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Depositor Preference and Implications for Deposit Insurance

Prepared by the IADI Research Unit[1]

Kumudini Hajra, Senior Policy and Research Advisor
Ramadhian Moetomo, Senior Policy Analyst

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International Association of Deposit Insurers
C/O BANK FOR INTERNATIONAL SETTLEMENTS
CENTRALBAHNPLATZ 2, CH-4002 BASEL, SWITZERLAND
TEL: +41 61 280 9933 FAX: + 41 61 280 9554
WWW.IADI.ORG

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Depositor Preference

1. Introduction

Depositor preference has attracted renewed interest in the wake of the global financial crisis of 2007/8 and particularly in the context of international regulatory reform as it affects loss allocation among various stakeholders. This topic remains important to deposit insurers given their responsibility to protect insured depositors and the need to minimise their net failed bank resolution costs. Rules relating to the creditor hierarchy and preferential treatment of depositors affect deposit insurers' (DIs) recoveries and the overall protection of uninsured depositors vis-à-vis other unsecured creditors of a failed bank.

This briefing note explores the different types of depositor preference, the advantages and disadvantages of depositor preference and the issues arising in the context of depositor preference that are relevant for DIs.

2. Types of depositor preference and implications

Depositor preference[2] typically provides priority to the claims of depositors on the assets of an insolvent bank. It therefore allocates a relatively larger portion of losses to the non-depositor unsecured creditors of an insolvent bank (that is, the senior unsecured creditors).

The rules regarding loss allocation among creditors are usually described in insolvency laws. The application of depositor preference varies across jurisdictions, but is commonly represented by the following three approaches (Table 1):

- Insured depositor preference offers preferential treatment for insured depositors, which treatment is passed to the DI through subrogation. It ranks uninsured depositors *pari passu* with the senior unsecured creditors.
- General depositor preference provides preference to all depositors, including uninsured depositors, over senior unsecured creditors. In this case, the DI in its role as the subrogated party for insured depositors ranks *pari passu* with uninsured depositors.
- Tiered depositor preference gives preference to insured depositors (and the DI through subrogation) over uninsured depositors, and prefers both over senior unsecured creditors.

[2] According to IADI (2019 Annual Survey), 71% of deposit insurance systems (DIS) operate under legal frameworks with some form of depositor preference. See Table 2.

Table 1: Different Types of Depositor Preference[3]

No depositor preference	Insured depositor preference	General depositor preference	Tiered depositor preference
All depositors, subrogated DI and other senior unsecured creditors rank *pari passu*	DI (subrogated for insured depositors)	All depositors (with DI subrogated for insured depositors)	DI (subrogated for insured depositors)
	Uninsured depositors and other senior unsecured creditors rank *pari passu*		Uninsured depositors (over deposit insurance limit)
		Other senior unsecured creditors	Other senior unsecured creditors

Depending on the type, depositor preference could partially mitigate the likelihood of contagion by providing depositors with a higher probability of recovering their claims in a bank failure. However, it does not address the speed with which uninsured depositors will recover their funds. Therefore, although depositors will have a preferred status, given that there will be loss of access to deposits, depositor fears of a bank failure may not be reduced. At the same time, senior unsecured creditors have more incentive to devote resources to monitoring that bank and pressuring management to adopt a safer strategy.

For jurisdictions where the DI is subrogated for insured depositors, insured or tiered depositor preference can reduce the risk of the DI suffering losses. In such cases, losses that would otherwise be shared will be shifted to other creditors, including uninsured depositors. The type of depositor preference can have an effect on the amount of DI resources that can be used for purposes other than payout (FSI, 2019).

3. Pros and cons of depositor preference

The introduction of depositor preference is mostly supported by the argument that it enhances recoveries by uninsured depositors and the DI and thus lowers costs for these parties. Depositor preference legislation in the United States was enacted in 1993, primarily as a means of cost savings for the FDIC. In the European Union (EU), tiered depositor preference was introduced as part of the EU Bank Recovery and Resolution Directive (BRRD) in 2014 in order to potentially reduce costs for DIs and for uninsured depositors. Depositor preference exists for deposits held by natural persons and small and medium enterprises (SME) above the coverage level of 100,000 Euro while insured deposits up to 100,000 Euro are also ranked with a higher level of protection than these latter deposits together with the subrogated rights of the DI. In both insolvency and resolution proceedings, claims of natural persons and SMEs have a higher ranking than claims of other creditors.

