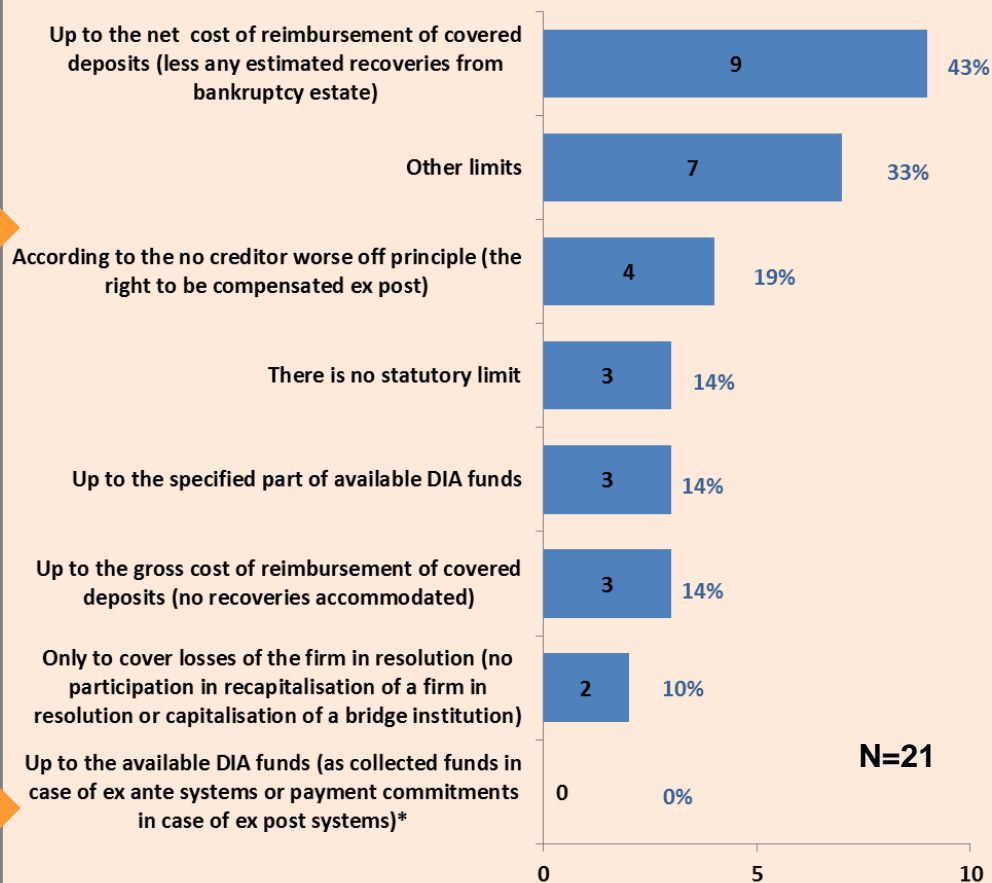


Compulsory

Subject to a discretionary decision of DIA

Source: BFG's elaboration on the basis of IADI survey on Bail in implications for DIA and funding (2014)

Statutory limits for the use of DIA funds to finance resolution measures other than pay-box



* DIA cannot contract an obligation (excluding short term bridge financing in case of ex post systems)

- Crisis management and safety net evolution
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Guidance on Developing Effective Resolution Strategies

A resolution strategy establishes an approach for resolving a failing firm in a way that protects:

- its critical functions,
- government funds,
- systemic stability,

and achieves other relevant resolution objectives.

A resolution strategy needs to consider inter alia:

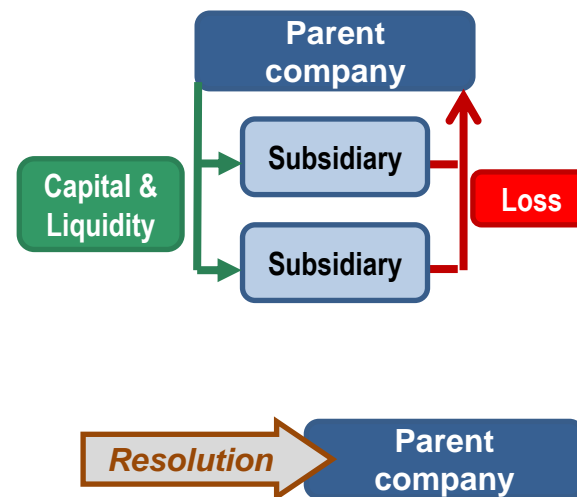
- Operational structure and business model,
- Financial structure, and
- Interconnectedness between group entities.

A resolution strategy should identify resolution powers to be applied by home and host authorities that are most likely to deliver the strategy, such as the use of a bridge institution, purchase and assumption or bail-in powers.

