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Protecting Bank Depositors after Cyprus

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Introduction

1 During the recent financial crisis in the Republic of Cyprus[1] in March 2013,[2] the government proposed taking a percentage of all bank deposits. Despite the fact that the proposal was not pursued, it raised a number of questions about the current nature of depositor protection. The particular question that was asked after the Cypriot proposal was: what is the point of a deposit guarantee system if a government can simply decide to remove funds from guaranteed deposit accounts because the country is in a state of financial crisis? But in the wider context of depositor protection and the movement from "bail-out" to "bail-in" for failing banks, this question should be re-framed to ask whether depositor protection should apply only where an institution is declared to be insolvent and unable to repay its depositors or whether it should apply in a wider set of circumstances.

2 It has long been an article of faith amongst deposit insurance experts that "deposit insurance schemes"[3] play a crucial role in ensuring the stability of the financial

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[1] This refers to the Republic of Cyprus which has been a Member State of the European Union since 1 May 2004. References to "Cyprus"/"Cypriot" are to this state. It is not to be confused with the Turkish Republic of Northern Cyprus.

[2] It is not entirely clear whose idea this was. The government in Cyprus was in negotiations with the so-called "Troika", the International Monetary Fund, the European Commission and the European Central Bank. According to the Eurogroup Statement on Cyprus of 16 March 2013, the Eurogroup welcomed "the Cypriot authorities' commitment to take further measures mobilising internal resources… [including]… the introduction of an upfront one-off stability levy applicable to resident and non-resident depositors." (see: http://eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-16-03-13). The plan presented to the Cypriot parliament exempted savers with less than EUR 20,000 in their accounts, but savers with deposits up to EUR 100,000 were to be charged 6.75% and savers with sums above this amount, 9.9%. The plan was ultimately rejected by the Cypriot parliament (see: http://www.bbc.co.uk/news/world-europe-21842966) (both sites last accessed 25 July 2013).

[3] This is the term most commonly used internationally, but other terms are sometimes used. In European Union law, the term used is "deposit guarantee".

system and in protecting depositors.[4] The rationale behind deposit insurance schemes is that they work because a limit is set determining the extent to which depositors' funds will be protected and depositors' funds are then protected up to that limit. Depositors then have the certainty that, in times of financial turbulence, their funds are protected against bank failure up to this limit, so giving them confidence in the financial system as a whole. The Cypriot government did not appear to have considered the possibility that their proposal might have implications for the Cypriot depositor protection scheme and so it is unsurprising that questions were immediately asked. Fortunately, the proposal was quickly withdrawn in relation to deposits which came within the level of protection provided in all Member States of the European Union[5] under the European Union Deposit Guarantee Schemes Directives.[6]

3 In the discussion that follows, it is important to be clear that the authors are concerned only with the protection of depositors' funds up to the insured limit. It is accepted that, once the insured limit is reached, any surplus funds held in depositors' accounts will be available to the liquidator, receiver or other manager of an insolvent bank. These surplus funds may then be legitimately applied to meet the bank's debts in the event that other capital adequacy measures, such as bail-ins, provide insufficient funds to do so.

4 The potential damage which the Cypriot proposal could have caused to financial stability throughout the European Union had not been adequately considered before it was made public. The proposal was ill-thought through from the start, since it would have had the effect of imposing a "tax" of 6.75%, even on deposits guaranteed under the DGSD. Since the financial crisis began in or around September 2007, its impact on public trust and confidence in banks and bankers has become a matter of real concern. Trust in bankers has been severely eroded and the Cypriot government's proposal is unlikely to have done anything to improve matters. As Ian Henderson remarked:

> "*…when trust in the banking sector is at an all-time low according to the Edelman Trust Barometer, and people all around the Eurozone periphery are watching nervously to see what happens to Cyprus because it may be their bank going under next, who but the wilfully blind would do the thing guaranteed to collapse any remaining trust in their banks?*"[7]

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[4] Discussed below and recently reiterated in the Financial Stability Board, *Thematic Review on Deposit Insurance Systems – Peer Review Report* (8 February 2012), at 8, a copy of which is available at: http://www.financialstabilityboard.org/publications/r_120208.pdf (last accessed 25 July 2013).

[5] See the Eurogroup Statement on Cyprus of 25 March 2013, a copy of which is available at: http://eurozone.europa.eu/newsroom/news/2013/03/eg-statement-cyprus-25-03-13/ (last accessed 25 July 2013).

[6] Directive 94/19/EC (hereafter the "1994 DGSD"), as amended by Directive 2009/14/EC (hereafter the "2009 DGSD").

[7] I. Henderson, "From Cuba to Cyprus", *Chartered Banker*, June/July 2013, at 50 (The Edelman Trust Barometer measures trust in institutions, industries and leaders).

5 As has been identified at the beginning of this article, it is significant that the levy on deposits was to be charged even though no Cypriot bank had actually failed. This begs the question as to what it is that we are trying to protect through deposit insurance schemes. One of the most important reasons for the introduction of the DGSD was to ensure that all bank depositors, up to a particular limit, would know that their deposits were totally safe. Guaranteed, in fact, by European Union law. But what does the term “guarantee” actually mean in this context? Is it a guarantee only against bank insolvency or is it a guarantee that depositors’ funds will be protected in a wider financial crisis including a situation where their bank does not actually fail? Does the retraction of the Cyprus levy mean that depositors now have confirmation that deposits will be guaranteed up to the DGSD-protected limit in all situations? Or is the imposition of a levy still a possibility in a future case? If so, what checks would there be to prevent the government of a Member State from deciding to take a much higher percentage than the 6.75% identified by the Cypriot Ministry of Finance?

6 This article seeks to explore the nature and extent of the protection offered to depositors in the European Union context. What are the circumstances in which a deposit will be insured or guaranteed within the European Union? In a wider context, the terms “deposit guarantee” and “deposit insurance” tend to be used synonymously, but is there a distinction between them? The paper will also consider the question as to what will happen when a government-backed depositor protection scheme is not, itself, “good for the money” (as was the case in Cyprus), where a country is on the brink of bankruptcy. It seems clear that the Cypriot proposal damaged confidence in deposit guarantee systems within Europe (and quite possibly beyond it) and this situation needs to be repaired. There may be lessons to be learned from the authorities in New Zealand, where the deposit guarantee scheme has, somewhat controversially, been abolished. This paper neither pretends to have definitive answers to the issues it raises nor does it seek to make any recommendations: rather, its purpose is to raise awareness of these matters for international consideration by policy makers.