[3] In addition to the three forms of depositor preference focused on in this paper there is a fourth form defined as eligible depositor preference which gives preference to all deposits meeting the eligibility requirements for deposit insurance coverage.

According to IADI (2019 Annual Survey), 71% of DIS operate under legal frameworks with some form of depositor preference (Table 2 and Annex).

Table 2: Depositor preference among deposit insurers (IADI Members)

Region	Yes	No	Yes responses (% of total)
Asia Pacific	10	4	71%
Africa	4	2	67%
Caribbean	3	2	60%
Eurasia	3	1	75%
Europe	20	2	91%
Latin America	9	4	69%
Middle East	1	3	25%
North America	2	3	40%
Total	**52**	**21**	**71%**

Source: IADI Annual Survey 2019

Depositor preference, by potentially lowering the risk of loss for uninsured depositors from the insolvency of a bank, can play a complementary role to the financial system safety net (conventionally understood to encompass a lender of last resort function, deposit insurance, resolution, and prudential supervision and regulation) in three main ways:

a. Depositor preference (and in particular general depositor preference) may reduce the incentive for runs at a failing bank by reducing the risk of potential losses for uninsured depositors. This may reduce the possibility of contagion risk.

b. Depositor preference may reduce the net resolution costs to the DI.

c. Depositor preference may facilitate the use of certain resolution tools, such as the purchase and assumption (P&A) transaction. Without depositor preference, a P&A transaction could be challenged in a number of jurisdictions if it were to discriminate in the treatment of creditors, thus violating the principle of *pari passu* (in which case compensation may be needed under the no-creditor-worse-off rule). By creating clear legal grounds for the preferential treatment of depositors, depositor preference may reduce legal challenges when only deposits are transferred to another institution or if there is a bail-in of non-deposit creditors only.[4]

Depositor preference also poses a number of challenges. The implementation of depositor preference may be hampered by the reaction of depositors, other creditors or by market reactions. Specifically:

[4] In Japan, although depositor preference has not been introduced, the Deposit Insurance Corporation of Japan (DICJ) has conducted P&A transactions by assuming the depositors' losses under the Deposit Insurance Act based on the equality principle between depositors and general creditors. Therefore, depositor protection and the principle of creditor equality (i.e. without depositor preference) could be attained under P&A transactions in such circumstances.

a. Depositor preference may be undone or undermined if non-deposit creditors take action to secure their claims, for example, through the purchase of covered bonds. If most non-deposit claims are secured, resolution options may be limited and potentially result in lower recoveries than would otherwise be the case for the DI.

b. Depositor preference may make it more likely that non-preferred creditors will "run" too readily and possibly create funding challenges for the bank. This is an important consideration in systems where banks are heavily funded by non-deposit instruments.

c. Depositor preference could aggravate moral hazard problems if the depositors believe that their preferred deposits will not bear any losses. This could influence depositor behavior in selecting financial institutions and instruments.

4. Some issues for deposit insurers

a. ***Depositor preference does not replace deposit insurance protection***. Effective depositor protection requires quick reimbursement of insured deposits. Introducing general or tiered depositor preference allows for an expanded scope for protecting depositors, although uninsured depositors remain at risk if there are few unsecured creditors available to absorb losses. Depositor preference may have limited effect in containing contagion of financial crises to other banks as unsecured creditors, and to an extent uninsured depositors, still have some incentive to run. Depositor preference enhances the scope for protecting depositors but is not effective as a stand-alone policy.