The implemented resolution strategy significantly influences the engagement of DIA funds in resolution financing (in jurisdictions where such an option is available)

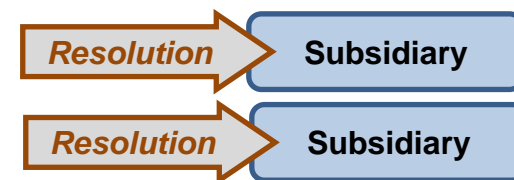
Single point of entry (SPE)

- Parent company absorbs potential losses within the group by up-streaming losses,
- Operations of particular subsidiaries preserved on a going concern basis by down-streaming capital,
- Loss absorbing capacity on group level,
- **Resolution powers applied at the level of the top company.**



Multiple point of entry (MPE)

- Higher degree of financial separation of group entities,
- Sufficient loss absorbing capacity available at level of each entry point,
- **Resolution powers applied where the problem has arisen.**



Advantages and potential impediments

Single point of entry

- Operations of particular subsidiaries preserved on a going concern basis,
- Strong incentives for host jurisdictions to refrain from taking independent action and rely on group resolution strategy,

- Possible lower average cost of financing the bail-inable debt,

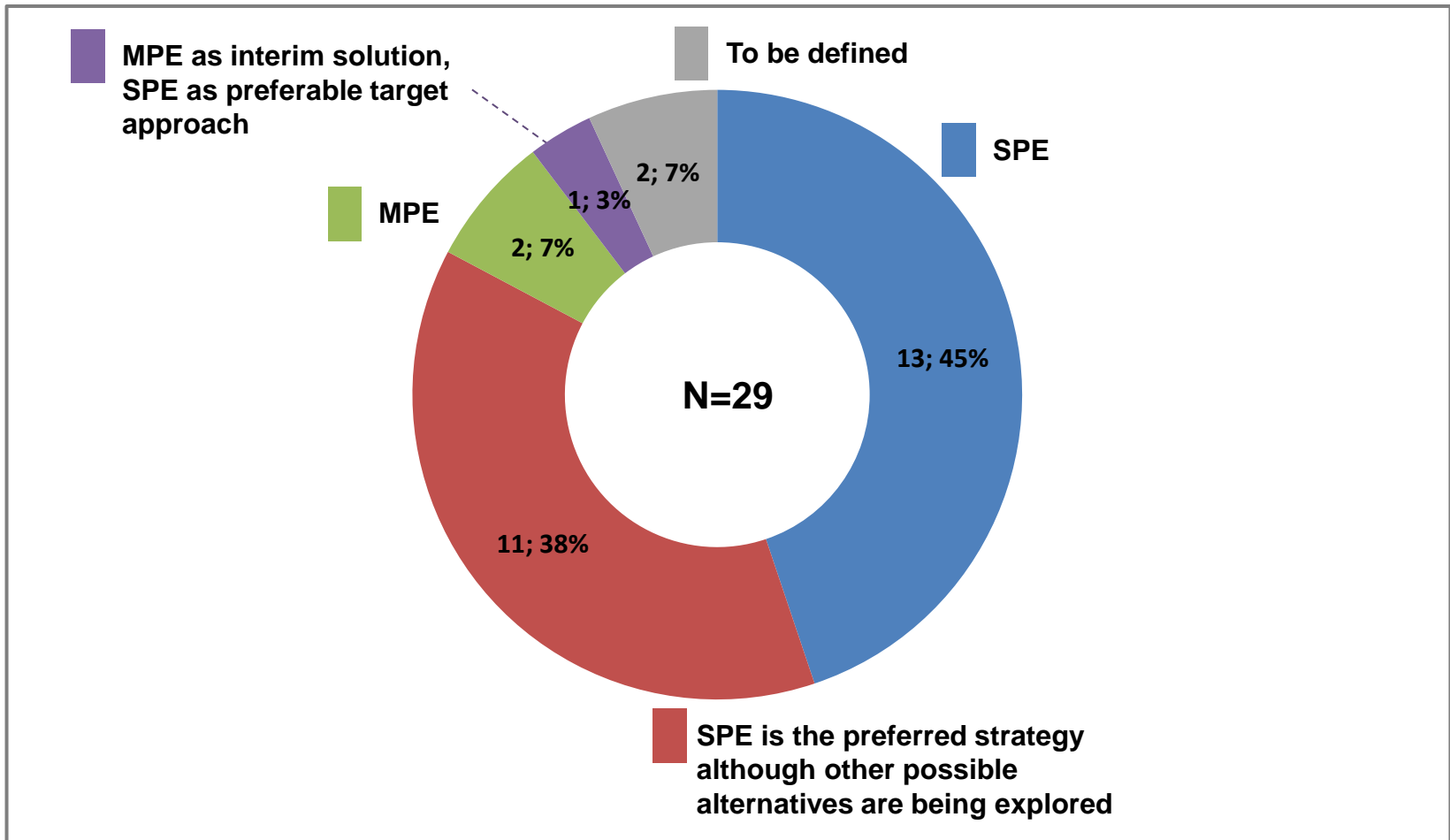
- **More complex** – losses passed up, capital and liquidity down-streamed – **possible obstacles resulting from legal, regulatory, accounting and tax requirements,**
- **More complicated process of valuation to determine loss absorbing capacity.**