A Short History of Depositor Protection

7 In order to understand why depositor protection has a role in financial stability, it is worth considering its development during the late nineteenth and early twentieth centuries in the United States and its more recent history beyond the United States.

The Development of Depositor Protection in the United States

8 According to Pesek,[8] the protection of bank depositors became a matter of the business of the nation on 9 March 1933. Between the October 1929 Wall Street crash and the cessation of banking operations across the United States on 3 March 1933, over 9,000 banks in the United States had failed and the Great Depression was well under way. But it was the failure of 4,000 banks in the first three months of 1933 that prompted President Roosevelt to declare a bank holiday that March. The closures had caused:

> "*...panic… The financial system was on the verge of collapse and both the manufacturing and agricultural sectors were operating at a fraction of capacity*."[9]

9 Clearly, the government had to do something to restore public confidence and it went for deposit insurance. Why? What was it seeking to achieve?

10 The concept of a federal system of deposit protection was not new within the United States in 1933. A number of states had introduced deposit insurance systems to prevent bank runs with varying degrees of success from as early as 1829.[10] Although the state run systems generally proved to be unworkable, the role deposit insurance could play in maintaining stability in the sector was recognised and, from 1866 onwards, a number of requests were made to Congress to adopt a federal system. What seems to have been different in 1933 was the sheer scale of the banking failure and the devastating impact it had on the day-to-day lives of United States citizens: it seems that it was public opinion that led to the Banking Act of 1933,[11] which established the FDIC and the federal system for the protection of deposits.[12]

11 Thus the 1933 Act was passed despite significant opposition, which came not only from members of the Senate Banking Committee and those in the banking industry, but even, at the early stages of the process, the President himself. The arguments ranged against depositor protection then are familiar today: deposit insurance would be expensive and would, effectively, protect banks that were badly managed. This latter argument is the argument against "moral hazard". It has two aspects. First, why should a bank look after depositors' money carefully if it knows that it will be bailed out however high risk its activities? Second, why should

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[8] F.K. Pesek, *The First Fifty Years – A History of the FDIC 1933-1983* (1984, Federal Deposit Insurance Corporation, Washington DC), at iii.

[9] Ibid., at 3.

[10] Ibid., Chapter 2.

[11] Hereafter the "1933 Act".

[12] Pesek, above note 8, at iii, Chapters 1 and 3. Senator Glass is quoted (at 41) as saying that the "…voters wanted the guarantee [deposit insurance]" (presumably, on the basis of the principle adopted by Bill Clinton in his 1992 election strategy "it's the economy, stupid" - if people cannot run their businesses with any hope of success or are starving in the streets as was the case in the United States at this time,, they will feel less inclined to vote for you).

depositors take care about where to deposit their money if they know it is protected by a deposit insurance scheme? Those who argued that the increase in moral hazard should prevent the introduction of deposit insurance lost.[13]

12 The United States deposit insurance system was set up as a system whereby banks paid for their potential failure in advance. In 1933, a temporary fund was set up funded by the United States Treasury and twelve Federal Reserve Banks. Insured deposit-taking banks were then assessed and required to pay half their assessment to the FDIC with the rest due if the FDIC called upon it. Individual depositors were immediately protected for deposits of up to USD 2,500. Within two years, a permanent plan was put into operation and the protected amount increased to USD 5,000.[14] Things improved quickly. During 1934, deposits in United States banks increased by 22%. In the same year, the rate of bank failure declined significantly, with "only" nine insured banks and 52 uninsured banks suspending operations.[15] The message that banks were safe had been given to, and received by, the public: insured banks were required to display the fact that they were insured and it seems likely (from the strength of public feeling at the time) that the public was well aware that the United States Treasury was ultimately behind the scheme. So the deposit insurance system worked, because it gave depositors the confidence that, if they put their money into an insured bank, they would not lose it. This, in turn, gave them confidence in the wider financial system: there were gradually fewer and fewer bank runs as confidence rose. There is some evidence to suggest that the economic climate improved in 1934, but it seems clear that at least a significant share of the credit for the reduction in bank failure during this period should go to the introduction of the deposit insurance scheme.[16]

13 The FDIC was set up in recognition that "measures of a *national* scope" [17] had become necessary to alleviate the problems caused by bank failures: only with the funding power of the Federal Reserve Banks behind it could the FDIC insurance system provide sufficient confidence to the public. The United States state system of deposit insurance during the nineteenth century could be likened to the current situation in the European Union, where individual Member States have their own depositor protection systems in place.

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[13] This article does not focus on the moral hazard issue and readers are referred to: A. Campbell and P. Cartwright, *Banks in Crisis: The Legal Response* (2002, Ashgate, Aldershot), Chapter 7 and G.G.H. Garcia, *Deposit Insurance – Actual and Good Practice* (IMF Occasional Paper No. 197) (2002, International Monetary Fund, Washington DC), at 10 on this topic. Arguably, however, a well-designed depositor protection scheme coupled with an effective system of supervision and regulation can effectively limit moral hazard.
[14] Pesek, above note 8, Chapter 3.
[15] Ibid., at 49.
[16] Ibid., Chapter 2.
[17] Ibid., Chapter 1 (at 3).

14 It is worth noting here that the United States system was then, and still is, described as a system of deposit "insurance". This is different from the current language of the DGSD, which talks about deposit "guarantee" schemes.[18] The terms "guarantee" and "insurance" tend to be used synonymously in the context of depositor protection, yet little thought appears to have been given as to whether there is a legal distinction between these terms.