b. ***The type of depositor preference can have an impact on the amount of DI resources that can be used for purposes other than payout (ie "Least Cost Criterion).*** A higher priority for the DI (insured or tiered depositor preference) increases the expected share in recoveries of the DI in liquidation as uninsured depositors and other general creditors will bear losses before the DI. Where a financial cap is applicable on the DI's contribution towards measures other than payouts (eg under the EU BRRD) and the cap is calculated net of estimated recoveries, this could limit or even eliminate the sums that can be provided by the DI for supporting these measures. On the other hand, general depositor preference, by which all depositors rank equally ahead of other unsecured creditors, may result in lower recoveries for the DI compared to insured or tiered depositor preference. This would particularly be the case where deposits constitute most of the liabilities of the failed bank.

c. ***General depositor preference can be helpful in the context of a bank resolution regime, especially if a P&A transaction is the chosen resolution strategy.*** Depositor preference may facilitate the protection of deposits by P&A transactions by permitting differential treatment of deposits compared with more junior liabilities that are not as easily transferred. As a general principle, where the DI is subrogated to the claims of covered depositors in insolvency, depositor preference is likely to result in a higher share of recoveries for the DI and lower net costs for the DI.

d. ***Type of depositor preference regime has implications for "pricing" of deposit insurance.*** When the depositor preference regime favors insured depositors (insured or tiered depositor preference), there is less likelihood that, in an insolvency, the deposit insurer will suffer losses compared to a situation where there is no depositor preference.

This expected lower loss rate would need to be taken into consideration when calculating the "fair price" or "least cost" of deposit insurance. Depositor preference, therefore, can change the funding dynamics for providing deposit insurance, which is also influenced by the efficiency of recovery from assets of failed banks.

e. ***Cross-border considerations.*** Differences in depositor preference rules (eg due to differences in insolvency regimes, powers of courts, DI mandates, creditor hierarchies and other factors) can present challenges to resolving banks with cross-border operations.

5. Summary and conclusions

a. Depositor preference changes the allocation of losses between preferred depositors and senior unsecured creditors of an insolvent bank by creating a new order of priority in claims. It may be general, applying to all depositors, specific (such as insured depositor preference), or tiered, applying to all depositors, but giving insured depositors preference over uninsured depositors.

b. General depositor preference helps to protect uninsured depositors from the risk of loss due to the insolvency of a bank; in so doing it can play a complementary role to deposit insurance in the financial safety net.

c. Under depositor preference, the deposit insurer, after paying specific protected depositor claims, receives, through its subrogation rights, preferential claims treatment, thereby maximising its share in failed bank recoveries and helping to reduce its net resolution costs. However, it could add to the complexity of the resolution process and lead to delays as well.

d. Depositor preference is not a substitute for deposit insurance. Instituting depositor preference may improve the standing of uninsured depositors and through subrogation the DI in the creditor hierarchy. In the case of insured or tiered depositor preference, the cost to the DI could be further reduced.

e. For uninsured depositors, general or tiered depositor preference may lessen incentives to run and help to mitigate to some degree the likelihood of contagion. However, it may also increase moral hazard.

f. Depositor preference may help facilitate the implementation of resolution options, such as P&As, the use of bridge institutions, and the conversion of debt to equity.

g. Jurisdictions considering introducing depositor preference, or changing their existing depositor preference arrangements, should weigh the advantages and disadvantages in the context of their legal and judicial framework and financial system structure.

6. Future research

This Brief has approached the issue of depositor preference from a deposit insurance and resolution perspective. Depositor preference has also implications in many other areas of the financial system. Thereby creating opportunities to conduct further research on this topic. Some questions flagged for future research include:

- To what degree can depositor preference reduce or exacerbate contagion effects?
- Do depositors really take into account the existence of depositor preference and alter their behavior? If so, does this lead to any additional moral hazard in the financial system?
- How do the different types of depositor preference affect DI measures other than payouts and resolution costs?
- What are the implications of depositor preference in the context of bail-in?

References

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5) IADI (2014), *Core Principles for Effective Deposit Insurance Systems*.

6) International Monetary Fund (2013), *Cross-Border Bank Resolution: Recent Developments.*

7) James Marino and Rosalind Bennett (1999), *The Consequences of National depositor preference*, FDIC Banking Review.