Multiple point of entry

- Problem solved at point where it arose,
- No obstacles resulting from legal and regulatory differences between jurisdictions involved,
- Coordination challenge

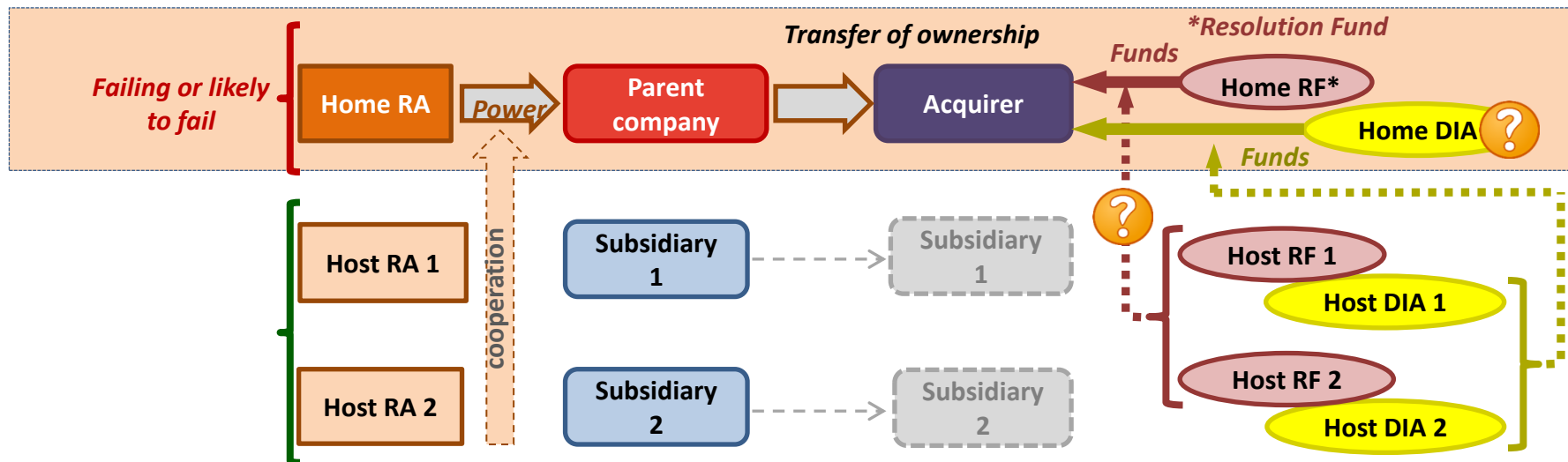
- Lack of strong incentives for host jurisdictions to refrain from taking independent actions based on their own resolution plans,
- May result in a change of ownership and separation from the group,
- Additional forms of intra-group support necessary if the loss absorbing capacity is not sufficient to cover losses.

G-SIFI resolution planning commitments



Source: BFG's elaboration on the basis of „G-SIFI resolution planning commitments” (FSB, Apr 2014)

SPE **Transfer tools**

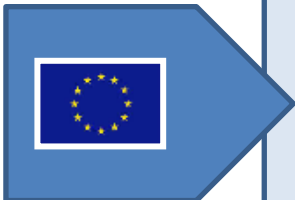


- Efficiency of resolution depends on cross-border trust and cooperation
- Involvement of home and host resolution funds and DIA funds subject to arrangements between home and host resolution authorities Next slide
- Use of home DIA funds only if parent company conducts business activity financed by deposits
- Use of host DIA funds not very likely (but attention to FSB RRP guidance) Next slide
- In case of bail-in appropriate loss absorbing capacity (GLAC) at group level

In case of cross-border group resolution funds available for financing resolution measures at national levels shall participate (be mutualized)