Depositor Protection beyond the United States

15 The second half of the twentieth century saw a growing international trend to introduce schemes to protect bank depositors and many countries beyond the United States started to introduce their own schemes. Some examples are Canada in 1967, Nigeria in 1988, Brazil in 1995, Australia in 2008, France in 1999, Russia in 2004 and Malaysia in 2005. In fact, by 1995, forty seven countries had formal deposit protection schemes.[19] Within Europe, some individual states had already introduced their own schemes before there was a European Union response. In the United Kingdom, the Banking Act 1979 introduced the first scheme, which came into effect in 1982. The 1994 DGSD introduced mandatory deposit guarantee schemes for all Member States of the European Union and required a minimum level of cover throughout the European Union. By the time this came into force in 1995, virtually all Member States already had their own schemes in place.[20]

16 The design and scope of the schemes varied considerably, even within the Member States of the European Union, in regard to such matters as level of cover, types of funding, method of compensation payments and the use of co-insurance.[21] The actual scope and role of the deposit insurance agency also varied greatly from country to country. These ranged from the very broad, such as the FDIC, which has both regulatory and receivership responsibilities as well as responsibility for managing the deposit insurance fund, to very narrow so-called "paybox" schemes, which are restricted to collecting contributions to the fund and to making compensation payments where required.

Depositor Insurance Today

17 The importance of deposit insurance in contributing to public confidence in the financial system was acknowledged by the Basel Committee on Banking Supervision's[22] Core Principles for Effective Banking Supervision in 2006, although it did not draft any guidance at that time. In 2008, however, the BCBS

[18] 1994 and 2009 DGSDs.
[19] See: www.iadi.org (last accessed 25 July 2013).
[20] For further information on this, see Campbell and Cartwright, above note 13, at 179–181.
[21] Co-insurance is where the depositor has to take a share of the loss. Its use in the United Kingdom, and subsequent removal, is discussed below.
[22] Hereafter "BCBS".

sought the assistance of the International Association of Deposit Insurers[23] in developing and publishing a set of Core Principles for Effective Deposit Insurance Systems.[24] This was an important development, which has assisted many countries in assessing the effectiveness or otherwise of existing schemes and which has also given guidance for reform post-crisis. The fact that the Core Principles have been drafted in conjunction with the BCBS gives them an international legitimacy, which serves to assist countries which are considering introducing schemes for the first time. In addition to IADI, Europe has its own organisation, the European Forum of Deposit Insurers,[25] which was established in 2002 with the support of the European Commission.

18 It is worth observing that the Core Principles are not prescriptive and reflect the fact that policy makers have various choices available to them as to how they protect depositors. Having said that, the Executive Summary notes that, although such choices exist, the introduction of a system of explicit deposit insurance has become the preferred choice when compared to other options, such as reliance on implicit protection.[26]

19 All the major economies now have deposit insurance systems in place, except for China, which is in the process of developing a system.[27] The international trend in recent years has clearly been in favour of the use of formal, explicit schemes to protect depositors as recommended by IADI. That is what makes the decision by New Zealand to abolish its deposit insurance scheme all the more interesting.

The Circumstances in which a Deposit will be Insured or Guaranteed

20 Having considered why depositor protection is considered to be important for the purposes of financial stability, it becomes necessary to consider the circumstances in which a deposit will be insured or guaranteed. Is a depositor protection scheme meant only to protect depositors in a bank which has failed or is it a guarantee against all eventualities? This brings us back to the Cyprus issue and the European Union position under the DGSD.

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[23] Hereafter "IADI". The role of IADI is discussed below.

[24] BCBS and IADI, *The Core Principles for Effective Deposit Insurance Systems* (2009, Bank for International Settlements, Basel). Hereafter the "Core Principles" (these are discussed later in this article).

[25] Hereafter "EFDI". For details of what EFDI does, see: www.efdi.net (last accessed 25 July 2013).

[26] Executive Summary, at paragraph 3.

[27] According to the IADI website, as at 30 June 2013, 112 jurisdictions have set up an explicit deposit insurance scheme. China is listed as one of 41 jurisdictions which are studying or considering the implementation of an explicit system: it has not yet got as far as constructing one (see: http://www.iadi.org/di.aspx?id=68 (last accessed 25 July 2013).

21 The purpose of the 1994 DGSD was to ensure that Member States had deposit guarantee schemes in place and it was recognised that different Member States would achieve this in different ways. The Preamble recognises the need for harmonisation of the amount of depositor protection across the European Union to prevent unfair competition and also reflects the fact that depositor protection is an important part of the prudential framework.[28] Although the 1994 DGSD does not define the term "guarantee", it states that it can be invoked "in the event of deposits becoming unavailable".[29] Deposits are "unavailable" when they are:

> "*…due and payable but [have] not been paid by a credit institution under the legal and contractual conditions applicable thereto…*"

in two situations. Either:

> "*…the relevant competent authorities have determined that… the credit institution concerned appears to be unable… for reasons which are directly related to its financial circumstances, to repay the deposit and to have no current prospect of being able to do so*"[30]
>
> or
>
> "*…a judicial authority has made a ruling for reasons which are directly related to the credit institution's financial circumstances which has the effect of suspending depositors' ability to make claims against it.*"[31]

22 From this, the most obvious circumstances in which deposits would be "unavailable" will be those where a bank becomes insolvent and does not have the money to pay its depositors. But could deposits also become "unavailable" during the process of a wider national debt restructuring? Would "unavailable" include the removal of a portion of a protected deposit by a government, for example, through the imposition of a levy such as the Cypriot authorities suggested? Arguably, it would not. Although a protected portion of the deposit would be "unavailable" to the depositor, it would not necessarily follow that the competent authorities would have determined that the bank in question was unable to repay the deposit – indeed, it might be in the interests of the competent authorities *not* to make such a determination if they thought that they could take a levy and not have to subsidise the guarantee.[32] It may also be the case that, by deducting such a levy, the

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[28] The Preamble states that "it is indispensable to ensure a harmonised minimum level of deposit protection" and that "deposit protection is as essential to the prudential rules for the completion of a single banking market."
[29] 1994 DGSD, Article 7(1).
[30] Ibid., Article 1(3)(i).
[31] Ibid., Article 1(3)(ii).
[32] The 2009 DGSD does not change this position as its purpose was to increase and harmonise the coverage level and reduce pay-out delays. Article 1(3)(i) of the 1994 DGSD was amended to reduce the time for making the determination from 21 to five working days.

competent authorities would have greater confidence that the bank could, in fact, repay depositors.

