

The Quest for Deposit Stability*



By Fernando Restoy
Bank for International Settlements

JEL codes: G21, G28, G33, G38.

Keywords: Deposit insurance, Basel standards, crisis management, bank supervision.

Recent bank failures may point to a less stable banks' deposit base. That might eventually justify the consideration of bold policy reforms aiming at further protecting financial stability. Those reforms should be grounded on compelling evidence and, crucially, on a rigorous cost-benefit analysis. For the time being, though, those episodes already constitute a good case for speeding up a full implementation of the Basel standards in all jurisdictions. Moreover, they support the development of pragmatic bank failure management regimes that sufficiently acknowledge the need to provide non-covered deposits with a sensible degree of protection when banks fail. Finally, they forcefully indicate the need to strengthen supervision to address the root causes of bank failures.

*This paper is based on the speech I delivered at the International Conference organised by the European Federation of Deposit Insurers on 25 May 2023 in Budapest. I am grateful to Rodrigo Coelho, Rastko Vrbaski, Ruth Walters and Raihan Zamil for comments on an earlier draft. The views expressed are my own and do not necessarily reflect those of the Bank for International Settlements or the Basel-based standard-setting bodies.

Introduction

The recent financial turmoil initiated with the collapse of Silicon Valley Bank (SVB) in March 2023 has affected banks with different risk profiles on both sides of the Atlantic. On the American side of the ocean, a few mid-sized banks – with significant interest rate risk exposure – have failed. On the European side, a major bank – actually a globally systemically important bank (G-SIB) – with a weak business model also failed.

While those banks were quite different, their failure followed a broadly common pattern. Although all failing banks satisfied minimum solvency requirements, market concerns about their viability provoked sharp corrections in equity prices which triggered unprecedented runs on deposits, particularly those not covered by the deposit guarantee scheme.

Those bank failures shined a spotlight on the significant increase in non-covered deposits and the structural risks posed by banks' reliance on them. A larger demand for banks' deposits can well result from a specific juncture characterised by ample liquidity and low opportunity costs in a context of low market rates. However, the speed at which the runs took place – fuelled by social media and the new technological means to move funds rapidly from banks' accounts – could call into question prevailing assumptions about the stickiness of non-covered deposits.

The prospect of a structural loss of stability in banks' deposit base could have severe implications for the sustainability of commercial banks' business models and the robustness of the current regulatory framework, including features of current deposit guarantee schemes.

That has triggered a debate on what policy actions, if any, should be explored to preserve banking system stability in the light of recent developments.

How to contain bank runs: the US experience

Arguably, both prudential regulation and deposit insurance share the same origin. In the first half of the 19th century there was a wave of bank failures affecting in particular the redeemability of bank notes issued by entities chartered in some US states, starting in New York in 1829. These triggered the creation of the first insurance programmes.

Those programmes included not only the insurance of a series of banks' obligations but also the introduction of some regulatory restrictions, such as a specific list of eligible investments for bank capital and the creation of an authority with examination powers.

Prudential regulation and oversight were introduced mainly to mitigate the risk exposure of the insurance programmes. Yet authorities also recognised at that time the supplementary objective of providing assurance about banks' safety to their clients.¹

The establishment of a prudential regime for banks has accompanied all deposit insurance programmes implemented since then in the United States, including the one leading to the creation of the Federal Deposit Insurance Corporation (FDIC) in 1933.

¹ FDIC (1998).

Indeed, the first federal deposit insurance scheme had a limited coverage (\$2,500). However, it also contained a detailed set of rules – including the compulsory separation of investment and commercial banking – established rigorous admission requirements and gave the FDIC substantial supervisory powers.

Over the years, this scheme combining insurance coverage up to a specified limit and prudential controls has served the US financial system well and restrained the number of bank runs. This outcome has been supported by the progressive increase of the maximum coverage amount (currently \$250,000) and the strengthening of prudential regulation in parallel with the development of international standards. In their latest version, Basel III, those standards include, for the first time, liquidity requirements (a Liquidity Coverage Ratio (LCR) and a Net Stable Funding Ratio (NSFR)) that differentiate between covered and non-covered deposits as a function of their estimated stability. In the US, however, only a few large banks are directly subject to the Basel standards.

