FSI/IADI Seminar on Bank Resolution: Current Developments, Challenges and Opportunities

Role of DIS in the Financial Safety Net

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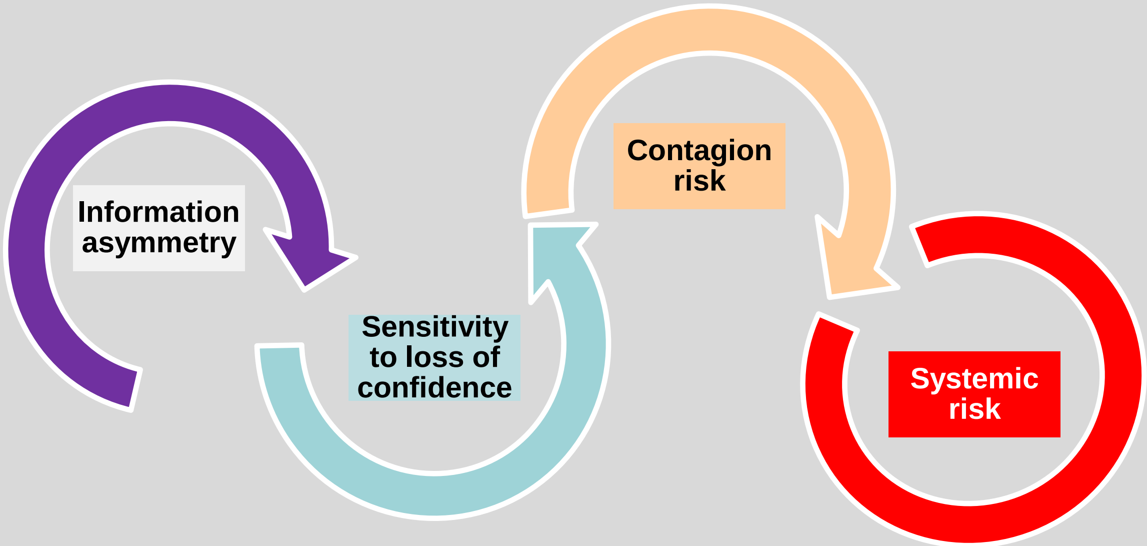
Basel, Switzerland, 28 August 2012

Safety net evolution

Financial stability as a public good

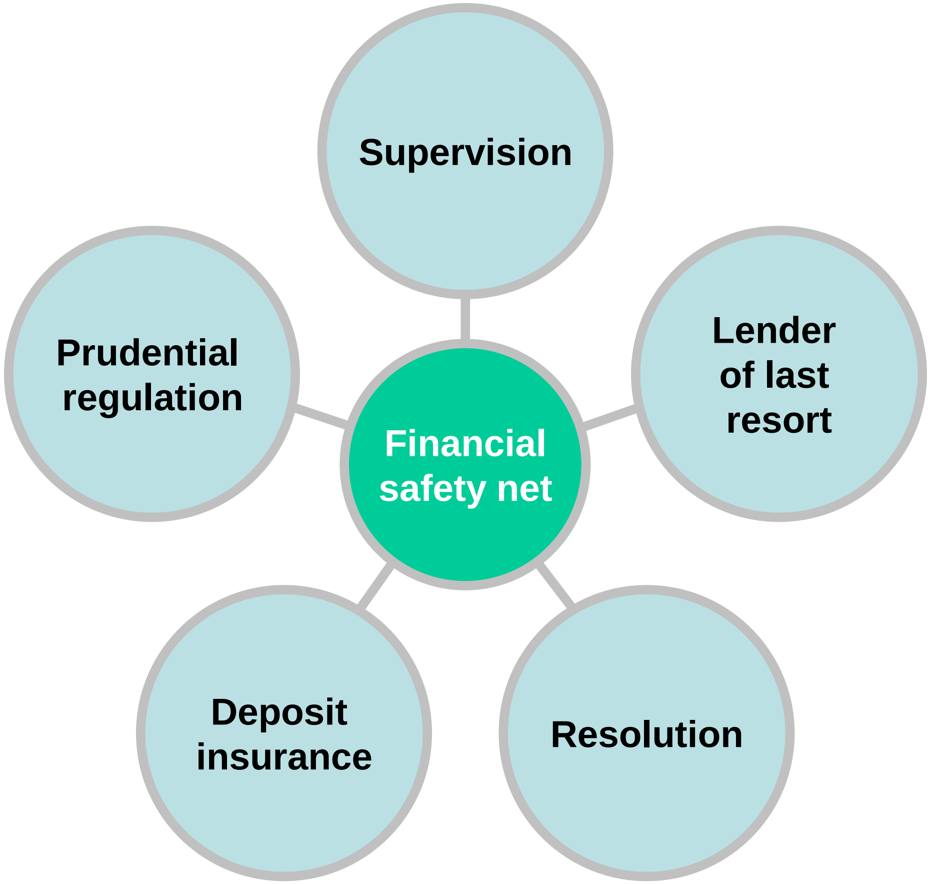
Financial stability is a public good while financial markets due to:



are susceptible to crises

Necessity of establishing strong financial safety net

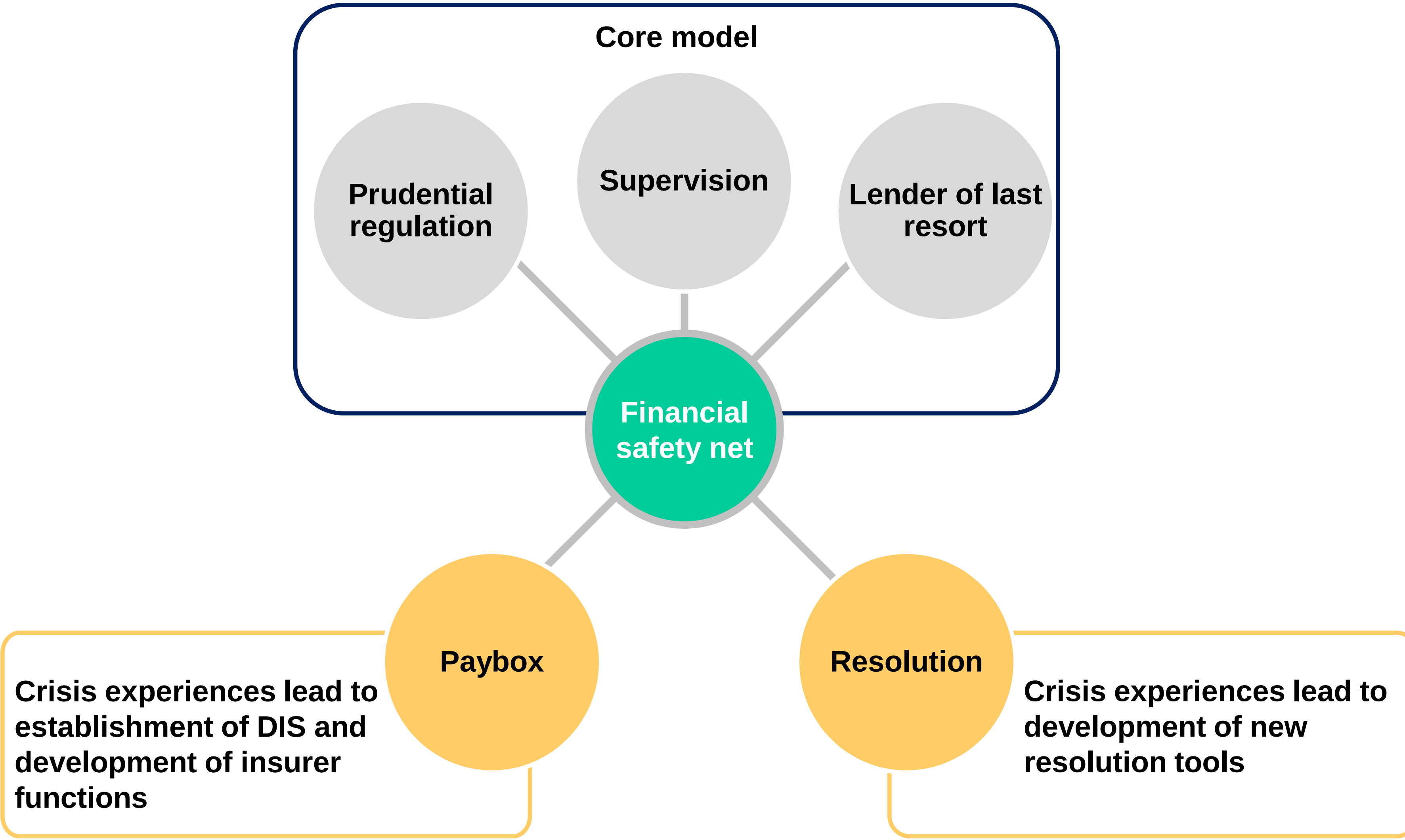
Components of the safety net



IADI (2006)

- promote an efficient and stable banking system during normal times
- manage the eventuality of a financial crisis