23 But if deposits are not fully protected against all possible eventualities how can depositors have trust in the system? In the Cyprus case the authorities quickly withdrew the proposal to "tax" guaranteed bank deposits, but what if they had not? In the wider, international, context, it is also worth considering whether there is a distinction between a deposit insurance scheme ("insurance" being the term used by IADI) and a deposit guarantee scheme ("guarantee" being the term used in the DSGD). It is beyond the scope of this article to consider anything other than the English law understanding[33] of the terms "guarantee" and "insurance" in this context, but the identification of the English law distinction serves to provide a useful example of how terms which may seem to have a similar commercial effect can result in different legal effects.

24 As a matter of English law, guarantees and insurance contracts fall within the category of contracts of suretyship:[34] a guarantee is an undertaking to make good another's default and is, therefore, a secondary obligation. Essentially, with a guarantee, the guarantor[35] is only called upon to deliver on the guarantee when there is a default by the person whose obligation has been guaranteed. In contrast, an insurance contract provides an indemnity against loss and, because it is not dependent upon another party's default, it is a primary obligation of the insurer. This means that the insurer is required to pay up under the contract of insurance if loss is suffered, regardless of whether there has been a default or not.[36] Does this mean then that, without a bank default, a "guaranteed" deposit is not protected, whereas, if the deposit were subject to a deposit "insurance" scheme, it would be? In the latter case, the protection would come from the insurer's primary obligation to pay the depositor and so it would not depend upon the bank defaulting first. In other words, if it were possible to impose a levy without triggering a default, the guarantor would not have to pay, whereas the insurer would.

25 Internationally, there is a shift towards a consensus that failing banks should be "bailed in" and remain operational through an Open Bank Resolution process,[37] rather than closed and "bailed out" by governments (and therefore the taxpayer). Broadly, this means that regulators and/or central banks will actively intervene to prevent a bank from defaulting by pumping in certain shareholder funds (and

[33] Other European Union Member States will doubtless have their own jurisprudence in this area and the authors are not qualified to comment upon it. The English law position is only presented to illustrate the possibility that there may be a distinction between the legal effect of these terms and to ask the question: does this matter for the purposes of determining the scope of depositor protection?
[34] C. Bamford, *Principles of International Financial Law* (2011, OUP, Oxford), at 240.
[35] The guarantor is the person giving the guarantee.
[36] See the discussion on analogous transactions in R. Goode, *Commercial Law* (3rd ed) (2004, Penguin Books, London), at 800.
[37] Hereafter "OBR".

possibly a level of subordinated debt) to protect the general unsecured depositor. If a bank never defaults, it may well be the case that a DGSD guarantee cannot be called.

26 As this article has sought to demonstrate, the general international understanding of the role of deposit insurance and deposit guarantee schemes in the context of the financial safety net has been rooted in a belief that such schemes promote financial stability and protect those most likely to be disadvantaged by bank failure – ordinary people, doing ordinary jobs who put money into banks to keep it safe. Trust and confidence in the system can only be maintained where there is a degree of certainty that the money of ordinary depositors is secure. It may be a matter of semantics that some schemes are described as insurance schemes and others as guarantee schemes, but the fact remains that it is not clear how they would operate if a government levy were to be imposed and it seems at least arguable, that the DGSD would not protect depositors in every case. Consequently, there is an urgent need for clarification as it seems that a DGSD guarantee may not, in fact, be a guarantee when you (as a depositor) want or need it to be.

Is the Importance of Deposit Insurance a Truth Universally Acknowledged?

27 The importance of depositor protection in promoting financial stability was described above as an article of faith. Its importance in restoring stability in the years after the Wall Street Crash has been explained in this article and its importance as a mechanism within the financial safety net was recently reiterated by the Financial Stability Board in its 2012 Thematic Review on Deposit Insurance Systems.[38] Yet not all countries have decided that protecting depositors through a deposit insurance scheme is the most appropriate course of action. One country which has decided to move in the other direction and remove its existing deposit protection scheme is New Zealand.[39]

28 The New Zealand government decided not to renew its deposit guarantee scheme when it expired at the end of 2011. The reasons given were that it was hard to price and that it blunted any incentives both for depositors and bankers to manage risks (the moral hazard argument).[40] It is intended to be replaced with an OBR regime and, in June 2013, the Reserve Bank of New Zealand[41] issued a document setting out the OBR policy and the pre-positioning requirements for

[38] Financial Stability Board, above note 4, at 8: "A financial safety net typically consists of prudential regulation and supervision, an emergency lender of last resort, problem bank insolvency frameworks and deposit insurance."
[39] On 11 March 2011. See the statement from the New Zealand Finance Minister available at: http://www.beehive.govt.nz/release/maintaining-confidence-financial-system (last accessed 25 July 2013).
[40] See literature cited, above note 13.
[41] Hereafter the "Reserve Bank".

banks (the "Policy").[42] The Reserve Bank is New Zealand's central bank and the prudential regulator for New Zealand's banks.

29 The OBR is described as a tool for responding to bank failure and all New Zealand incorporated banks holding retail deposits of more than NZD 1 billion will be required to take part in the scheme. It is intended that, should a bank become insolvent and be put into a statutory management process, the OBR regime will enable the bank to be open for business the next working day. By using the OBR process, there will be minimal disruption to customers who will be able to access their deposits the next working day.

30 But herein lies the rub. Depositors may not, in fact, be able to access *all* of their deposits. According to clause 5(1) of the Policy, OBR is an option that provides the ability to allocate losses to *creditors* (in other words, depositors) of the failed bank after losses have first been allocated to shareholders and subordinated creditors (in that order).

31 The mechanism works as follows. The initial losses of the bank are identified, access channels to the bank are closed and the bank is placed in statutory management. A determination of the amounts owed to each customer is made and those liabilities which fall into the category of "pre-positioned liabilities" are identified. Pre-positioned liabilities are, essentially, the kinds of liabilities that would be insured under a deposit insurance system, so include products such as transaction accounts, savings accounts, overdraft facilities and credit balances on credit cards. Non-pre-positioned liabilities are those liabilities which are not in the nature of customer liabilities and would include derivative financial instruments and some money market transactions.