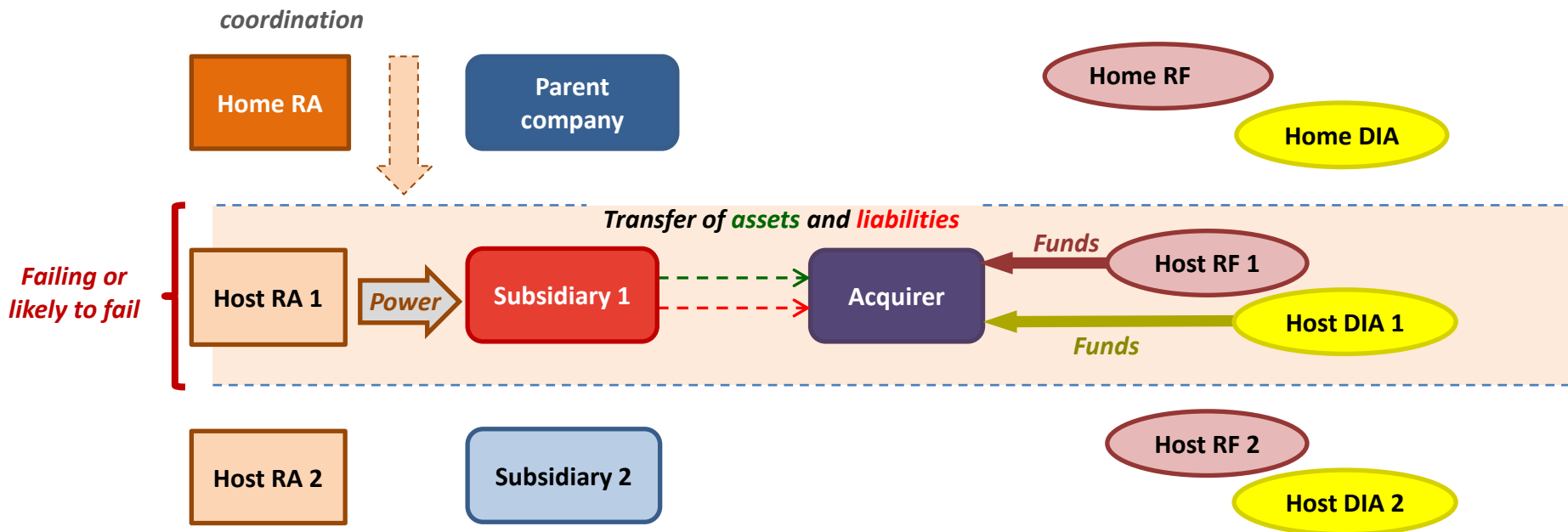


- Availability of funding arrangements in home and host jurisdictions and application of insurance schemes in the form of a commitment within an **institution-specific cross-border cooperation arrangement (COAG)** made by a Crisis Management Group
- Where DIA funds are available to contribute to resolution, a mechanism **shall be found** to require DIA to contribute to the resolution of a holding company (RRP; p. 4.6)



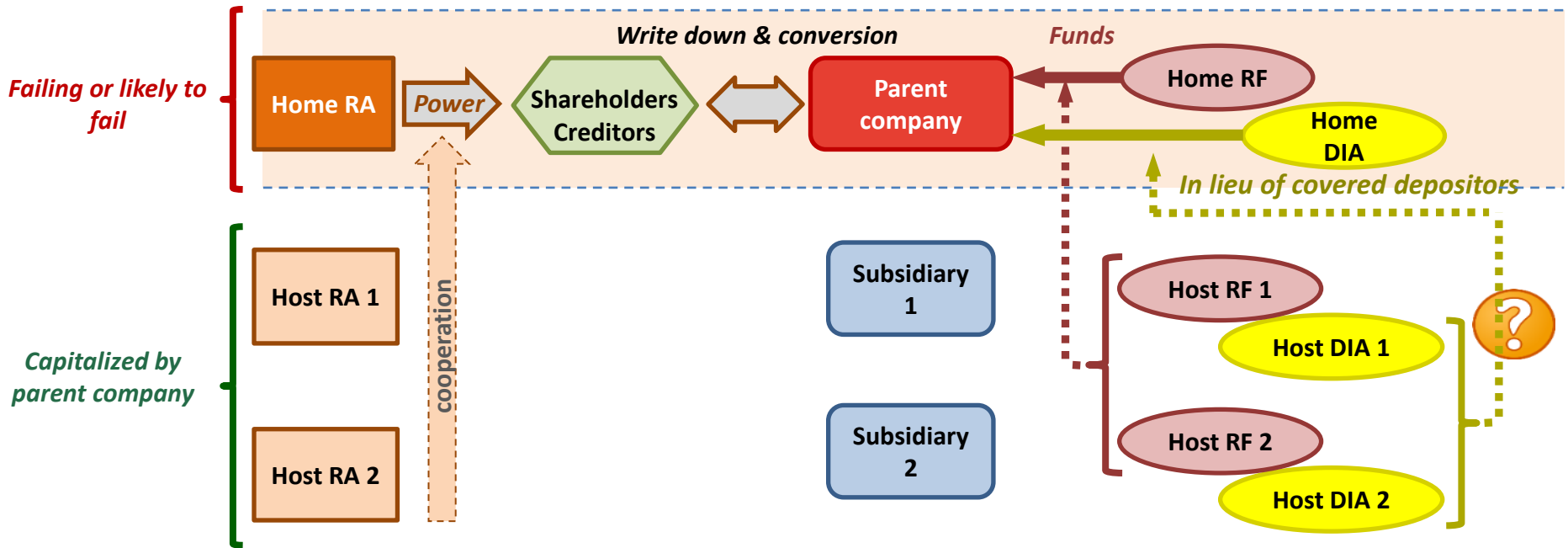
- Laid down in a **financing plan** that is part of a resolution scheme drafted by resolution college
- A financing plan specifies the amount that the national resolution fund of each affected group entity is required to contribute,
 - Contribution of each national resolution fund shall have regard inter alia to:
 - Proportion of the group’s assets and RWA,
 - Proportion of the losses, which have given rise to the need of resolution,
 - Proportion of resources expected to be used to benefit group entities.
 - **Lack of explicit indication that national DIA funds shall participate in the mutualization.**