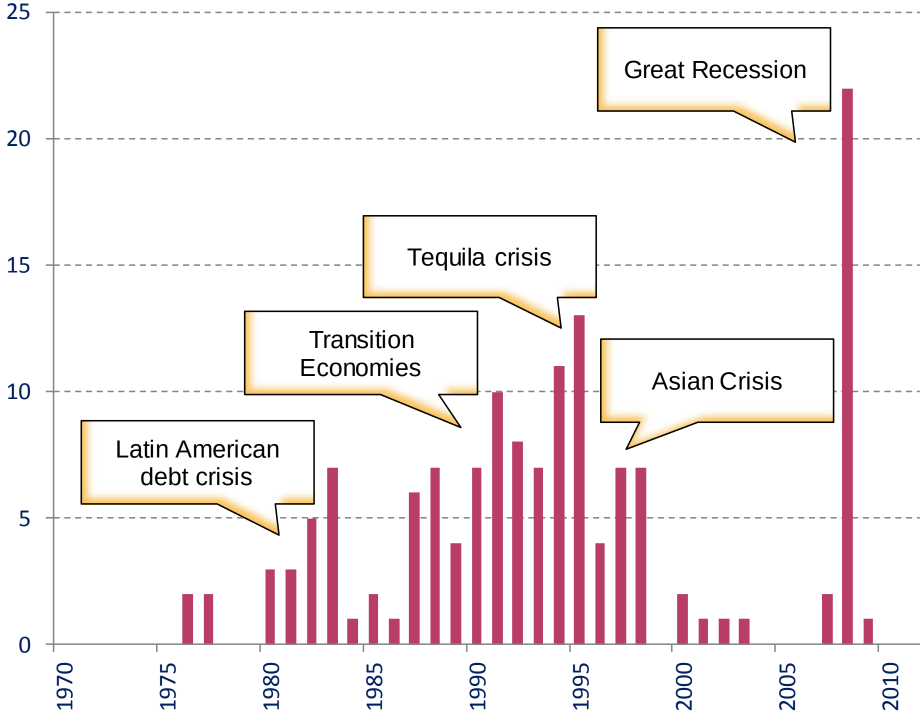
Safety net


Core model
Prudential regulation
Supervision
Lender of last resort
Financial safety net
Paybox
Resolution
Crisis experiences lead to establishment of DIS and development of insurer functions
Crisis experiences lead to development of new resolution tools

Banking crises

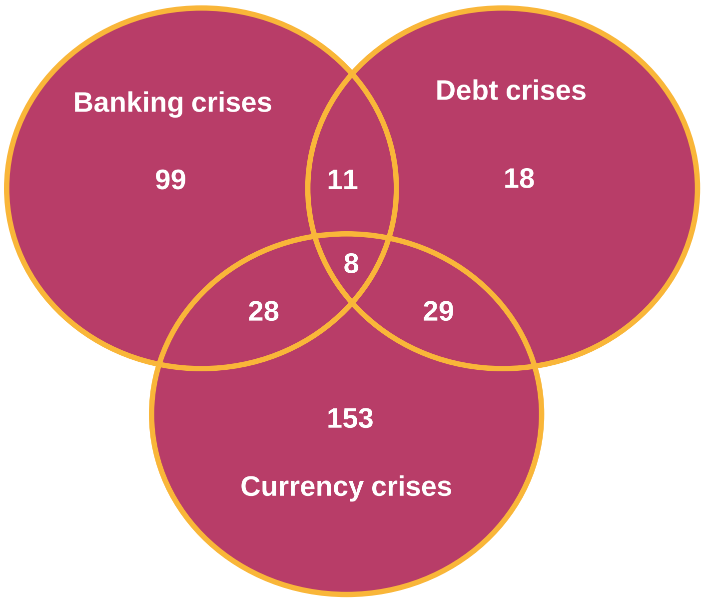
Banking crises 1970-2011

Banking Crisis Cycles



Source: Systemic Banking Crises Database (Laeven&Valencia 2012)

The common occurrence of crises



In contrast to previous crises, the Great Recession affected mostly advanced countries, had global reach and lasted longer

Banking Crisis Outcomes

Crisis outcomes in % of GDP (1970-2011)				
Country	**Output loss**	**Increase in debt**	**Monetary expansion***	**Fiscal cost****
All	23,0	12,1	1,7	6,8
Advanced	32,9	21,4	8,3	3,8
Emerging	26,0	9,1	1,3	10,0
Developing	1,6	10,9	1,2	10,0

Source: IMF

The crisis management methods are costly and ineffective

Deeper financial systems contribute to more disruptive banking crises in advanced economies

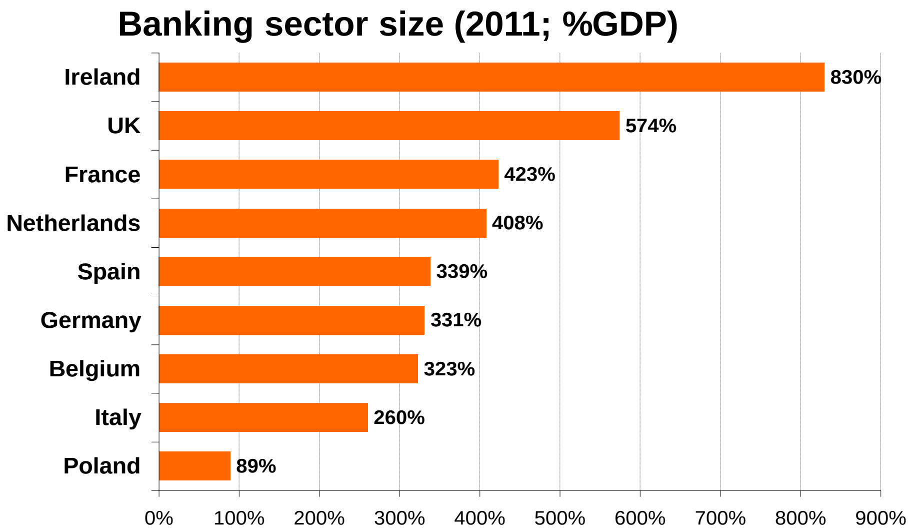
In advanced economies fiscal costs associated with financial sector intervention did not contribute decisively to the increase in public debt. The substantial increase in debt was caused by discretionary fiscal policy, automatic stabilizers and substantial loss of GDP

The limited efficiency of monetary policy combined with the exhaustion of fiscal policy tools were a factor in explaining the persistence of the crisis

* Monetary expansion – change in the monetary base between its peak during the crisis and its level one year prior to the crisis

** Fiscal cost – the component of gross fiscal outlays related to the restructuring of the financial sector

Overdependence of economies on the banking sector

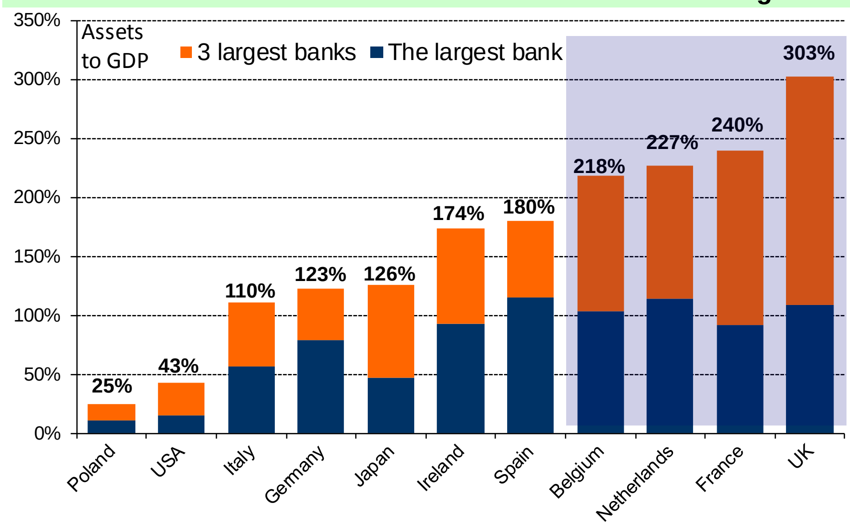


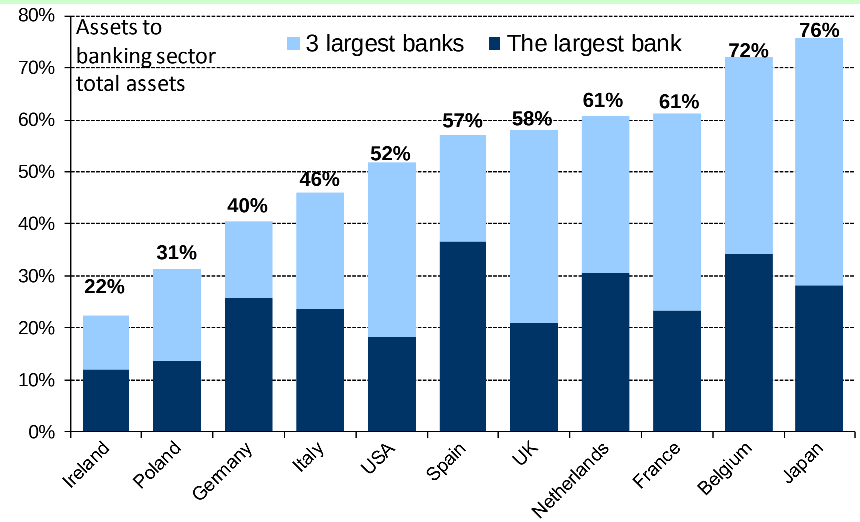
European market – many big banks, with size disproportionate in comparison to parent country economies

Creates problems of:

- **„too big to fail”**
- **„too big to be saved”**
- **“too complex to fail” etc...**