32 Once the pre-positioned liabilities have been identified, a *de minimis* amount is determined. This is an amount of money which is protected from the allocation of losses and which will remain fully available to the account holders. It is defined as "unfrozen funds". Any surplus to this amount that an account holder has in his or her account is then subjected to a "partial freeze". This is effectively a suspension by the bank of its obligation to pay the sum in excess of the *de minimis* amount to the deposit holder. It is anticipated that the unfrozen funds will be guaranteed by the New Zealand government. Any non-pre-positioned liabilities will be automatically frozen.

33 Although it is envisaged that the frozen funds will be gradually released to account holders, if it becomes clear that they are not needed to cover losses. Potentially, they may never be. At first blush, this looks remarkably similar to the

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[42] A copy of which is available at: http://www.rbnz.govt.nz/regulation_and_supervision/banks/banking_supervision_handbook/5341478.pdf (last accessed 25 July 2013).

Cypriot deposit levy. But it may, in fact, prove to be closer to the deposit insurance model. Clause 11(8) of the Policy makes it clear that a customer with a balance up to or below the specified *de minimis* is exempt from the partial freeze. This means that if, for example, the *de minimis* were to be set at the NZD equivalent of EUR 100,000, then New Zealand depositors would be no worse off than depositors in the European Union.

34 The approach taken by the OBR policy appears to be one where you work from the "bottom up" as opposed to the "top down" approach of the limit set in the 2009 DGSD. This is meant in the sense that, presumably, the lowest possible figure for the *de minimis* amount will be set under the OBR in order to minimise the New Zealand government guarantee obligation in respect of the unfrozen funds and so minimise the cost to tax payers. This contrasts with the DGSD approach, where a relatively high limit is set above which deposits will not be protected. This would suggest that depositors in New Zealand will be more likely to lose something on a bank insolvency under OBR than depositors in the European Union would be under the DGSD. The corollary is, of course, that the New Zealand government would, presumably be better off than the governments of the European Union Member States and would know that it could afford the guarantee that it gave.

35 It is worth exploring how OBR might be compared with the Cypriot levy on deposits. The Cypriot proposal indicated that depositors in Cyprus with less than EUR 20,000 were to be exempt from the levy. It is possible to envisage a situation where there may prove to be little difference between the level of protection given to New Zealand depositors under OBR and the level of protection available to Cypriot depositors under the levy. This would always depend, however, upon the OBR *de minimis* level and the ultimate losses of the failing New Zealand bank that creditors would have to absorb.

36 What is clear, however, is that the OBR is a fairer system than the Cypriot levy for the following reason. The New Zealand government has made a series of public statements over the last two years explaining that it was going to close down its deposit guarantee scheme and indicating how it was going to replace it. Statements have been made which explain how OBR works. Even if depositors do not like it, at least they have been told about it. This enables them to take an informed decision as to whether to bank with a New Zealand bank or not. In contrast with the OBR regime in New Zealand, the Cypriot levy was sprung on depositors in a situation where a deposit guarantee system was already in place. Depositors thought that they already understood the level of risk to their deposits. They had no prior warning of the new system and had not had the opportunity actively to determine whether to deposit money with the Cypriot banks in the light of what was, effectively, an increased level of risk.

37 Despite this, there is a flaw in the OBR system as has been identified in the June 2013 Organisation for Economic Co-operation and Development's[43] Economic Survey of New Zealand. This points out that OBR on its own:

> "*…may not be enough to prevent bank runs in all circumstances, as once OBR is applied to one bank, depositors may fear contagion to the others.*"[44]

38 One of the OECD's key recommendations was to introduce permanent deposit insurance to reduce this risk. The OECD also considered that a degree of moral hazard already existed, since New Zealand had introduced a deposit insurance scheme as matter of urgency during the financial crisis in 2008.

39 Although the description of OBR as an option which enables losses to be allocated to creditors of a failed bank may make the blood of depositors run cold, it may prove to be less Draconian an idea than it first appears. It is unlikely that the *de minimis* threshold will ever be as high as the DGSD limit, but the idea of trying to make an accurate assessment of the level of cover to be provided by the New Zealand government is, we believe, consistent with IADI Core Principle 9.[45] It is also possible that, in the event of a bank collapse, the New Zealand government will set an OBR *de minimis* level that is sufficiently high to give the public confidence in the system and so prevent a bank run.

40 What is important to note is that the Head of Prudential Supervision at the Reserve Bank has stated publicly that, with regard to deposit insurance and OBR:

> "*It is not a case of choosing between one or the other – they have different objectives and can work alongside one another if need be.*"[46]

The Approach to the Protection of Depositors Post-Crisis: Funding and Coverage

41 In this section, we unavoidably cover some ground that has already been the subject of much attention. We think that this is necessary in order to bring together a number of important issues, particularly but not exclusively, because of the crises in Cyprus, Iceland, Greece and elsewhere.

42 One of the immediate effects of the financial crisis of 2007 and beyond was to prompt the governments of many countries around the world to issue a blanket state

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[43] Hereafter "OECD".
[44] OECD Economic Surveys (New Zealand) (June 2013) Overview, at 16.
[45] Discussed below.
[46] "Handling Banking Failures", a speech delivered to the Institute of Directors in Wellington on 11 April 2013 by Toby Fiennes, Reserve Bank of New Zealand Head of Prudential Supervision, a copy of which is available at: http://www.rbnz.govt.nz/research_and_publications/speeches/ (last accessed 25 July 2013).

guarantee of all bank deposits in their jurisdictions.[47] It is significant that blanket state guarantees were given by a number of countries where a deposit insurance scheme was already in place suggesting that, in these countries, depositors did not feel adequately protected by existing schemes. Gradually, the blanket guarantees were withdrawn and most were replaced by new or enhanced deposit insurance schemes, almost invariably with the level of cover having been increased from the pre-crisis level.