In addition, the development, starting in the 1950s, of a broadly successful bank failure management regime has further contributed to the overall stability of banks' deposit base.

At present, that regime gives non-covered deposits the same privileged ranking as covered deposits in the hierarchy of liabilities in insolvency. Moreover, the FDIC can support transfer transactions involving all (and not only covered) deposits if this satisfies a least cost test, ie if it is less expensive for the deposit insurance fund than paying out covered deposits in liquidation. As seen recently, that requirement to adopt the least cost method of managing a bank failure can be waived in case of a risk to financial stability.

Under this regime, there have been a relatively limited number of bank failures in which non-covered deposits have suffered losses.² That has logically generated the stabilising perception – but in no way the certainty – that non-covered deposits have, in practice, a fair amount of protection.

The US experience illustrates that, at least until now, limited coverage deposit insurance can deliver sufficient stability, but only if it is properly accompanied by an effective prudential framework and a bank failure management regime which moderates expected losses for uncovered deposits.

The European situation

What is the situation in Europe in terms of those elements that help maintain the stability of banks' deposit base?

The summary could be that, compared with the US, deposit coverage is smaller, the prudential regime is somewhat more stringent (at least for small and medium-sized institutions) and the bank failure management framework is relatively weaker.

Thus, deposit insurance is currently only provided at the national level, but following rules established in European legislation. The coverage is harmonised and kept at a maximum of €100,000.

Prudential regulation, which closely follows the Basel standard, is also developed in European legislation and applies with little variation to all credit institutions in the EU. The rule book includes Basel's LCR and NSFR, which have been applicable in Europe since 2015 and 2021, respectively.

² Since 1992 (2008), in only 20% (6%) of the failures, non-covered depositors have suffered losses, the average loss being 28% (43%). See FDIC (2023).

As for bank failure management, the current framework is a combination of a centralised regime (a common resolution framework) for banks whose failure passes a public interest test and domestic (mostly non-bank-specific) insolvency regimes for the rest. The former largely relies on the application of creditors' bail-in rules that can affect non-covered deposits for banks under resolution. The latter contains a partially harmonised creditor hierarchy that gives covered depositors preference over holders of all other non-preferred liabilities, including non-covered depositors.

As has been discussed already for a few years³, this framework fails to offer a robust toolbox to deal effectively with the failure of mid-sized banks which are too large and sophisticated to be subject to liquidation but also too small and too unsophisticated to be able to issue large amounts of bail-in-able liabilities. In particular, as those banks typically have little market funding, their failure would often imply losses for non-covered deposits, through the application of bail-in in resolution and, in liquidation, through their subordination to covered deposits. In order to avoid the destabilising implications of that outcome, European authorities have often relied on substantial bailouts. In particular, given the existing restrictions on public support in resolution, in recent crisis episodes they have opted for stretching the potential under national insolvency regimes to support the sale of failing banks with the provision of liquidation aid by the state.

The most reasonable approach to addressing these deficiencies is to learn from the US experience and facilitate sale of business strategies – involving the transfer of deposits to an acquirer – by establishing effective funding arrangements, with the key participation of deposit insurance funds. Some proposals in that direction have been put forward over the last few years.⁴

Building on those proposals, the European Commission⁵ has recently launched a legislative initiative aimed at improving the crisis management framework by facilitating transfer strategies under the common resolution framework. Without being exhaustive, the proposal establishes a general depositor preference rule to replace the current super-preference of covered deposits and makes deposit insurance funds more readily available to support sale of business operations under resolution. The amount of funds available remains capped through a US-type least cost restriction but without the flexibility created by the systemic exception. In parallel, the proposal aims to expand the range of cases that are dealt with through resolution by effectively banning the application of domestic insolvency regimes when public liquidation aid is foreseen. Bringing more failures within the resolution framework not only gives resolution tools effective transfer powers, but also brings an additional source of funding from the Single Resolution Fund in appropriate cases.