Banking sector concentration

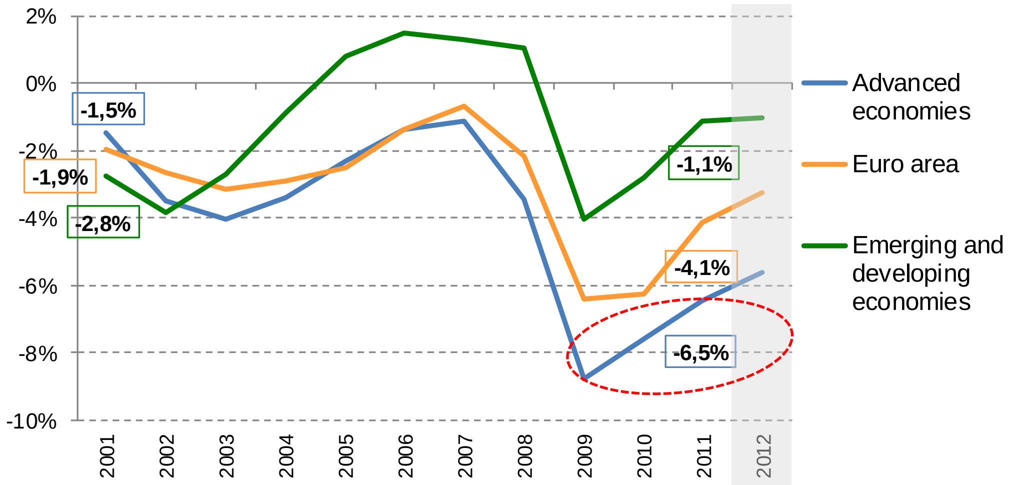




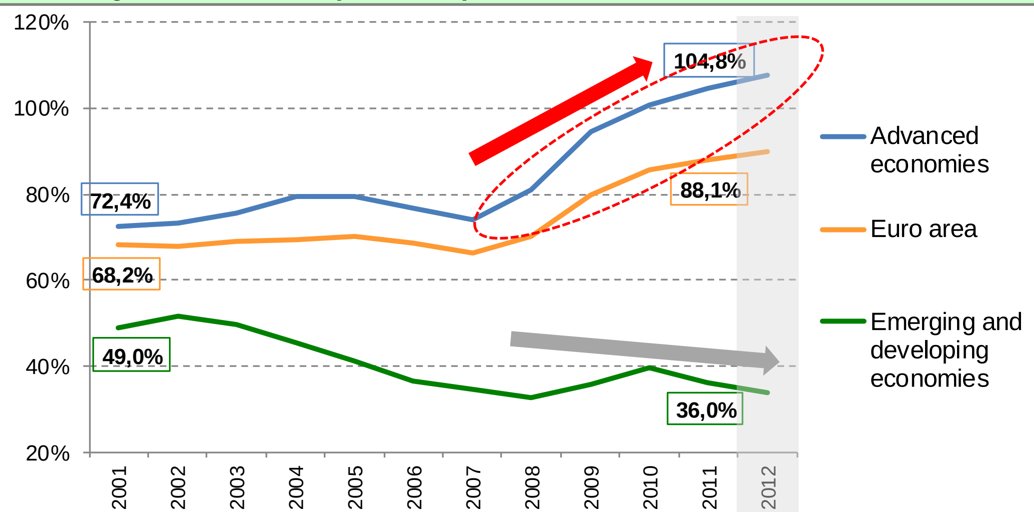
Source: ECB, Bank annual financial statements, „The Forbes Global 2000” rank

Public finance after current crisis

Budget deficit (% of GDP)



General government debt (% of GDP)



Simultaneous occurrence of:

- **gaps and inefficiencies in terms of institutional structure and available tools,**
- **excessive dependence of economies on the banking sector,**
- **limited competitiveness of economies,**

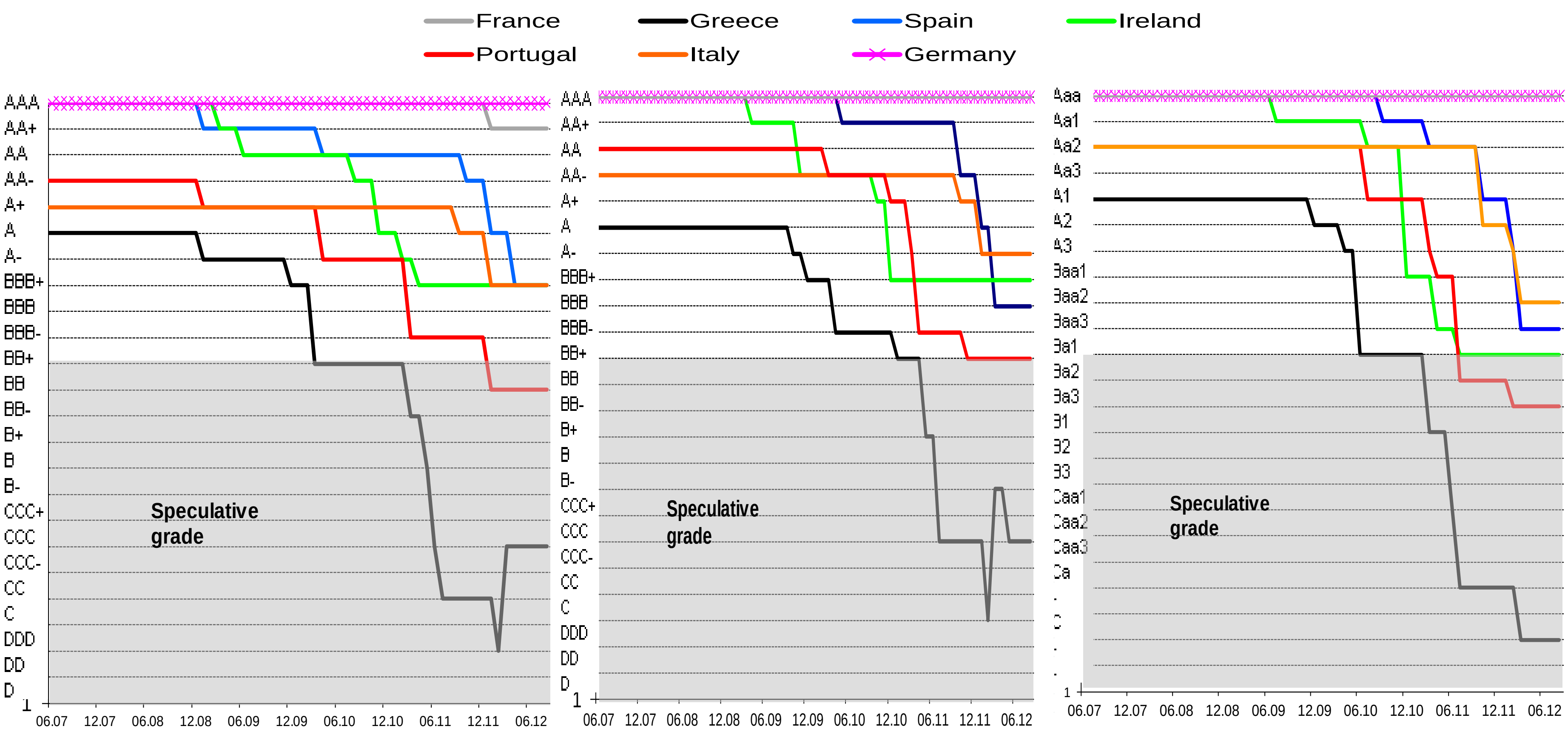
may lead to escalation of the banking crisis into a fiscal crisis.

The increase in debt to GDP ratio, already high before the crisis, was influenced by output losses.