43 Some countries had what is referred to as "co-insurance" as a feature of their deposit insurance schemes and this proved problematic. One notable example was the scheme in the United Kingdom, which only provided total protection up to the relatively low limit of GBP 2,000. Deposits above that amount received 90% protection up to a ceiling of GBP 35,000 and deposits above GBP 35,000 were not protected at all. During the Northern Rock crisis depositors with the bank clearly demonstrated their combined dislike and lack of understanding of co-insurance.[48] The 1994 DGSD was subsequently amended so that co-insurance is no longer permitted within the European Union. Depositors made it clear by their actions that they expected deposits in a bank, at least up to a reasonable amount, to be totally safe. A large percentage of Northern Rock depositors had balances in excess of GBP 2,000 and the run which took place actually increased in intensity once the details of the United Kingdom's Financial Services Compensation Scheme[49] became known.[50] The public perception was clearly that the level of protection provided was insufficient.[51]

44 From the European Union perspective, it became clear that although all Member States had deposit guarantee schemes in place,[52] a number of countries would have encountered serious problems in meeting claims from depositors of failed banks. Iceland, although not a European Union Member State, provided a classic example of a country whose banking sector had become so huge that a bank failure would essentially "bankrupt" the country. The situation that developed more recently in Cyprus was very similar in many respects, although in other respects it was different. It is apparent that its deposit-taking banking sector had grown too quickly

[47] This had happened in previous crises so was not very surprising. It explains why guidance from both the International Monetary Fund and IADI had sections on removing a blanket guarantee. See, for example, "On Instituting and Removing a Full 'Blanket' Guarantee" in Garcia, above note 13, at 44-54.
[48] For more on this, see House of Commons Treasury Committee, *Fifth Report of Session 2007-08 The Run on the Rock* (26 January 2008), at 89; Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), at 74, a copy of which is available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf (last accessed 25 July 2013).
[49] Hereafter "FSCS".
[50] Prior to the Northern Rock crisis, depositors in the United Kingdom appear to have given virtually no thought to the safety of deposits in United Kingdom banks and building societies.
[51] The depositors of Northern Rock were not only unhappy about the low ceiling at which full protection was provided and the existence of co-insurance, but also with the potential delay in receiving compensation.
[52] As required by the relevant Directive.

and had become far too large in relation to the size of the country's economy but one of its major problems came from the fact that it had invested in Greek government bonds. Although investments in government bonds were generally seen as the right type of investment for European Union governments to have been making, the choice of government and country turned out to be wrong: as it transpired, Greece was not the safest place to invest depositors' funds.

45 Although the latter part of the crisis saw many deposit insurance schemes revisited and changes made, the changes tended to relate to the amount of cover, the speed of pay-out and, in the European Union, the removal of co-insurance. A number of questions have not been addressed, however, including questions as to the appropriate level of cover offered under the guarantee and the extent to which governments can actually afford to fund the schemes at all. IADI has played a key role in influencing the changes to date.

The Role of IADI[53]

46 Since its inception, IADI has undertaken much research into all aspects of deposit insurance and has published a significant amount of material to assist with the operational effectiveness of deposit insurance systems.[54] Perhaps the most significant achievement has been the publication of the Core Principles (referred to above) in June 2009, in conjunction with the BCBS. The Executive Summary to the Core Principles recognises that deposit insurance is only part of the toolkit to be used in financial crises, noting that:

> "*…a deposit insurance system is not intended to deal, by itself, with systemically significant bank failures or a 'systemic crisis'.*"[55]

47 In such situations, the safety-net members will need to work together. The Executive Summary also recognises that the introduction of a system of deposit insurance is most likely to be successful when certain preconditions exist.[56] Four are listed as being necessary for the introduction of an effective deposit insurance system:

- An ongoing assessment of the economy and the banking system;
- Sound governance of agencies comprising the financial system safety net;
- Strong prudential regulation and supervision; and

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[53] IADI was established in 2002 "to enhance the effectiveness of deposit insurance systems by promoting guidance and international cooperation", for which see: www.iadi.org (last accessed 25 July 2013). IADI has developed significantly and now has 69 member countries and nine associate members. Associate Members are entities that do not fulfil all of the criteria to be a Member, but are considering the establishment of a deposit insurance system, or are part of a financial safety net and have a direct interest in the effectiveness of a deposit insurance system.

[54] See: www.iadi.org/Publications.aspx (last accessed 25 July 2013).

[55] Core Principles, above note 24, Executive Summary, at 1.

[56] Ibid., at paragraph 4.

- A well-developed legal framework and accounting and disclosure regime.[57]

48 There is little doubt that these are sensible preconditions and it would be extremely risky and costly to the public purse to introduce deposit insurance in a country which does not satisfy these criteria. In reality, however, new systems are more likely to be introduced, or changes made to existing schemes, in the immediate aftermath of a banking crisis (as has happened in the last few years) regardless of the preconditions and often these preconditions will not be met.

A Reflection on Some of the Core Principles

49 IADI and BCBS identified eighteen Core Principles. It is beyond the scope of this paper to examine the Core Principles in detail, so we have concentrated on the five which are most relevant to this article.[58]

Core Principle 8

50 Principle 8 considers the issue of compulsory membership. It provides that:

> "*Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (e.g. retail and small business depositors) to avoid adverse selection*."

51 It is clear from this that the focus of the protection is on the individual customer: it is about protecting the average depositor. It is not beyond the bounds of possibility to think that a failure to protect individual depositors could lead to real human suffering and/or potential political unrest, so the importance of this protection should not be underestimated.

Core Principles 9 and 10

52 Principles 9 and 10 address the amount of cover to be provided and the question of blanket guarantees. Principle 9 provides that:

> "*Policymakers should define clearly in law, prudential regulations or bye laws what an insurable deposit is. The level of coverage should be limited and be credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features*."

53 It is worth noting that this Principle does not attempt to define exactly what types of event are covered.

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[57] Ibid., at paragraph 7.
[58] However, we do not wish to give the impression that the other Core Principles are less important.

54 Principle 10 is concerned with the transition from a blanket guarantee to a limited coverage deposit insurance system; a topic which has been very much to the forefront in the last few years. It provides that:

> "*…when a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as the country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably [an increase in] moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.*"

55 While this approach is a sensible one, it raises the potential problem of actually managing to convince the public that their protection is now limited. Empirical research undertaken by one of the authors has demonstrated that a large percentage of bank depositors in the United Kingdom do not believe that protection would actually be limited in a crisis. [59] When the Northern Rock crisis took place the then Chancellor of the Exchequer's knee-jerk reaction was to provide a blanket guarantee. It is unlikely that this has been forgotten.

