



# Financial Stability Institute Seminar on Selected Issues in Financial Stability

## Deposit Insurance and Financial Stability

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# Deposit Insurance—One Part of the Financial Stability Framework

- Adequacy of deposit insurance cannot be judged in isolation from the other parts of the financial stability framework
- Other key parts of the financial stability framework include:
  - Regulation
  - Supervision
  - Resolution

# U.S. Response to the Banking Crisis of the 1930s

- Declare a “bank holiday”
  - All banks closed until they could be examined
  - Only solvent banks allowed to reopen
- Establish a deposit insurance system
  - Protect small savers
  - Prevent bank runs
- Create a federal system to resolve failed banks
  - Outside the bankruptcy process
  - Minimize disruption to local communities

# Outline

- How the FDIC handled the increase in bank failures during the financial crisis
- Extraordinary actions taken by the FDIC to help stop the crisis

# A Tale of Two Runs

## Northern Rock

- Experienced a run in September 2007
- Deposit insurance system characterized by
  - Low coverage levels (100% of first £2000)
  - Co-insurance (90% of £33,000)
  - Set-off (applied against all loans, regardless of status)
  - Difficulty in making quick payout
    - Manual application process
    - Limited access to data
    - Funding
  - Public awareness

# A Tale of Two Runs

- IndyMac
  - Run began in June 2008 after rumors of its failure seemed to be confirmed by letters from a U.S. senator
  - Bank placed into receivership in July with little time for preparation by the FDIC
  - FDIC created a bridge bank to resolve IndyMac
  - Run continued after the bank reopened
  - Deposit insurance system characterized by:
    - Limited claims staff on site
    - Confusing coverage rules, especially regarding trusts
    - Lack of public awareness about deposit insurance
      - Only 3 bank failures in almost 3 ½ years

# FDIC Response to the Increase in Bank Failures

- Simplify deposit insurance coverage rules where possible
- Conduct a public awareness campaign
- Manage the Deposit Insurance Fund
  - Level (size) of the fund can be misleading, but can affect public perception
  - Must have working capital, preferably from the industry
    - Increase assessment rates
    - Special assessment
    - Prepaid assessment

# Deposit Insurance—Critical Elements

- A deposit insurance system must:
  - Have a clear objective(s)
  - Have coverage levels that align with the objective(s)
  - Be predictable and clearly understood by depositors
- The deposit insurer must:
  - Be prepared to act quickly when a bank fails (that is, short pay out periods)
    - Source of funding
    - Action plan
  - Have access to information and participate in the bank resolution process



# The Financial Crisis of 2008—What Went Wrong?

- Reported capital high, but illusory
  - High leverage ratios
  - Mark-to-market accounting reduced asset values
- Reported liquidity high, but illusory
  - Funding models based on wholesale borrowing
  - High leverage ratios
  - Assets not truly liquid
- Little systemic oversight
  - Interconnectedness, contagion risks not understood
  - Risk models of banks were inadequate
  - Off-balance-sheet risks not transparent

# Response to the Crisis—United States

- Financial safety net extended
- Funds to stabilize asset markets
- Temporary changes in deposit insurance limits
  - Transaction Account Guarantee Program
  - Increase coverage from \$100,000 to \$250,000 (by Congress)
- Bank debt guarantee program
- Restore deposit insurance fund/access working capital
  - Special and pre-paid assessments
  - Increase line of credit (by Congress)