Source: based on World Bank and IMF data

Ratings

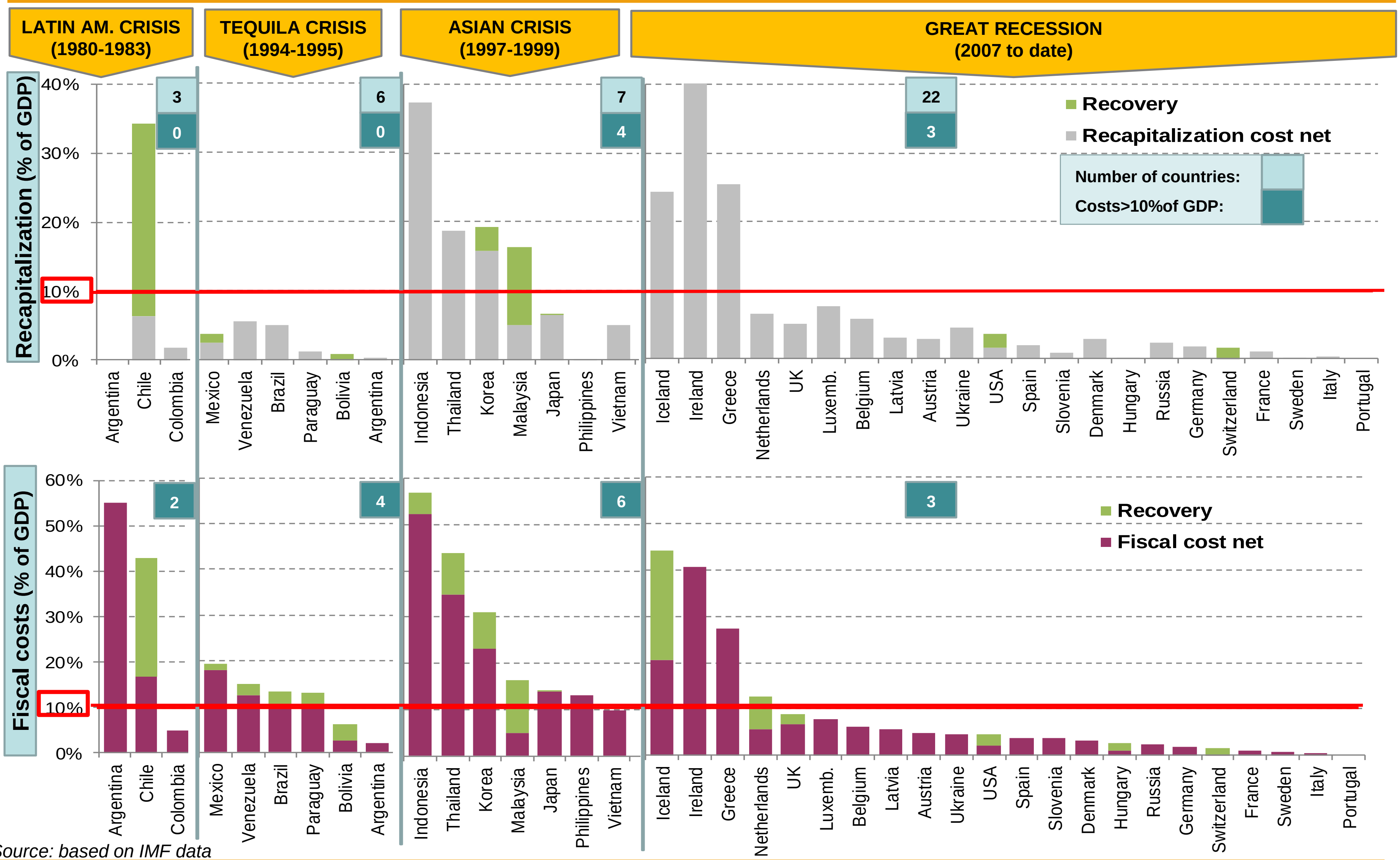
S & P	Fitch	Moody's



Source: based on Reuters data

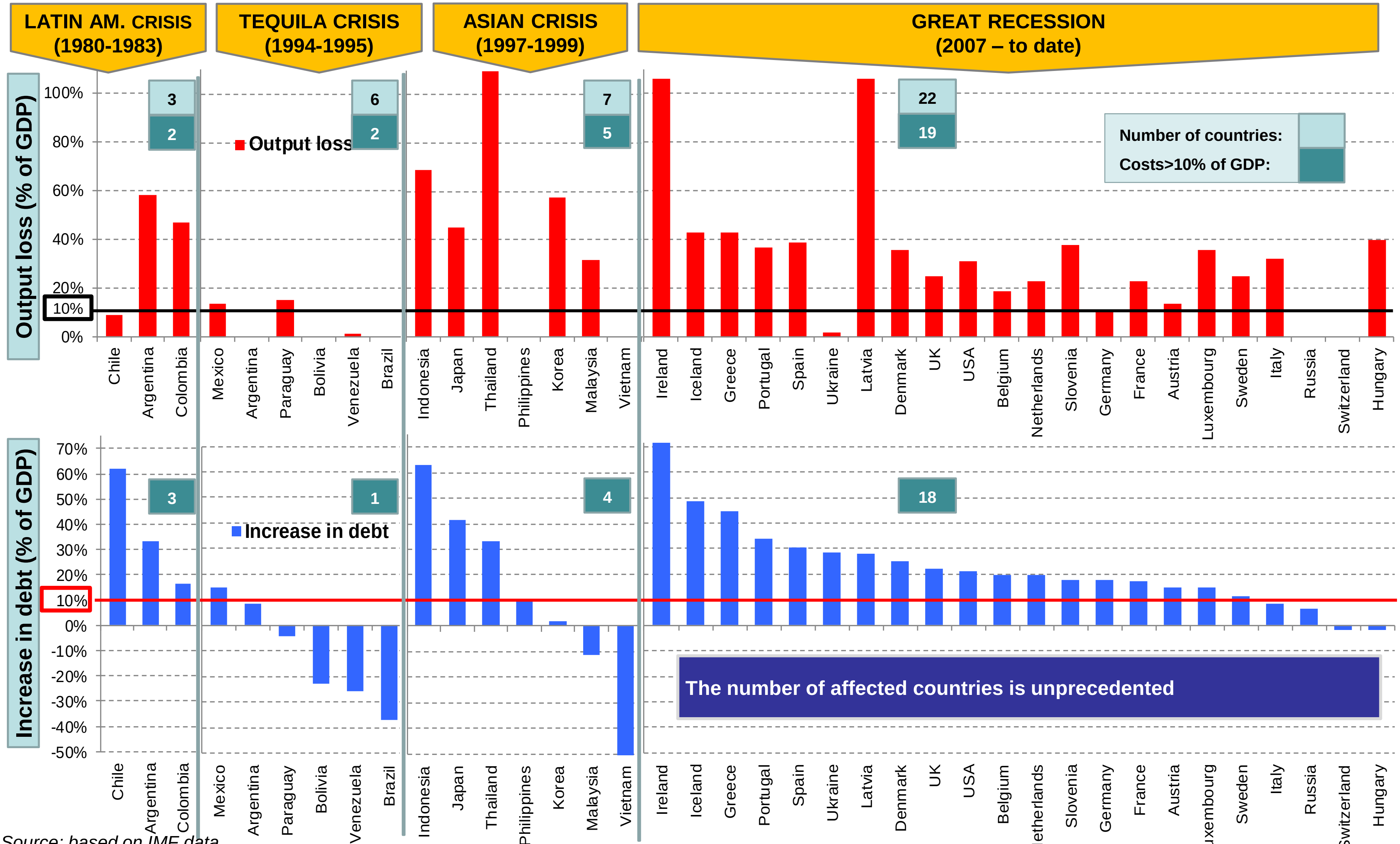
Sovereign debt crisis reflected in substantial rating downgrade of many countries

High fiscal cost…



Source: based on IMF data

… and output losses lead increase in public debt



Source: based on IMF data

Conclusions

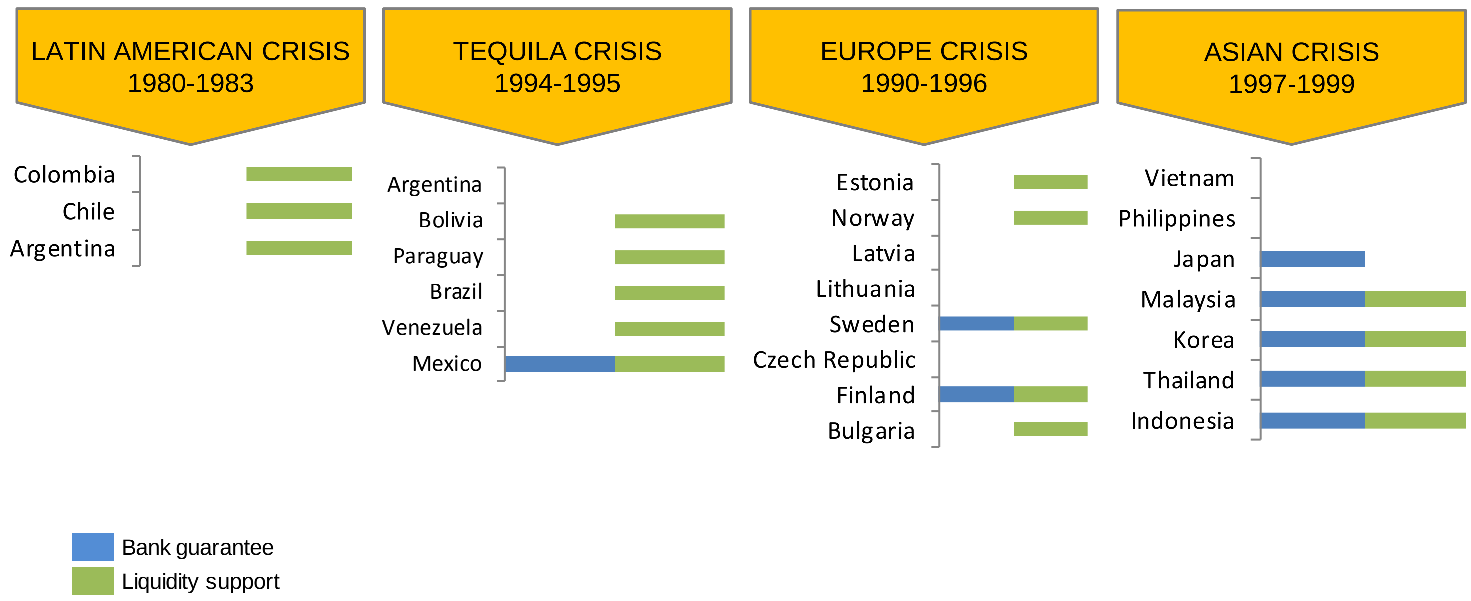
Characteristics of recent crisis

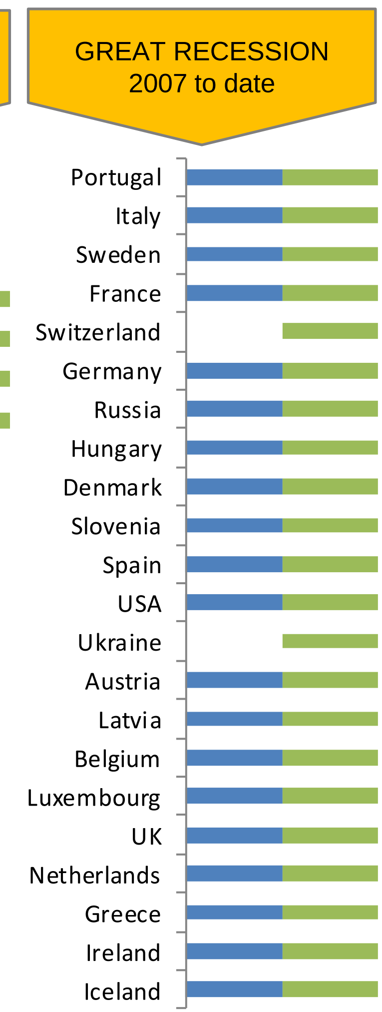
New

Characteristic	
Banking crises affected mostly advanced countries	✓
Banking crises developed into public debt crises	
Costs of affected countries are significantly higher than previously (10% of GDP threshold)	✓
The key issue in Europe is lack of competitiveness and inaccessibility of FX policy	✓
The high cost of recapitalization reflects both the severity of the crisis and insufficiency of appropriate crisis management tools	
Overdependence of some advanced economies on the banking sector	✓
The problem of „too big to fail" and „too big to be saved" has materialized during the crisis	✓