56 Of course, the current level of protection is so much higher than it was in September 2007 that very few depositors are likely to have deposits beyond the level of protection now guaranteed. Those who have savings above the protected limit will generally have sufficient financial acumen to be aware of the need to ensure protection and, therefore, take action to ensure that savings are spread around different institutions to ensure that all of their savings remain fully covered. Principle 9 refers to cover being "limited but credible". But what does this actually mean? Immediately following the onset of the financial crisis we witnessed blanket guarantees of all deposits being rapidly introduced. After things had appeared to settle down the trend was to increase the level of cover. In the United States this went up to USD 250,000 and, in 2009, the European Union limit was increased to EUR 100,000, or in the case of the United Kingdom GBP 85,000.

57 Consistent with Principle 10, the Financial Stability Board recommends that its members should review their level of cover:

> "…*to ensure that it strikes an appropriate balance between depositor protection and market discipline and that it promotes financial stability*."[60]

58 Where jurisdictions have high levels of protection in place, they should have other measures in place to mitigate moral hazard. Specifically, it recommends that unlimited protection (i.e. blanket guarantees) should be avoided for this reason. It is the authors' view that the current European Union limit is higher than is strictly

[59] Campbell carried out random questioning about this in the United Kingdom during the period 2008 to March 2011. The respondents were mostly professional people who were still in employment but some were retirees.
[60] Financial Stability Board, above note 4, at 6.

necessary. It would be interesting to know what is the average amount of money held in protected accounts across the European Union in order to make a realistic assessment; something that is beyond the scope of this article to determine.

Core Principle 11

59 Principle 11 is concerned with the funding of schemes. This subject has proved to be problematic both during the crisis and in the post-crisis period. Principle 11 deliberately avoids being prescriptive, but in the supporting guidance it is noted that:

> "*sound funding arrangements are critical to the effectiveness of a deposit insurance system*"

and it is difficult to avoid drawing the conclusion that upfront funding[61] must be the preferred system as this ensures that those banks which fail will have contributed towards the cost of compensation payments.

60 In the absence of upfront funding it is likely that, as in the United Kingdom, it will be necessary to borrow money from HM Treasury or an equivalent body. The problem with requests for such funding is that, realistically, they are likely to come at a time where there are many other calls for financial assistance. Accordingly, although the Core Principles do not advocate a particular system, the majority of countries now use systems which collect upfront payments. It is the authors' view that the affordability of the current systems remains an issue that has not properly been addressed.

Core Principle 12

61 Principle 12 addresses the issue of public awareness. In many countries there was virtually no public awareness of the deposit insurance arrangements until the financial crisis hit. This was certainly true at the time of the failure of Northern Rock in the United Kingdom. Principle 12 states that:

> "*In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the limitations of the deposit insurance system.*"

62 Nout Wellink, Chairman of the BCBS and Governor of De Nederlandsche Bank, has made the point that:

> "*…one of the lessons of the financial crisis is that deposit insurance is instrumental in recovering and maintaining financial stability*."[62]

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[61] Frequently referred to as "ex-ante".

[62] Address by Mr Wellink at the Joint Conference of the Financial Stability Institute/IADI/BCBS, Basel, 23 September 2009.

63 The reason for this is that it provides confidence to depositors and will have an effect on their behaviour by removing the need to rush to withdraw their deposits at the first sign of trouble. Of course, this will only work where there is an appropriately designed deposit insurance scheme in place and a public awareness of the scheme together with a general acceptance that it is well designed and meets the needs of most depositors. As has been seen, the run on Northern Rock in the United Kingdom provided the clearest possible demonstration of what is likely to happen when the public perception is that a scheme is flawed.

64 In the United States, as previously discussed, awareness of the level of protection provided by the FDIC scheme has always been high since it was introduced in 1933. This was certainly not the case within the European Union, although things have improved considerably since Northern Rock collapsed. The deposit insurance agencies in many countries have been doing much to raise awareness of what protection is actually provided and IADI has been particularly important in assisting them to do this.[63] It seems likely that the Cypriot proposals for a levy on deposits will have caused damage in this respect, as it may now be the case that depositors have lost confidence in the level of cover they actually have.

What Type of Product is Protected?

65 The question of public awareness also raises the issue of what exactly is, or should, be protected. What is a deposit for the purposes of protection? Recent problems at the Co-operative Bank in the United Kingdom have highlighted this issue. Some customers, whose products are considered to be a form of bond and not a deposit, are not covered by the United Kingdom's FSCS and are being subjected to bail-in.[64]

66 As members of the depositing public will not generally understand the difference between what is described as a "bond", rather than as a "deposit", it becomes vital that it is made clear which products are protected and which are not. It will often be the case that some products described as bonds will actually be deposits and this can cause further confusion. It is therefore important that all deposit-taking institutions make it clear to customers who are depositing money whether or not the type of product is classified as a deposit for compensation purposes as recommended by Core Principle 9.[65]

[63] For example, the FSCS in the United Kingdom ran a series of television advertisements to raise awareness.

[64] At the time of writing, it is far from clear exactly what will happen to these Co-operative Bank customers. There is the possibility that some of these customers, who could stand to lose as much as 40% of their savings, may claim to have been misled by the Co-operative Bank's staff about what exactly they were investing in. The term used in the United States and some other countries is "haircut", which arguably provides a better description of what is actually happening.

[65] This has also been a problem in many other countries, including the United States.

Can we actually afford our Deposit Protection Systems?

67 As has been discussed, the Cypriot proposal for a levy on deposits was made in the context of a country in a state of financial crisis. Cyprus had to demonstrate that it was trying to put its finances in order before it could receive bail-out funds from the European Union and the levy was one of a number of mechanisms proposed to help to achieve this. But this leads to another important question, raised by Professor George Kaufman: what happens when a country which provides cover under a deposit guarantee scheme is not itself in a sufficiently stable financial position to be able to meet any claims it may face under the scheme? [66] While it is one thing to pass a law saying that something is protected it is another to be able actually to provide that protection if required to do so. There seems little doubt that, in the European Union, the increased level of cover under the 2009 DGSD was introduced without any serious consideration having been given to the affordability issue, despite the example of Iceland, which had, effectively, become bankrupt when its banks failed.