MPE **Transfer tools**



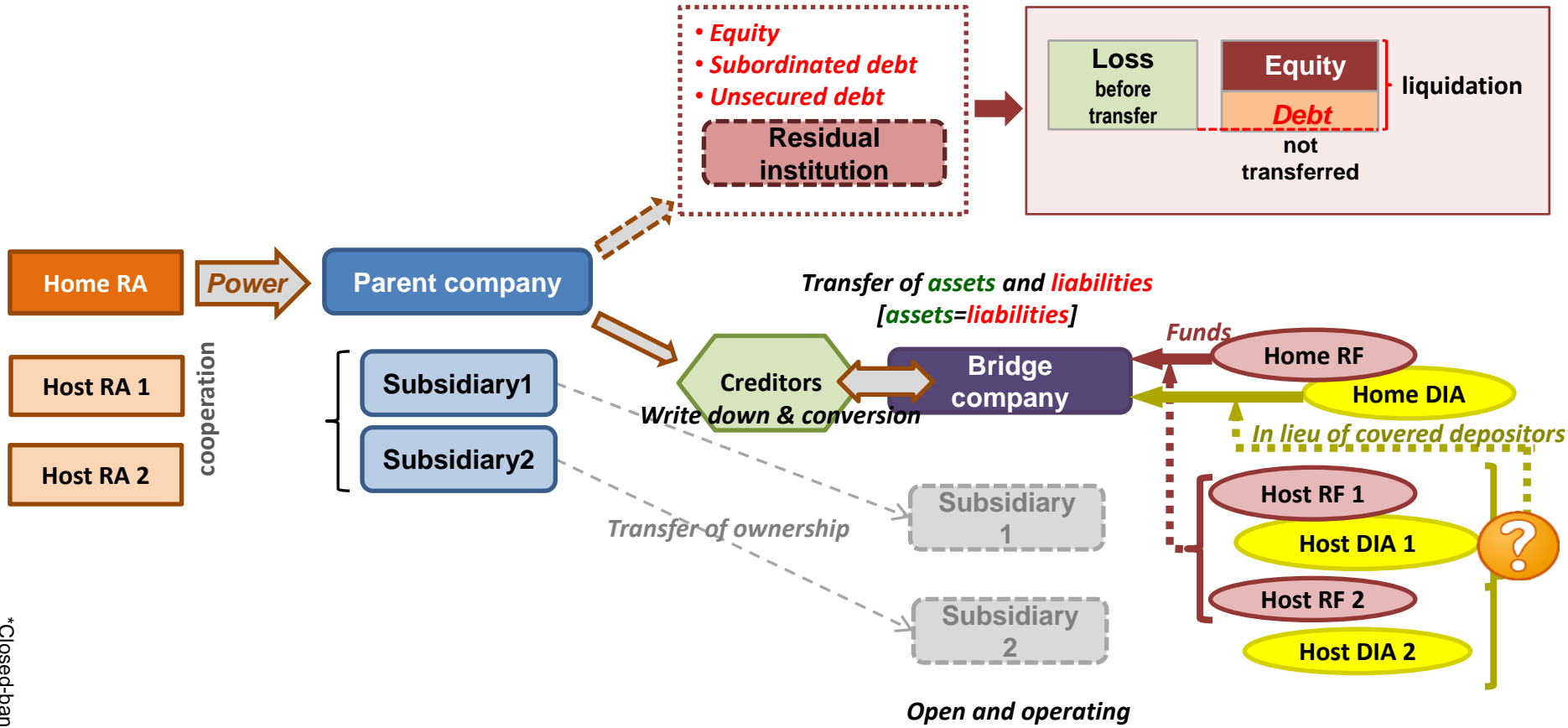
- Likely use of host DIA fund to support resolution, subject to set of safeguards,
- In case of bail-in tool, host DIA fund participates in lieu of covered deposits,
- Debt write-down and conversion may result in a change of ownership and separation of the subsidiary from the group.