Crisis management tools

Crisis management tools (1)



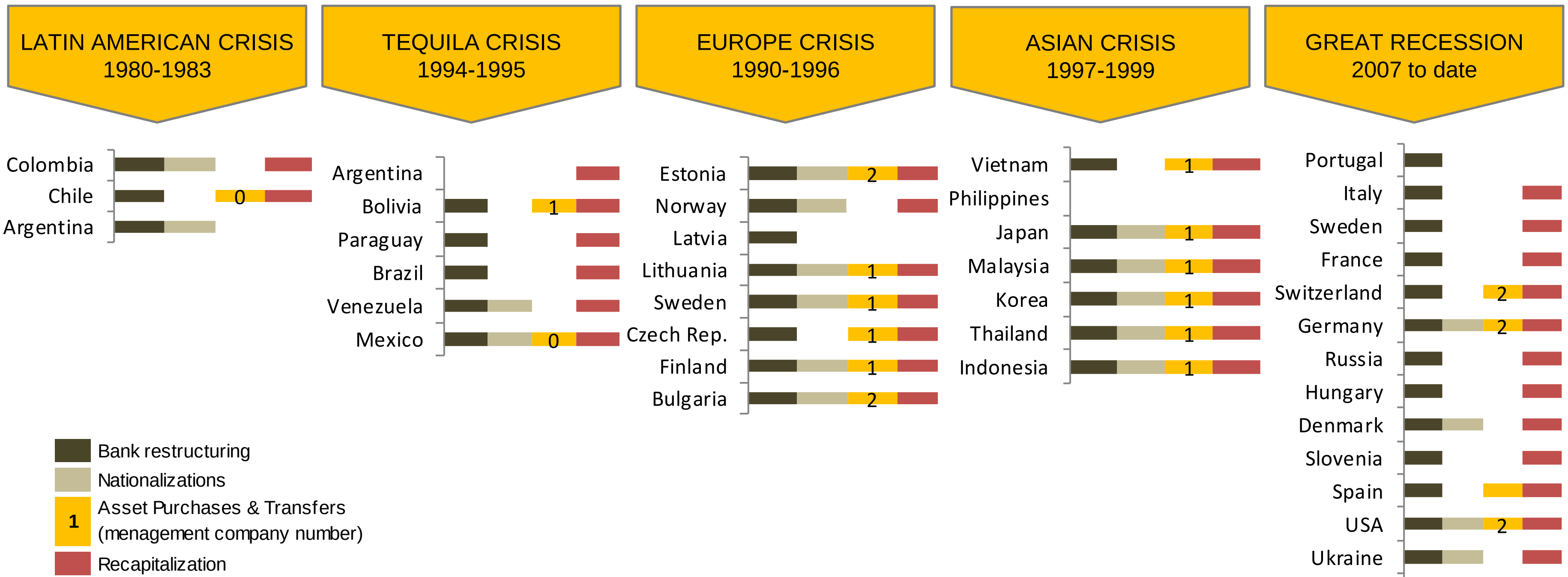


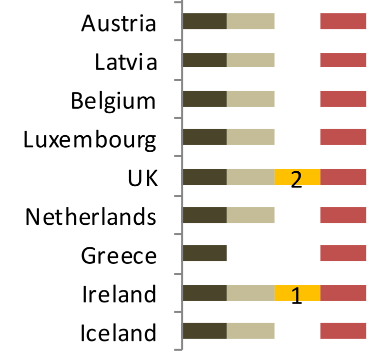
Liquidity support and widespread guarantees remain key tools in crisis intervention

Increasing role of DIS's

Source: based on IMF data

Crisis management tools (2)





Bank restructuring is a widely used anti-crisis tool

Since the 90's recapitalization has become a widespread tool

Source: based on IMF data

Losses imposed on depositors

LATIN AMERICAN CRISIS 1980-1983	
Argentina	
Chile	
Colombia	

TEQUILA CRISIS 1994-1995	
Mexico	
Venezuela	
Brazil	
Paraguay	
Bolivia	
Argentina	

EUROPE CRISIS 1990-1996	
Finland	
Czech Rep.	
Sweden	
Lithuania	
Latvia	
Norway	
Estonia	

ASIAN CRISIS 1997-1999	
Indonesia	
Thailand	
Korea	
Malaysia	
Japan	
Philippines	
Vietnam	

GREAT RECESSION 2007 to date	
Iceland	
Ireland	
Greece	
Netherlands	
UK	
Luxembourg	
Belgium	
Latvia	
Austria	
Ukraine	
USA	
Spain	
Slovenia	
Denmark	
Hungary	
Russia	
Germany	
Switzerland	
France	
Sweden	
Italy	
Portugal	

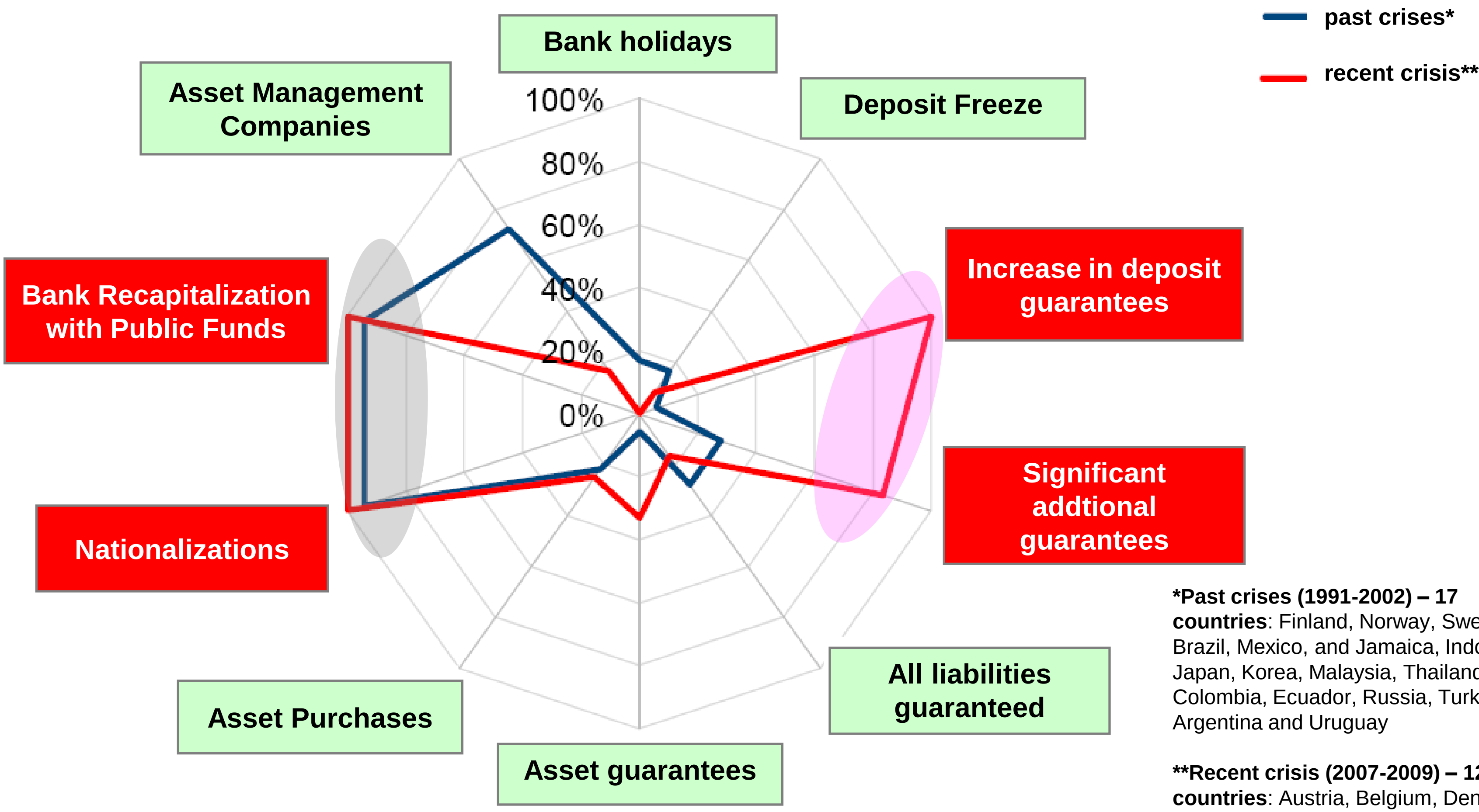
- No loss imposed on depositors
- Moderate loss imposed on depositors
- Severe loss imposed on depositors

The crises that occurred in the years 1990-1996 (Tequila crisis and crises in some European countries) were the most costly for depositors

Great recession – no losses imposed on depositors

Source: based on IMF data

Public funds and guarantees



***Past crises (1991-2002) – 17 countries**: Finland, Norway, Sweden, Brazil, Mexico, and Jamaica, Indonesia, Japan, Korea, Malaysia, Thailand, Colombia, Ecuador, Russia, Turkey, Argentina and Uruguay