68 There are now proposals at a European Union level for a pan-European deposit guarantee scheme, which would be funded by a levy on the banks in each country and operated by the European Central Bank in Frankfurt. These proposals are not currently going anywhere too quickly, but, if such a scheme were to be introduced, it would assist in dealing with the strong country-weak country issue. Within the European Union, it is widely believed (probably correctly) that a number of southern Member States have very weak financial positions and would not be able to meet demands by depositors should a significant bank fail. However, it is not only in southern Europe that there are potential problems. In September 2007, the United Kingdom Chancellor of the Exchequer, Alistair Darling, effectively guaranteed all the deposits in the United Kingdom banking system. It is far from clear whether this was something the United Kingdom government could actually afford to do. Could the United Kingdom authorities actually meet their obligations at the current level of cover under the DGSD? There is no fund in place and the money would have to be borrowed from HM Treasury. The current patchwork of depositor protection schemes across Europe today resembles the position of the individual states within the United States in the late nineteenth century: only when the might of the Federal Reserve Banks was put behind the FDIC scheme was a sufficient level of confidence achieved. This makes the proposals for the pan-European scheme look eminently sensible.

[66] This is a question that was raised in conversation between Professor Andrew Campbell and Professor George Kaufman of Loyola University, Chicago at the Second Research Conference of IADI in Basel, Switzerland, in March 2013.

Concluding Thoughts

69 This article has sought to identify a number of questions about depositor protection which require clarification. First, on the basis of what has been discussed, is it reasonable, or indeed rational, to believe that bank deposits up to the insured limits are actually fully protected from all possible events? The move towards bank bail-in and OBR might suggest that the DGSD guarantee will be ineffective in a situation where a bank does not actually fail (as was the case in Cyprus): if the bank does not default, can the guarantee actually be called? What are the circumstances in which depositors will be protected? Should deposits in fact be protected against all eventualities or are there some situations where it might be deemed reasonable *not* to protect them?

70 This leads to the second question: is there a legal distinction between a deposit insurance scheme and a deposit guarantee scheme which may have an impact on outcomes for depositors? This may just be a question of semantics, with everyone believing that the terms have the same legal and commercial effect, but it is a question that does not appear to have been considered.

71 These questions need answers from policy makers so that depositors know where they stand. The "Cyprus problem" has not actually gone away. While the proposal to "tax" insured deposits did not go ahead, there has been no indication from the relevant authorities that this could not happen in the future. The proposed Cyprus "tax" was set at the relatively low level of 6.75%, but there is nothing to suggest that a future "tax" could not be set at a significantly higher level. Many depositors in the United Kingdom and elsewhere in the European Union have expressed concern about whether this could happen to them.

72 A further question remains as to the funding of schemes. The European situation suggests that very few country schemes in the European Union have sufficient funds to be able to deal with a sizeable bank failure. In fact, many country schemes are not funded ex-ante and that is perhaps another problem which needs to be addressed. Is it right for law makers to set cover at unrealistically high levels? The level of cover was raised significantly in the European Union, the United States and in other jurisdictions during the post crisis period, seemingly without consideration being paid to whether or not the countries in question would ever be able to provide the promised level of compensation to depositors. It may be that the approach taken in New Zealand in determining the *de minimis* amount for the purposes of OBR has some merit, if it means that the government is not guaranteeing unrealistically large sums.

73 The pan-European scheme may provide an answer to the question of affordability, if it is subsidised by bank levy. Care would have to be taken to ensure that the knowledge that the system's ultimate backer was the European Central

Bank did not, of itself, lead to moral hazard. This option is not likely to arise soon as it is unclear whether there is consensus across the Member States.

74 The OBR policy, which allows depositors' money above a *de minimis* threshold to be set against bank losses, lacks appeal, as it smacks of co-insurance. Sir Mervyn King, the former Governor of the Bank of England, recently revealed that, during discussions about deposit insurance after the collapse of Bank of Credit and Commerce International in 1991, he supported the idea of providing 100% protection up to a particular limit.[67] However, at that time, the majority view was that there should be an element of co-insurance applied to all bank deposits to ensure that all depositors were aware that they would share the loss should their bank fail. The former Governor's view ultimately prevailed after the Northern Rock crisis and the overwhelmingly prevailing view now is that at least a certain level of deposit should have total protection.[68]

75 But, in its practical application, OBR may lead to outcomes which are little different from the application of, for example, the DGSD. Quite how different will depend upon the level of the *de minimis* threshold and the extent of the losses incurred by the failing bank. It could be argued that there is a greater degree of honesty, or perhaps reality, attached to the OBR: it is up front about the fact that, if the bank fails, you won't get all your money back and it tries to preserve government funds for the tax payer. But, it lacks the certainty associated with the DGSD: the DGSD limit makes explicit the scope of the protection afforded to depositors. The OBR does not do this and it is this lack of certainty that could lead to a bank run and potential contagion. In the light of the OECD comments, however, it may be the case that, were a financial crisis to arise, the *de minimis* amount would be set very high to prevent such a bank run. If this were to happen, then it would be difficult to see that the OBR posed any serious disadvantages for New Zealand depositors.

76 Both the European Union Member States and New Zealand government have sought to publicise the level of depositor protection available under the DGSD and the OBR respectively. Such awareness raising is consistent with Core Principle 12 and serves to distinguish these regimes from the Cypriot bank levy. As has been previously discussed, the outcomes for depositors under the Cypriot bank levy could prove to be no worse than those under, say the OBR regime, but the difference is that the depositors were not given the choice about where to put their deposits in the light of the risk.

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[67] *Financial Times*, 15-16 June 2013.

[68] The FDIC in the United States had never used co-insurance and provided 100% protection up to a particular amount. Initially the European Union Directive on Deposit Guarantees permitted Member States to use co-insurance if they wished, but post Northern Rock this has been removed and all Member States must provide 100% protection up to EUR 100,000.

77 The use of formal, explicit deposit insurance schemes which provide full protection up to a particular amount has clearly been the most favoured approach in the wake of the financial crisis and this, despite the approach taken by New Zealand, seems likely to continue to be the case.

78 The authors conclude that there is an urgent need for both IADI and EFDI to consider these questions and to make policy recommendations. Further, individual Member States within the European Union as well as the European Commission will need to determine their stance on these matters so that the European Union's position can be agreed by the European Council and Parliament. It is crucial that the depositing public know what protections they are entitled to, both as part of the mechanism of maintaining financial stability and in order to ensure the successful operation of deposit guarantee systems within the European Union in the future.

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