The proposal is a major step towards improving the European crisis management framework. Yet, as the European Commission openly recognises, a significant drawback is that the new framework for funding transfer strategies relies heavily on national arrangements rather than on a European deposit insurance scheme. This not only deprives the new framework of the diversification benefits of a pan-European fund, but also makes it unable to contribute to the core banking union objective of denationalising banks' risk.

Those shortcomings are also relevant from the point of view of providing stability to uncovered deposits. In that regard, the expected availability of public funds to support the liquidation of failing banks under domestic insolvency regimes, while sub-optimal from the point of view of limiting taxpayer' costs of a bank crisis, could have a stabilising effect on non-covered deposits. By excluding (formally unlimited) liquidation aid under

³ See Restoy (2018).

⁴ See eg Restoy (2019), Restoy et al (2020), Gelper and Veron (2020) and Garicano (2021).

⁵ European Commission (2023).

insolvency regimes and replacing it with funding provided by national deposit insurers in resolution, which is subject to quantitative limits, the proposal might not contribute much by itself to strengthening the expected protection of non-covered deposits in a crisis episode. Importantly, the lack of a European deposit insurance scheme with a greater capacity to support transfer strategies of individual banks than national funds could increase the perceived uncertainty about the protection of uncovered deposits in a bank's failure.

On recent reform proposals

Arguably, the current framework that combines limited deposit insurance coverage, a prudential regime and bank failure arrangements, while helpful for containing bank runs, it is not meant to eliminate the risk that a bank's crisis will entail costs for non-covered depositors. In fact, as discussed before, recent developments might suggest that the probability and speed of bank runs could become more acute in the future.

Against that background, it is reasonable to consider reforms aimed at further protecting the stability of the financial system in these new circumstances. Some reforms of this kind are already being put forward and can be broadly classified around the three key elements described above: coverage of the deposit insurance scheme, prudential rules and bank failure management.

A first set of measures would entail increasing the current limits of insurance coverage for all or specific types of deposits, and eventually the coverage of all deposits without pre-specified quantitative limits.

A second set of measures would seek to strengthen prudential regulation. In particular, some observers are now proposing more stringent controls on those risk factors that have had a bearing on recent bank failures. Those would include a review of Basel III's LCR to further restrict the instruments that would qualify as high quality liquid assets or to modify the underlying assumptions (eg non-covered deposit stickiness) that determine the required volume of those assets. A far-reaching regulatory reform, but with a similar objective, could consider the introduction of collateralisation obligations for non-covered deposits to explicitly enhance the protection of those instruments.⁶

A last set of proposals focuses on the management of banks' liquidity distress. Rather than trying to prevent bank runs, some initiatives aim to make them less disruptive by ensuring that central banks can cover any liquidity gap created by a bank run with collateralised lending. In its purest form, such a proposal would imply requiring banks to pledge ex ante sufficient qualifying collateral to central banks to cover all their runnable liabilities such as deposits or short-term market funding.⁷

All those proposals merit a careful analysis, particularly if further evidence emerges that current developments are the result of a structural reduction in the effective stability of the deposit base of financial institutions. Yet that analysis should include a rigorous assessment of the potential costs and side effects of each proposal.

A fundamental consideration is that reform options should not aim to fully transfer all banks' risks away from bank creditors to the state or the industry. Otherwise, this might well lead to disproportionate costs for taxpayers or the banking sector and may result in a slackening of banks' risk management discipline. In particular, a scenario in which some depositors would withdraw funds to avoid losses when the bank is perceived as weak constitutes a powerful disciplining device for banks' managers which can hardly be fully replaced by stricter regulation.

⁶ FDIC (2023).

⁷ See King (2023) and Noonan (2023). The latter contains quotes from Paul Tucker on the matter.