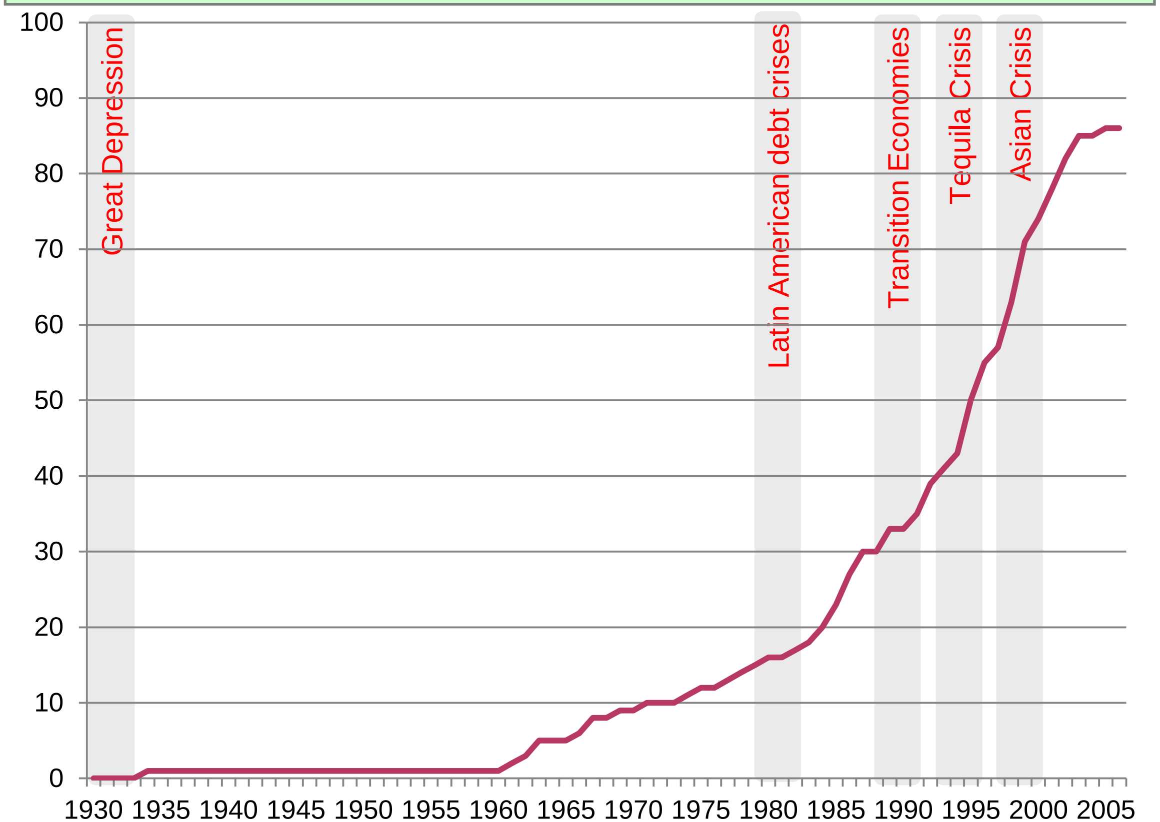
****Recent crisis (2007-2009) – 12 countries**: Austria, Belgium, Denmark, Germany, Iceland, Ireland, Latvia, Luxembourg, the Netherlands, Ukraine, the United Kingdom, and the United States

Source : Crisis Management and Resolution: Early Lessons from the Financial Crisis, IMF 2011

Evolution of deposit insurance systems

Expansion of DIS's

Number of countries with explicit DIS's



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

Crisis experiences were the fundamental factor that led to the expansion of deposit insurance systems

FDIC in the US was established in 1934 after the crisis of 1929

Most of the systems have a short history and were created after 1980

After 2005 the number of new DIS's increased to over 100

The importance of DIS's is growing and their tools and powers are expanded

Increasing role of deposit insurance systems

The growing importance of deposit insurance systems is reflected in establishement of international associations of deposit insurance schemes - the International Association of Deposit Insurers (IADI) and the European Forum of Deposit Insurers (EFDI) and an increasing number of their members.

IADI had:

25 founding members in 2002,

51 at the outbreak of the financial crisis in 2008,

64 members at present.

EFDI is grouping DISs from Europe (both, from EU and non-EU states) and at present it has 57 members from 43 countries.

Increasing importance of IADI

The increasing importance of IADI is reflected in its recognition as an international standard setter in deposit insurance and other financial stability measures

- IADI together with the Basel Committee on Banking Supervision (BCBS) developed the first international set of Core Principles for Effective Deposit Insurance Systems (published in June 2009) and then the Core Principles Methodology to enable assessments of compliance with these core principles (December 2010)

- In 2011 the Financial Stability Board (FSB) agreed to include the Core Principles in the list of key standards for sound financial systems

- IADI has been currently contributing to the new FSB Thematic Review of compliance to the Key Attributes of Effective Resolution Regimes

Extension of pay-box functions

Extraordinary measures taken during the crisis

Country	Coverage limit increase	Premium rate/system change	Coverage expansion	Full deposit guarantee	Extension of DIS powers and other measures
Australia	x			x	
Brazil			x		x
France	x			x	x
Germany	x			x	x
Hong Kong				x	
Indonesia	x				
Italy					x
Korea			x		x
Netherlands	x				x
Russia	x	x			x
Singapore				x	
Spain	x				x
Switzerland	x		x		x
UK	x				x
USA	x	x		x	x

Source: IADI, FSB

Extension of pay-box function was widespread

Coverage limit increase sometimes supplemented by full deposit guarantee

In Europe, reinbursement time was reduced to 20 working days

Measures used by deposit insurers

Resolution actions by deposit insurers (2007 – June 2010)

Country	Payout	OBA	Bridge Bank	P&A	M&A	Nationali-zation	Other	Total	Cost (milion USD)
United States	15	13	2	237				**267**	74 000
Russia	79			3	12	3		**97**	10 760
Korea			8					**8**	2 414
Taiwan				8				**8**	-
Indonesia		1						**1**	750
Finland	1						1	**2**	21
Hungary	1							**1**	15
Macedonia							3	**3**	30
Norway	1							**1**	-
United Kingdom	7							**7**	37 476
Vietnam	4							**4**	129
Argentina	1							**1**	9
Total	**109**	**14**	**10**	**248**	**12**	**3**	**4**	**400**	**125 604**

Asia, Russia & USA
Europe
Other countries

In Europe the activity of DIS's was limited to payout

In Asia and the US deposit insurers had greater powers

The most diversified and numerous resolution tools have been used in Asia, USA and Russia:

- P&A transactions were conducted mainly in the US
- OBA and bridge bank tools were used mainly in Asia and the US
- In Russia resolution tools were used next to payout action

Source: Based on IADI data

DIS resolution tools worldwide

USA

Experience in utilization of P&A methods and other resolution tools
Limited experience with large banks

Europe

In contrast to USA and Asia, the role of DIS's is limited to payouts in case of bank insolvency

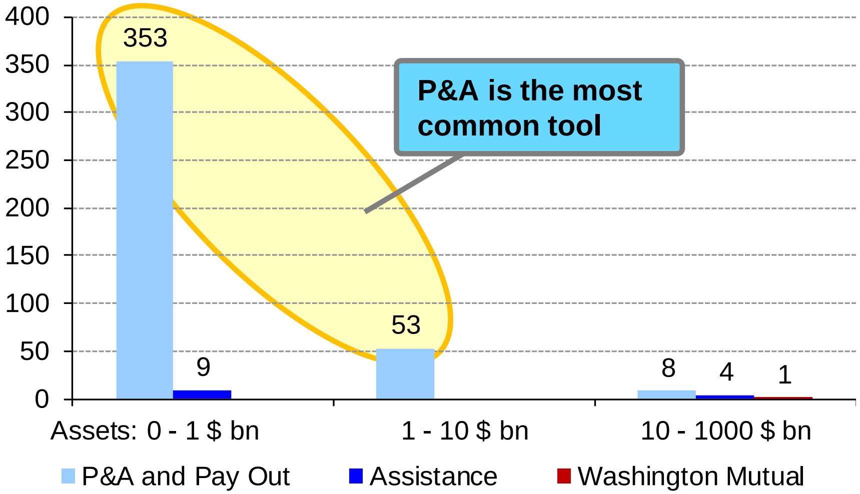
Asia

Full range of resolution tools, also applicable to large banks
Experience in crisis management and resolution of large banks

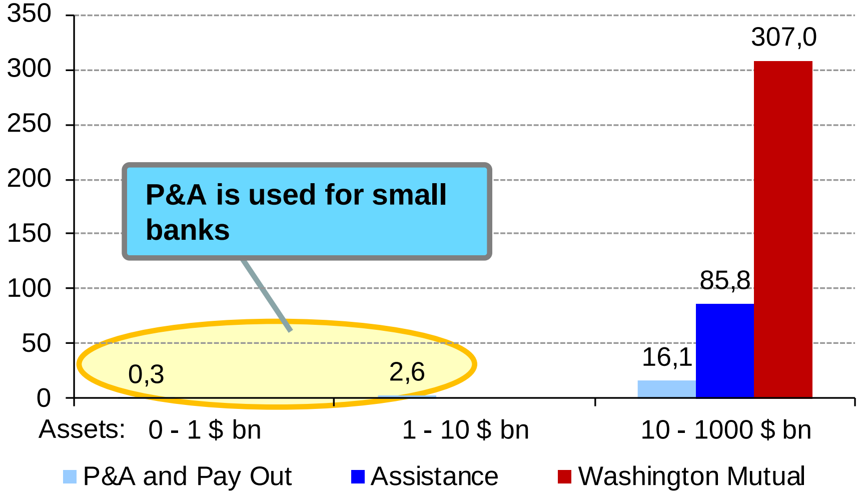
In view of the severity of the crisis in Europe the introduction of new tools is urgent

Last crisis – examples of resolution

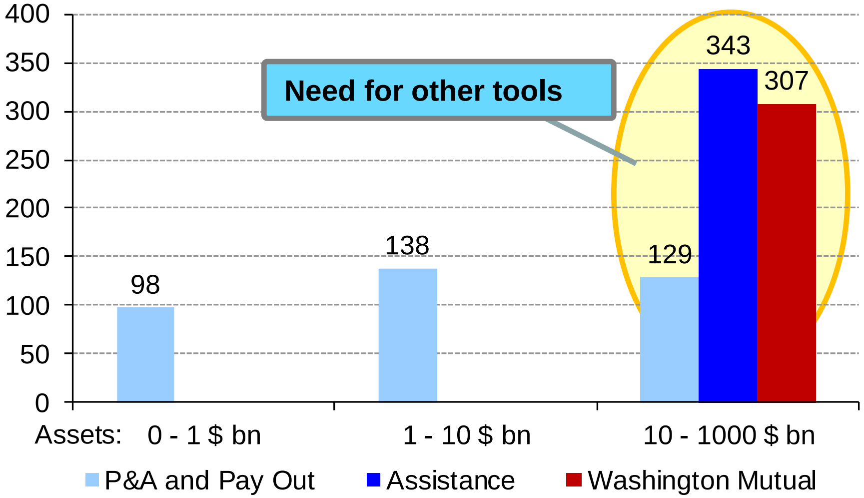
Number of banks covered by FDIC action



Average size of banks covered by FDIC action ($ bn)



Total assets of banks covered by FDIC action ($ bn)



After the negative effects of Lehman Brothers bankruptcy, the case of Washington Mutual Bank was an example of resolution tools applied to a SIFI

Source: based on FDIC database

IADI core principles for effective deposit insurance systems

Principle 6

A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalised.