# Troubled Asset Relief Program (TARP)

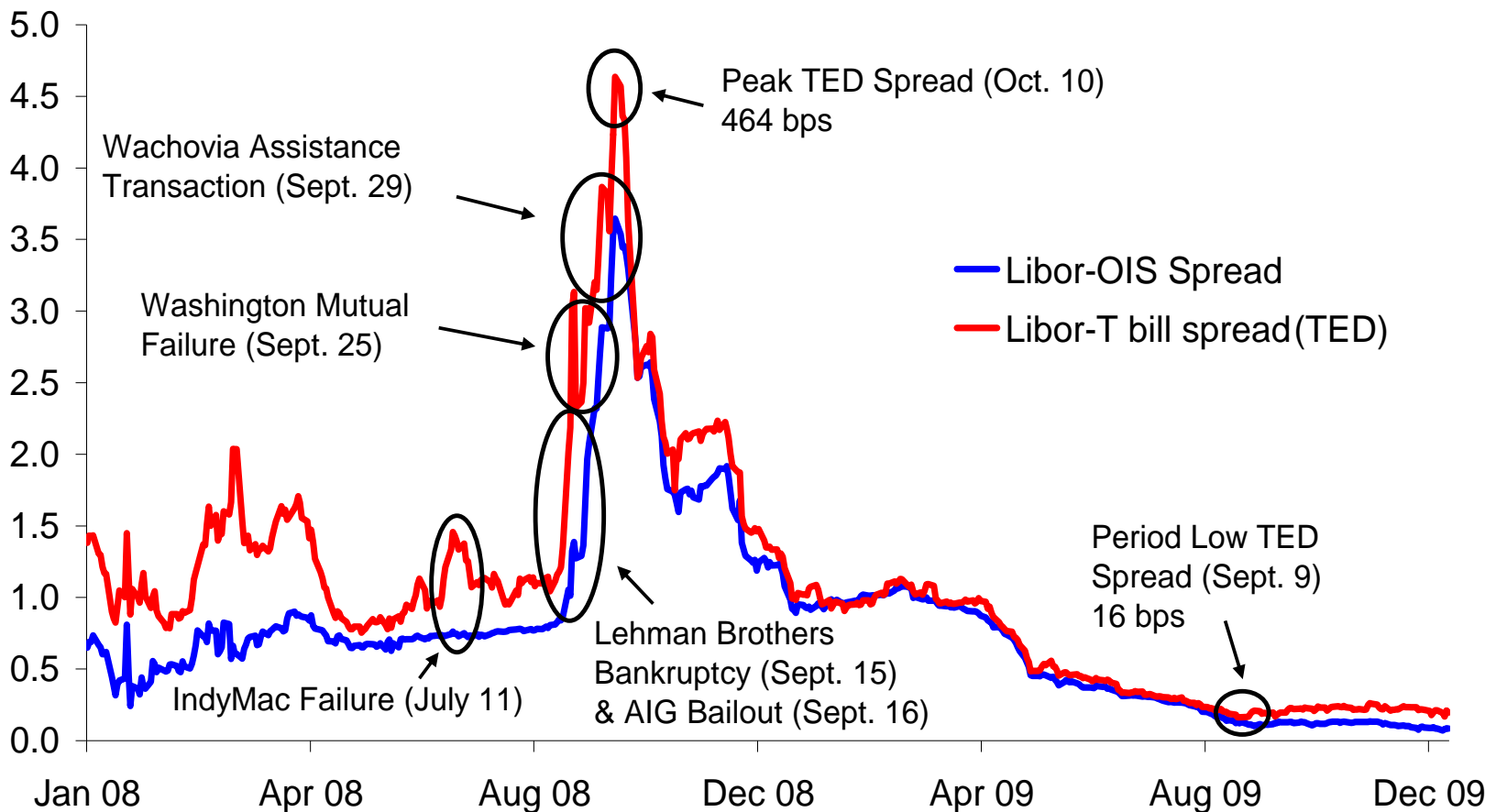
- \$700 billion authorized for Treasury to “purchase or insure” troubled assets
- As of March 31, 2010, about \$536 billion had been distributed:
  - Capital Purchase Program--\$205 billion distributed to 707 depository institutions and bank holding companies
  - Systemically Significant Failing Institution Program--\$69 billion preferred equity stake in AIG, plus \$3.2 billion drawn on credit line
  - Targeted Investment Program--\$40 billion preferred equity stake each in Citigroup and Bank of America
  - Asset Guarantee Program--\$12.5 billion in loan guarantees for Citigroup and Bank of America

# Federal Reserve Liquidity Programs

- Pre-September 2008
  - Term Auction Facility (TAF) - December 2007
  - Reciprocal Currency Agreements – December 2007
  - Term Securities Lending Facility (TSLF) - March 2008
  - Primary Dealer Credit Facility (PDCF) – March 2008
- After Crisis Erupts
  - Asset Backed CP Money Market Fund Liq. Facility (AMLF) – Sept 2008
  - The Commercial Paper Funding Facility (CPFF) – October 2008
  - The Money Market Investor Funding Facility (MMIFF) – October 2008
  - Term Asset-Backed Securities Loan Facility (TALF) – November 2008
  - Mortgage Backed Securities Program (MBS) – November 2008

# Several Events Shock Market Confidence in the Second Half of 2008

Three-Month  
Spreads



Source: Bloomberg.

# Creditor Guarantees

	Changes to Deposit Insurance	Wholesale Borrowing Guarantees
• <b>Australia</b>	✓	✓
• <b>Canada</b>		✓
• <b>France</b>		✓
• <b>Germany</b>	✓	✓
• <b>Indonesia</b>	✓	
• <b>Italy</b>	✓	✓
• <b>Mexico</b>	✓	
• <b>Netherlands</b>	✓	✓
• <b>Russia</b>	✓	✓
• <b>Saudi Arabia</b>	✓	✓
• <b>South Korea</b>		✓
• <b>Spain</b>	✓	✓
• <b>United Kingdom</b>	✓	✓
• <b>United States</b>	✓	✓

# Temporary Liquidity Guarantee Program (TLGP)

- Authorized by FDIC Board in October 2008 under systemic risk finding, extended in 2009
- Two components:
  - Debt Guarantee Program (DGP): Guarantee of senior unsecured debt issued by insured depository institutions and depository institution holding companies
  - Transaction Account Guarantee Program (TAPG): Guarantee of noninterest bearing transaction deposit accounts in excess of deposit insurance limits

# Response to the Crisis—Broadening the Financial Safety Net

- Public funds to stabilize asset markets
- Public funds to stabilize banks
- Significant extension of guarantees to all creditors
- Deposit insurance coverage levels raised or blanket guarantees imposed



# Deposit Insurance and the Financial Stability Framework

- The financial crisis has highlighted the importance of having a credible deposit insurance system that works as an integral part of the supervisory and resolution frameworks.
- “A well-designed and well-understood deposit insurance system contributes to the stability of a country’s financial system by reducing the incentives for depositors to withdraw their insured deposits from banks because of a loss of confidence. Policymakers should ensure that the authorities and the public view all components of the deposit insurance system as credible. The level and scope of coverage, the speed with which insured deposits are repaid, and the credibility of the underlying guarantee will affect the deposit insurance system’s ability to enhance the stability of the financial system.”
  - *Guidance for Developing Effective Deposit Insurance Systems*, Financial Stability Forum, September 2001

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