In addition, while it is worth considering whether some technical adjustments could be warranted, excessively stringent liquidity requirements (through higher minimum liquidity ratios or the collateralisation of non-covered deposits) could ultimately impair commercial banks' business models and make them constrain their credit supply and/or rely more on expensive and less stable short-term market funding.

Those potentially adverse effects are present, possibly to a larger scale, in the more radical proposals aimed at constraining the acceptable volume of runnable liabilities as a function of the assets that could be pledged to the central bank. As the central bank would need to cover the risk of lending in critical situations, acceptable collateral could only consist of either relatively safe assets (such as government securities) or risky assets (such as loans) only if they are subject to conservative haircuts. Since deposits would be constrained by available collateral, the proposal could possibly create funding gaps for the loan portfolio that might have to be covered either by reducing banks' lending in favour of less risky exposures or increasing the reliance on costlier longer-term (non-runnable) market liabilities.

Therefore, when considering this type of proposal, authorities should bear in mind the potential negative impact of those initiatives on banks' profitability, safety and soundness, and ability to intermediate. Otherwise, these initiatives could lead either to the reduction of credit availability to the real economy or to an excessively prominent role of non-banking intermediaries

The role of supervision

What about supervision? Arguably, the far-reaching regulatory proposals are motivated by a lack of trust in the ability of the existing regime to preserve a well-functioning banking system in a context of a more unstable deposit base. That could well be the justified, although much more evidence and analysis would still be required to establish the need to substantially modify the current regulatory framework.

That said, while the case for radical regulatory reforms still remains quite uncertain, there are already clear arguments for reviewing supervisory practices and seeking ways to strengthen them. For example, the materialisation of interest rate risks triggered several bank failures. But banks' vulnerabilities unveiled by those failures went beyond specific exposures or funding sources. This included excessively risky balance sheet structure, deficient risk management and unsound growth strategies. In other words, the root cause of the weaknesses of failing banks was a flawed business model and poor governance. Of course, the large amount of non-covered deposits – while not the predominant funding source in all cases – accelerated the failure, but this was not the main vulnerability of the failing banks. Put differently, the assumption that non-covered deposits are now less stable than in the past should primarily lead to the conclusion that more and earlier policy action is needed to promote sustainable business models and sound governance practices.

Importantly, the ability of standard prudential rules to address this type of weakness is limited. There is simply no feasible amount of capital and liquidity requirements that can compensate for banks with poor governance or business models. To the contrary, an attempt by authorities to compensate for a bank's structural deficiencies with more capital and liquidity could well exacerbate problems and further undermine the viability of the institution.

Actually, the prompt identification and correction of those deficiencies is the core business of supervision. Indeed, under the current Basel III pillar 2, supervisors have a broad range of powers and tools – including both quantitative and, more importantly, qualitative measures – that could help correct banks' structural weaknesses.⁸ Unfortunately, Pillar 2 is not sufficiently well developed in all jurisdictions.

⁸ Coelho et al (2023).

The European banking union is a good example of a jurisdiction which has developed a well-structured supervisory review and evaluation process (the SREP) which supports the application of Basel's pillar 2. In particular, unlike other jurisdictions, together with capital and liquidity adequacy, the ECB's SREP evaluates the governance and business model sustainability of all banks under its remit. On the basis of that evaluation, it regularly conveys recommendations or requirements to banks in order for them to address their weak points. In a recent report commissioned by the ECB, a group of experts have praised this structure, although it has also recommended that the approaches followed when deploying qualitative measures be further improved by refining their formulation, prioritisation and monitoring.⁹

More broadly, supervision can become more effective with a more forward-looking and intrusive approach. Authorities should have the means, powers and culture to challenge more forcefully banks' business plans, internal organisations and decision-making processes without, obviously, alleviating any management responsibility.

Concluding remarks

It would be a mistake to downplay the relevance of the recent bank failures. At a minimum, they indicate that a scenario in which banks and their regulation would need to adapt to a less stable deposit base cannot be ruled out. Against that background, given the potential disruption that this scenario could generate, we cannot now exclude the need to eventually consider bold policy reforms. In any event, those reforms should be grounded on compelling evidence and, crucially, on a rigorous cost-benefit analysis.