Principle 15

The insurer of deposits should be included in the financial system safety net. The safety net provides early detection of risk of bankruptcy, rapid intervention and carrying out the rehabilitation program

The tasks assigned to participants in the safety net under the recovery mechanism are clear and formally defined

Principle 16

Effective process of resolution proceedings should:

- facilitate quick and proper payment of guaranteed funds by insurer
- reduce insurer costs mitigates negative impact on markets
- maximize the scale of the recovered assets
- protect from neglect and abuse

To create a flexible mechanism to support the maintenance of key banking functions by:

- purchase of certain assets by another entity
- takeover of the threatened bank liabilities

Safety net modifications

Modification of safety net functions

	Basic functions	Extended functions
Failure of prevention	**Market disruption** Lack of institutional solutions for crisis intervention	**Limited market disruption** Institutional solutions for crisis intervention
Bank failure	**Disorderly bankrupcy** **Payout**	**Resolution** **Payout as last resort**

Increased role of DIS not only as paybox but also as resolution authority

Strong arguments to attribute resolution tools to DIS's

Consumer protection

- Selection of the most appropriate method

Funds

- Availability of funds

Costs of bank failure intervention

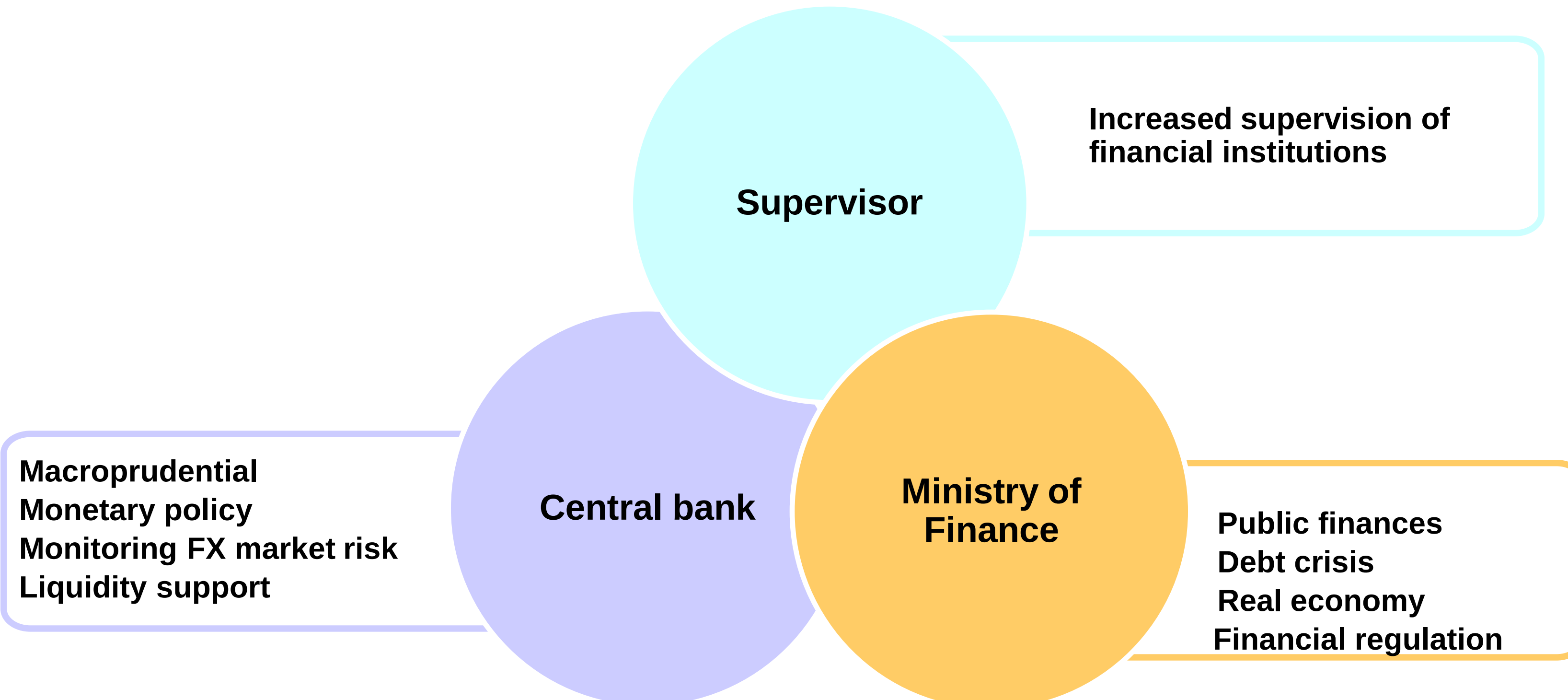
- Selection of the most appropriate method
- Cost reduction

Effectiveness of fund management

- Higher effectiveness due to joint location of funds
- Flexibility

Increased involvement of other safety net players

During the crisis the Central Bank, Supervisor and Ministry of Finance become more engrossed



Most of the G-20 country DIS's as loss or risk minimizers

	Europe	Paybox	Paybox plus	Loss minimiser	Risk minimiser
1	Germany	✓			
2	Netherlands	✓			
3	Switzerland	✓			
4	United Kingdom		✓		
5	France			✓	
6	Italy			✓	
7	Russia			✓	
8	Spain			✓	

	Asia & Australia	Paybox	Paybox plus	Loss minimiser	Risk minimiser
1	Hong Kong	✓			
2	India	✓			
3	Singapore	✓			
4	Indonesia			✓	
5	Japan			✓	
6	Turkey			✓	
7	Korea				✓
8	Australia	✓			

	North America	Paybox	Paybox plus	Loss minimiser	Risk minimiser
1	Canada			✓	
2	USA				✓

	Latin America	Paybox	Paybox plus	Loss minimiser	Risk minimiser
1	Argentina		✓		
2	Brazil		✓		
3	Mexico			✓	

- G20 countries with loss minimiser or risk minimiser function

- G20 countries

Source: Financial Stability Board; Thematic Review on Deposit Insurance Systems; February 2012

Explanation

Paybox
Narrow systems that are only responsible for the reimbursement of insured deposits

Paybox plus
Systems, where the deposit insurer has additional responsibilities such as resolution functions

Loss minimiser
Systems, where the insurer actively engages in the selection from a full suite of appropriate least-cost resolution strategies

Risk minimiser
Systems, where the insurer has comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities

Importance of DIS's in financial safety nets

Agencies responsible for dealing with systemic crises

		Central Bank	Ministry of Finance	Financial Supervisory Agency / Commission	Deposit Insurer	Other
ASIA & RUSSIA	Hong Kong	●	●			
	India	●	●			
	Singapore	●	●			
	Thailand	●	●			
	The Philippines	●			●	
	Indonesia	●	●		●	
	Russia	●	●		●	
	Malaysia	●	●		●	
	Kazakhstan	●	●	●	●	●
	Vietnam	●	●	●	●	
	Japan	●	●	●	●	
	Korea	●	●	●	●	
	Taiwan	●	●	●	●	
NORTH AMERICA	USA	●	●	●	●	●
	Canada	●	●	●	●	●

Source: CDIC (Taiwan), FDIC, CDIC (Canada)

Asian and American deposit insurers are active participants in systemic crisis management

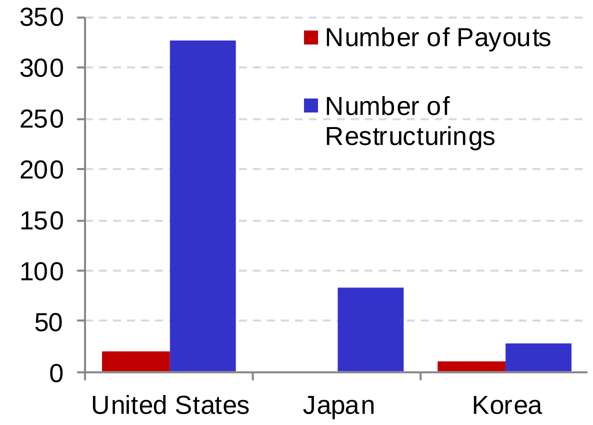
Extension of DIS toolkit

Examples of countries with full resolution powers

		Meeting insurance obligations			Financial assistance to problem institutions	Advance payments to depositors/ creditors of failed institutions
		Reimbursement	Financial assistance for P&A	Establishment of bridge banks		
ASIA & RUSSIA	Japan	●	●	●	●	●
	Korea	●	●	●	●	●
	Taiwan	●	●	●	●	●
NORTH AMERICA	USA	●	●	●	●	●
	Canada	●	●	●	●	●