SPE **Bail-in***



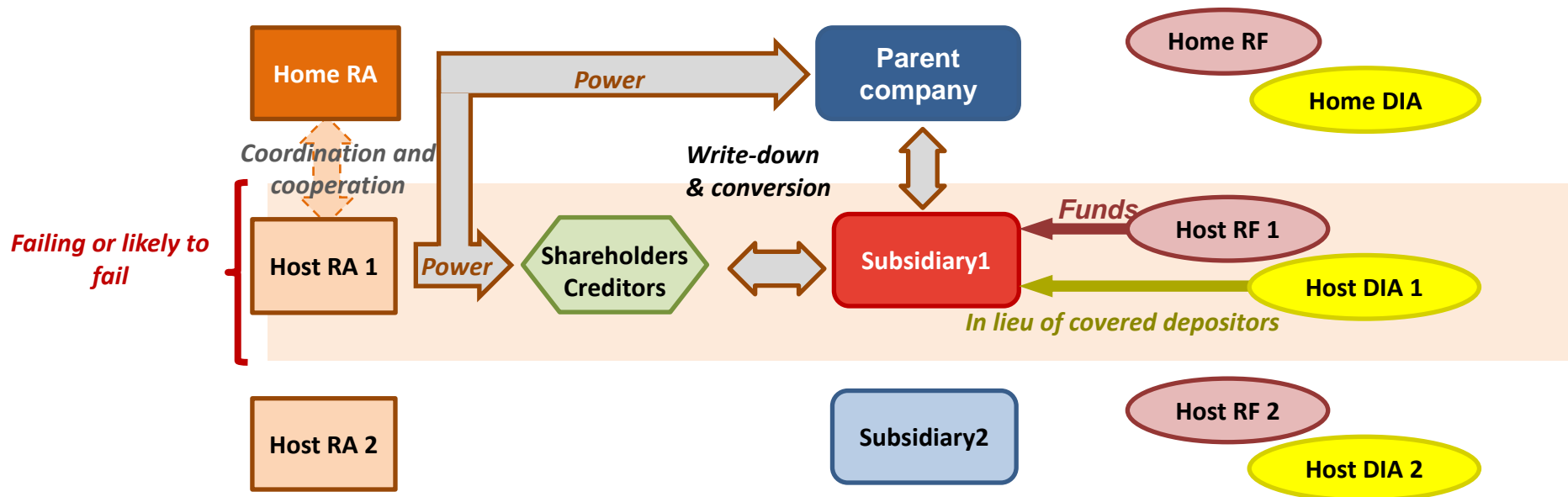
*Open-bank bail-in model

SPE Bail-in*



*Closed-bank bail-in model

MPE Bail-in*



*Open-bank bail-in model



Resolving Globally Active, Systemically Important Financial Institutions

Single point of entry approach analyzed by FDIC and Bank of England (BoE) from the perspective of its usability in relation to G-SIFIs in a cross-border context, though some findings are of a common nature.

- Powers applied by a single resolution authority to the top of a financial group,
- Use of the power to write-down and convert claims of creditors,
- Subsidiaries unaffected (open and operating).

Two concepts of bail-in:

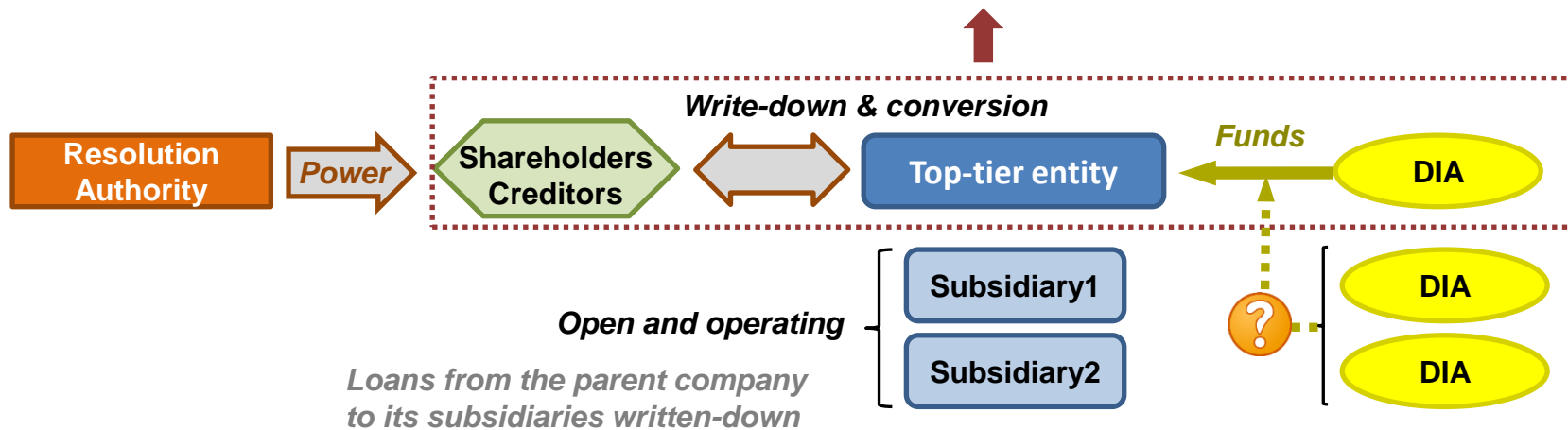
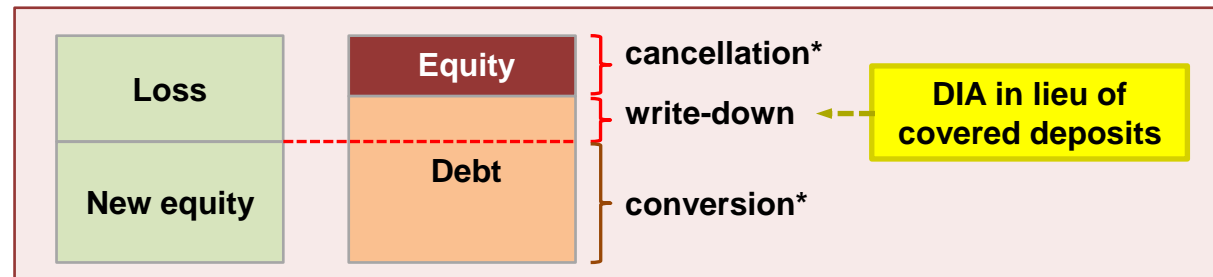
„*open-bank bail-in*”
(BoE)

„*Open-bank*” as it assumes that top-tier parent entity under resolution remains open.

„*closed-bank bail-in*”
(FDIC)

„*Closed-bank*” as it assumes liquidation of top-tier parent entity as a result of resolution proceedings.

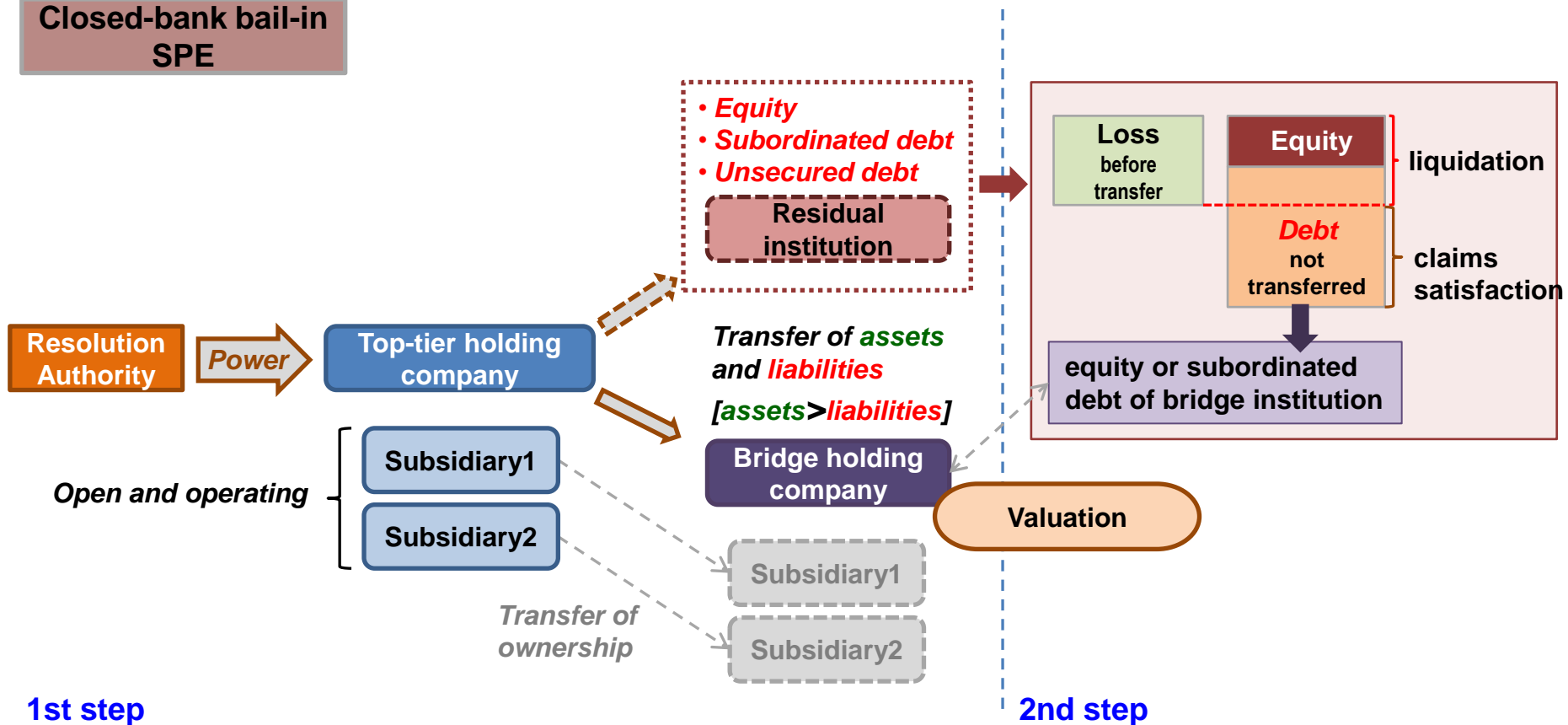
Open-bank bail-in (SPE)