For the time being, though, those episodes already constitute a good case for speeding up a full implementation of the Basel standards in all jurisdictions. Moreover, they support the need to put in place or further develop pragmatic bank failure management regimes that sufficiently acknowledge the need to provide non-covered deposits with a sensible degree of protection when banks fail.

More importantly, supervision already has the potential to address the root causes of many bank failures, and that this potential is often not fully exploited. Frankly, before we even think of introducing far-reaching changes in prudential rules or in the scope for deposit guarantees, we should first give supervision another chance. ■

⁹ Dahlgren et al (2023).

References

Coelho, R, F Restoy and R Zamil (2023): “Rising interest rates and implications for banking supervision”, *FSI Briefs*, no 19, May.

Dahlgren, S, R Himino, F Restoy and C Rodgers (2023): “Assessment of the European Central Bank’s Supervisory Review and Evaluation Process” Report by the Expert Group to the Chair of the Supervisory Board of the ECB.

European Commission (2023): “Reform of bank crisis management and deposit insurance framework”, May.

Federal Deposit Insurance Corporation (FDIC) (1998): *A brief history of deposit insurance in the United States*, September.

——— (2023): *Options for a deposit insurance reform*, May.

Garicano, L (2020): “Two proposals to resurrect the Banking Union: the safe portfolio approach and SRB+”, *CEPR Policy Insight*, no 108, November.

Gelpern, A and N Veron (2020): “Europe’s banking union should learn the right lessons from the US”, *Bruegel Blog*, 29 October.

King, M (2023): “We need a new approach for bank regulation”, *Financial Times*, 12 May.

Noonan, L (2023): “Former BoE deputy calls for radical overhaul of banks’ funding”, *Financial Times*, 7 May.

Restoy, F (2018): “Bail-in in the new bank resolution framework: is there an issue with the middle class?”, speech at the IADI-ERC International Conference “Resolution and deposit guarantee schemes in Europe: incomplete processes and uncertain outcomes”, Naples, 23 March.

——— (2019): “How to improve crisis management in the banking union: a European FDIC?”, speech at the CIRSIF Annual International Conference 2019 “Financial supervision and financial stability 10 years after the crisis: achievements and next steps”, Lisbon, 4 July.

Restoy, F, R Vrbaski and R Walters (2020): “Bank failure management in the European banking union: what’s wrong and how to fix it”, *FSI Occasional Papers*, no 15, July.

About the author

Fernando Restoy has been Chair of the Financial Stability Institute, the Bank for International Settlements, since January 2017.

He had been Deputy Governor of the Bank of Spain since 2012. Since 1991, he held other senior positions at the Bank of Spain. From 1995–97 he was Economic Advisor and Head of the Monetary Framework Section at the European Monetary Institute. He was Vice Chair of the Spanish Securities and Markets Commission from 2008–12 and Vice Chair of IOSCO Technical Committee. He was the Chairman of the Spanish Executive Resolution Authority from 2012–15 and has been a Member of the Supervisory Board of the ECB-SSM from 2014–16.

He holds an MSc in econometrics and mathematical economics from the London School of Economics and an MA and PhD in economics from Harvard.

SUERF Publications

Find more **SUERF Policy Notes** and **Policy Briefs** at www.suerf.org/policynotes



SUERF is a network association of central bankers and regulators, academics, and practitioners in the financial sector. The focus of the association is on the analysis, discussion and understanding of financial markets and institutions, the monetary economy, the conduct of regulation, supervision and monetary policy. SUERF's events and publications provide a unique European network for the analysis and discussion of these and related issues.

SUERF Policy Notes focus on current financial, monetary or economic issues, designed for policy makers and financial practitioners, authored by renowned experts.

The views expressed are those of the author(s) and not necessarily those of the institution(s) the author(s) is/are affiliated with.

All rights reserved.

Editorial Board:

Ernest Gnan
Frank Lierman
David T. Llewellyn
Donato Masciandaro
Natacha Valla

SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at