Annex: Depositor preference among deposit insurers (IADI Members)

Asia-Pacific		Africa		Caribbean		Eurasia		Europe		Latin America		Middle East and North Africa		North America	
Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
Bangladesh Bank	Deposit Insurance and Credit Guarantee Corporation (India)	Ghana Deposit Protection Corporation	Deposit Insurance Board of Tanzania	Deposit Insurance Corporation (Bahamas)	Jamaica Deposit Insurance Corporation	Agency of Deposit Compensation (Belarus)	Azerbaijan Deposit Insurance Fund	Albanian Deposit Insurance Agency	Deposit Insurance Fund (Czech Republic)	Seguro de Depósitos Sociedad Anónima (Argentina)	Credit Cooperatives Guarantee Fund (Brazil)	Palestine Deposit Insurance Corporation	Jordan Deposit Insurance Corporation	Credit Union Deposit Insurance Corporation of British Columbia	Canada Deposit Insurance Corporation
Central Deposit Insurance Corporation (Chinese Taipei)	Deposit Insurance Corporation of Japan	Kenya Deposit Insurance Corporation	Deposit Protection Corporation (Zimbabwe)	Barbados Deposit Insurance Corporation	Deposit Insurance Corporation (Trinidad and Tobago)	Kazakhstan Deposit Insurance Fund		Guarantee Fund for Financial Services (belgium	Deposit Protection Fund of German Banks - Association of German Banks	Guarantee Fund of Cooperative Entities (Colombia)	Fundo Garantidor de Créditos (Brazil)		Moroccan Deposit Insurance Corporation	Federal Deposit Insurance Corporation, USA	Autorité des marchés financiers, Canada (Québec)
Hong Kong Deposit Protection Board	Korea Deposit Insurance Corporation	Deposit Guarantee Fund (Rwanda)		Bermuda Deposit Insurance Corporation		Deposit Protection Agency of the Kyrgyz Republic		Bulgarian Deposit Insurance Fund		Fondo de Garantías de Instituciones Financieras (Colombia)	Corporación del Seguro de Depósitos (Ecuador)		Saudi Arabian Monetary Authority		Massachusetts Credit Union Share Insurance Corporation, USA
Indonesia Deposit Insurance Corporation	Deposit Protection Agency	West African Monetary Union DIF						Finnish Financial Stability Authority		Instituto de Garantía de Depósitos (El Salvador)					
Malaysia Deposit Insurance Corporation								Fonds de Garantie des Dépôts et de Résolution (France)		Banco de Guatemala					
Deposit Insurance Corporation of Mongolia								Hellenic Deposit and Investment Guarantee Fund (Greece)		Fondo de Seguro de Depósitos (Honduras)					
Deposit Protection Corporation (Pakistan)								National Deposit Insurance Fund of Hungary		Fondo de Garantía de Depósitos de las Instituciones Financieras (Nicaragua)					
Philippine Deposit Insurance Corporation								Interbank Deposit Protection Fund (Italy)		Fondo de Seguro de Depósitos (Peru)					
Singapore Deposit Insurance Corporation Ltd								Deposit Insurance Fund of Kosovo		Corporación de Protección del Ahorro Bancario (Uruguay)					
Deposit Insurance of Vietnam								Deposit Protection Fund (Montenegro)		Instituto para la Protección al Ahorro Bancario					
								Norwegian Banks' Guarantee Fund							
								Bank Guarantee Fund (Poland)							
								Bank Deposit Guarantee Fund (Romania)							
								Deposit Insurance Agency (Russian Federation)							
								Deposit Insurance Agency of Serbia							
								Swedish National Debt Office							
								esisuisse (Switzerland)							
								Savings Deposit Insurance Fund (Turkey)							
								Deposit Guarantee Fund (Ukraine)							
								Financial Services Compensation Scheme (UK)							

Note: Information is based on the 2019 IADI International Survey with updates provided by the Instituto para la Protección al Ahorro Bancario (Mexico).