*BoE model assumes that equity instruments are not canceled but transferred to the original creditors of the firm (instead of new issuance)

- One of the bail-in options laid down in BRRD
- Use of DIA funds depends on structure of financing of entity subject to bail-in
- Bail-in shall be accompanied by restructuring measures to address the causes of the failure.

Closed-bank bail-in
SPE



FDIC proposal - group top-tier entity is a pure holding company and does not conduct any operational business activity financed by deposits

- ❑ Crisis management and safety net evolution
- ❑ Evolution of DIA role in crisis management
- ❑ Resolution strategies
- ❑ **IADI Core Principles**
- ❑ Conclusions

- Extended powers of DIA (from pay-box to loss/risk minimizer), and
- Broad use of DIA funds to finance resolution measures

Ongoing need to create an international standard for DIAs reflecting their evolving role in the financial safety net and to establish appropriate safeguards to protect their interests

Crucial role of **International Association of Deposit Insurers** in cooperation with other international institutions as a standard setter for deposit insurers from around the world



inter alia

- Draft revised *IADI Core Principles for Effective Deposit Insurance Systems* (in consultations),
- Research projects (among others on *Bail-in implications for deposit insurance and funding*).

DIA as a fully-fledged, active, equally ranked safety net member

Principle 2 MANDATE & POWERS

- Mandate aligned with mandates of other safety-net participants,
- Powers support the mandate and enable DIA to fulfil its roles and responsibilities,
- Powers include inter alia:
 - Receiving and sharing timely, accurate and comprehensive information within the safety net,
 - Setting operating budgets, policies, systems and practices.

Principle 3 GOVERNANCE

- Operational independence and ability to use its powers without interference from external parties (e.g. government, central bank, FSA, industry) to fulfil its mandate,
- Capacity and capability to support its operational independence and the fulfilment of its mandate.

DIA as a fully-fledged, active, equally ranked safety net member

Principle 4 RELATIONSHIPS

- Close coordination of activities and information sharing, on an ongoing basis, among DIA and other financial safety net participants, in particular when material supervisory action taken in respect of member banks.
- Information sharing rules formalized through legislation, regulation, MoUs, agreements etc.

Principle 6 ROLE IN CRISIS MNG.

- Development of system-wide crisis preparedness strategies and management policies as a joint responsibility of all safety net participants,
- DIA as a member of any interagency institutional framework for communication and coordination related to system-wide crisis preparedness and management,
- Participation in regular contingency planning and simulation exercises as well as in the development of pre- and post-crisis management communication plans.

DIA interests appropriately protected by set of safeguards

Principle 9 USES OF FUNDS

- If DIA not the resolution authority, it has the option to authorize the use of its funds for resolution other than liquidation and pay-out,
- DIA informed and involved in the resolution decision-making process,
- Use of DIA funds only up to the net cost of pay-out of insured depositors,
- DIA funds not used for the recapitalization of resolved entity,
- Use of DIA funds subject to an independent audit,
- All resolution actions and decisions using DIA funds subject to ex-post review.

Principle 16 RECOVERIES

- DIA has right to recover its claims in accordance with the statutory creditor hierarchy,
- DIA clearly recognized as a creditor of the failed bank by subrogation,
- At least the same rights or status as a depositor.

Resolution follows creditor hierarchy in which insured deposits are protected from sharing losses and shareholders take first losses (CP14: EC 6)

Increasing recognition of DIAs in a crisis management framework:

- 1) Importance of prompt reimbursement crucial for maintaining depositor confidence**
- 2) Resolution as substitution for pay-out:**
 - **DIA as resolution authority**
 - **Financial involvement**
- 3) Evolving mandate**
 - **Dominance of pay-box plus and risk/loss minimizer models**