Source: CDIC (Taiwan), FDIC, CDIC (Canada), FSB

Activation of DIS during Past 10 Years



Wide range of resolution tools reduces the frequency of payout use and cost for taxpayers, contributing to financial stability

Diversification of DIS financial resources (1)

Financing of DIS activity – banking sector

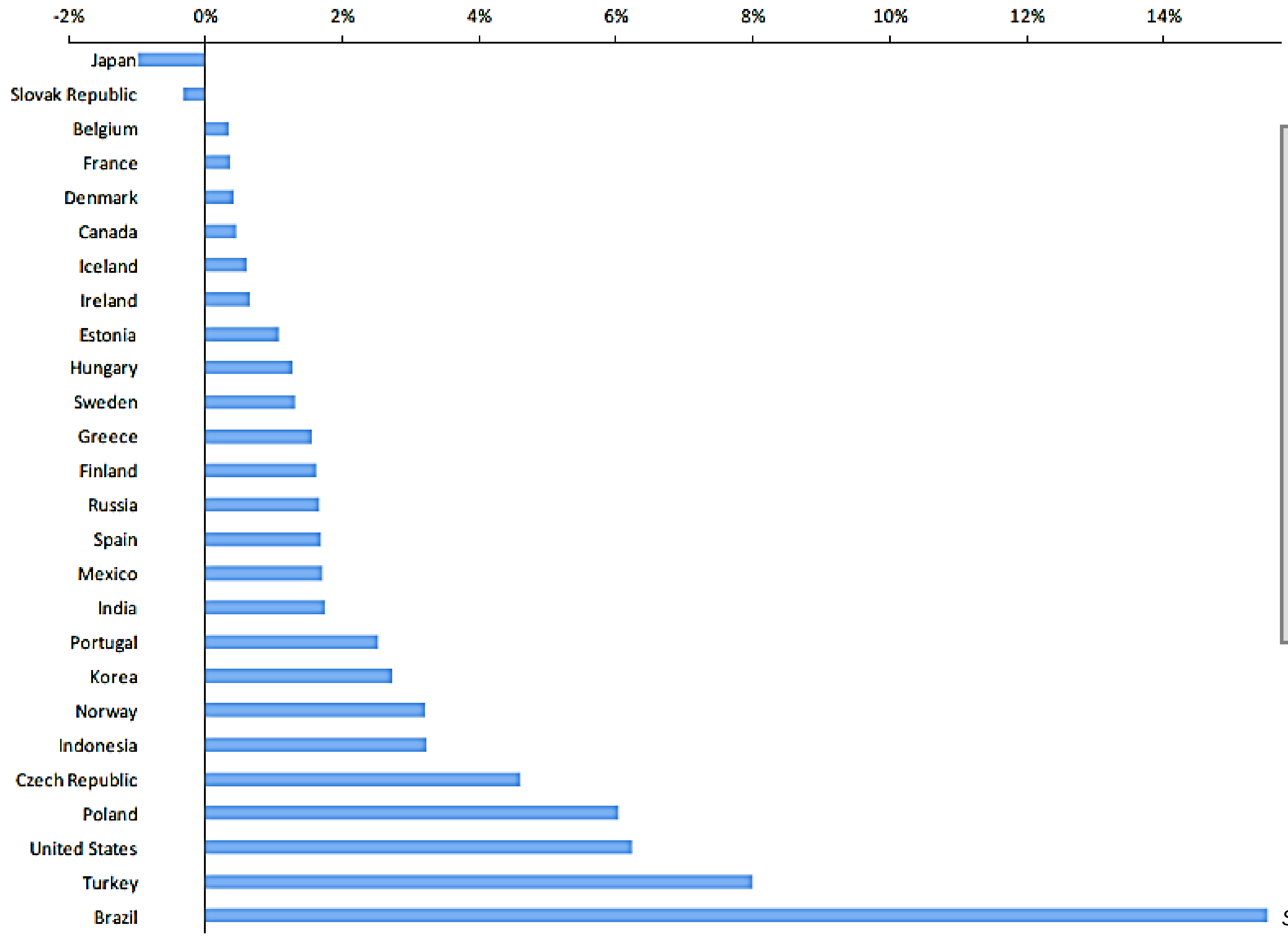
Region	Country	Protection level (2009-2011)	Total assets to GDP (2011)
Western Europe	Netherlands	ex post	408,0%
	Switzerland	ex post	500,5%
	UK	ex post	574,0%
	Italy	ex post	260,0%
	Germany	0,15%	331,0%
	France	0,21%	423,0%
	Spain	0,37%	339,0%
Other European countries	Finland	1,00%	340,3%
	Hungary	1,10%	113,9%
	Romania	1,50%	67,3%
	Poland	2,89% / 2,04%	89,0%
	Sweden	2,45%	294,9%
	Bulgaria	3,04%	109,6%
World	India	1,40%	-
	Korea	1,61%	-
	Russia	1,80%	-
	Turkey	5,41%	-

Source: BFG and ECB database

Extending safety net function to resolution and better deposit protection requires sufficient funding

Diversification of DIS financial resources (2)

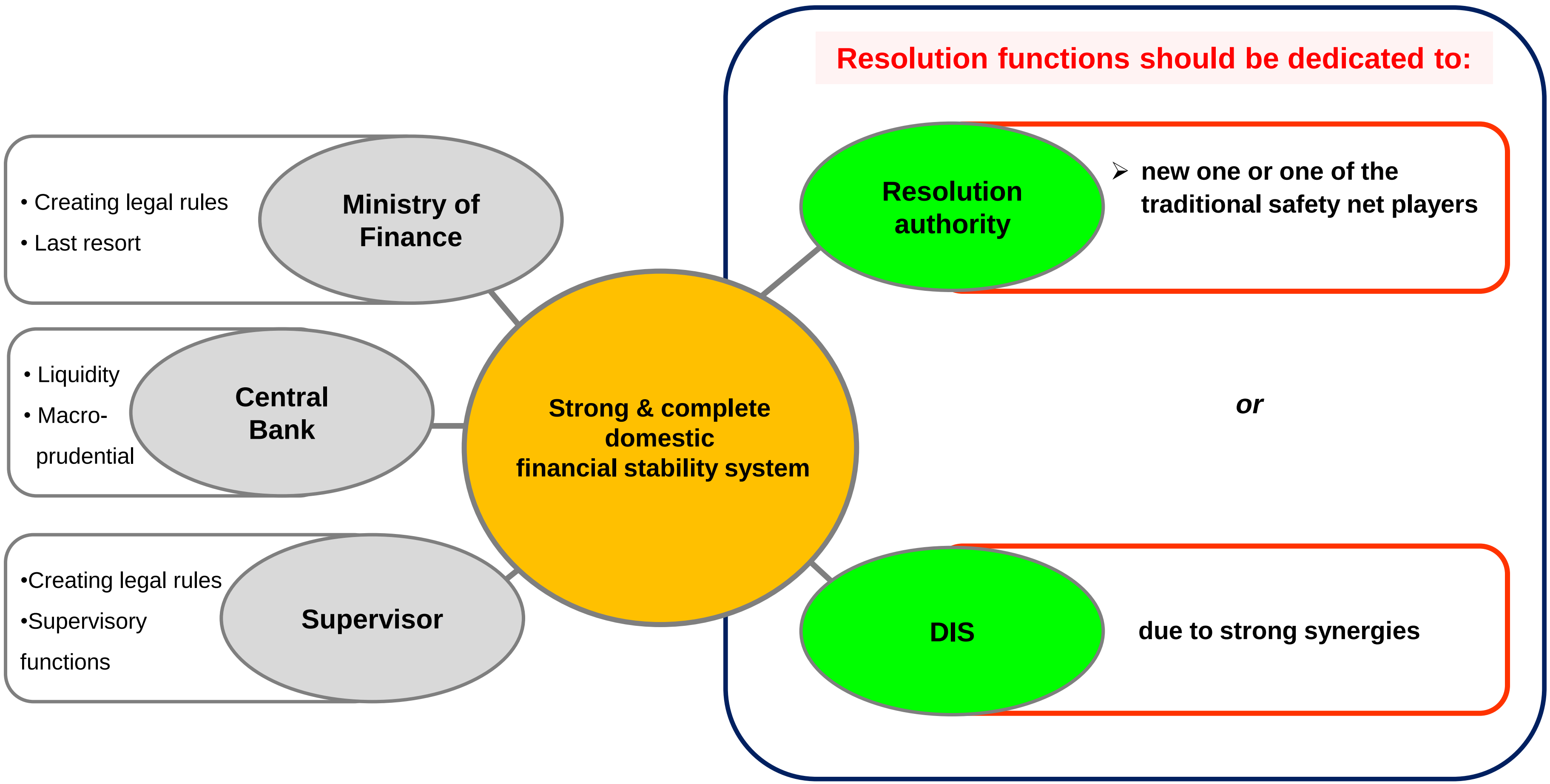
DIS balances as % of customer deposits at country's largest bank (2007)



There is a high diversity of funding levels among deposit guarantee schemes

Source: Schich and Kim (OECD 2010)

Robust domestic financial stability network



Conclusions and challenges

1 **DIS proved critically important in current crisis**

2 **Expansion of DIS**

•Strengthened pay-box

• From pay-box to risk minimizer

Challenges – how to cope with large banks

- Need for higher efficiency of resolution tools and powers (Dodd-Frank Act)
- Search for new tools such as bail-in (draft of EU directive)
- Adequate funding and emergency funding for resolution and pay-box

If not sufficient: bank subsidiarisation (?) or broader application of Volcker rule (?)

3 **How to coordinate supervision, deposit insurance and resolution in a cross-border dimension**

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