

Deposit insurance that draws on City strengths

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We have an opportunity to reshape the deposit insurance arrangements for UK banks using an approach that has long strengthened London as a financial centre. Applying proven models of mutuality can align the interests of banks, regulators and depositors and make our deposit insurance scheme more robust, cost-effective and capital efficient, thereby increasing London's competitive edge.

Certain characteristics of the British banking sector define what will be workable and durable over the business cycle for deposit insurance. The retail banking sector is dominated by a few big banks. These banks are global in assets, liabilities and exposures, complicating both depositor protection and the liquidation of failed bank assets. In addition, the UK's history of boom and bust in credit, real estate and asset markets exposes banks to failure when cyclical stress is intensifying. Securitisation, covered bonds, structured investment vehicles and derivatives may further complicate and delay recovery of the assets of failed banks in future liquidations.

Foreign models of deposit insurance cannot be easily implemented here. We are in a cyclical downswing; liquidity is tightening, capital is constrained, profitability is eroding and counterparties and depositors view banks with scepticism. Raising a large new deposit insurance reserve quickly risks draining profitability and diverting capital from banks already under pressure and increasing the risks of failure. The substantial premiums required for pre-funding might intensify consolidation, lessen competition, promote moral hazard and increase reliance on flawed risk assessment models.

A better solution would draw on City

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traditions and strengths in securities markets and insurance. Our preferred model for deposit insurance makes use of the "chain of security" activated in solving the recent crisis at the Society of Lloyd's, a market which has never defaulted a claim in over 300 years despite periods of huge stress. This approach recognises that deposit insurance is a backstop to protections embodied in Financial Services Authority regulation of bank capital and conduct of business, and Bank of England liquidity facilities to bridge short-term liquidity stress. Deposit insurance, when needed, should swiftly pay claims to depositors, spreading the liquidity impact and costs not only within the UK banking community but also more widely to the global insurance markets.

A Deposit Insurance Fund on the Lloyd's model would have tiered funding components: modest premium levies and subordinated debt for a cash reserve; a callable levy up to a fixed percentage of eligible bank insured deposits in the event of a claim exceeding the reserve; insurance of excess liabilities in catastrophe insurance markets, possibly combined with issuance of long-term debt; and a statutory preference against assets of the failed bank under the proposed Special Resolution Regime to repay any debt, levies and costs borne by the Deposit Insurance Fund. The arrangements for deposit insurance must mesh with the terms of the Special Resolution Regime for resolving future bank insolvencies. The precise funding arrangements can be flexible and should be subject to periodic review and retendering by the banks themselves in the governance of the Deposit Insurance Fund, subject to approval by the authority overseeing the Special Resolution Regime.

Excess liability insurance would spread deposit insurance risk beyond the UK banking sector to global catastrophe insurance markets, reducing the pro-cyclical liquidity impact of any deposit insurance claim. In normal circumstances it should cover the risk of a large UK bank failure at a cost well below pre-funding, particularly in upswings of the economic cycle, while spreading the costs in a managed way if claims are sustained during downswings. Periodic tendering would ensure that market pricing reinforces discipline in the banking sector toward better management throughout the business cycle, co-operation on rescues of troubled banks and efficient resolution processes. The capital efficiency of these flexible arrangements should give UK banks a competitive edge.

In the forthcoming debate about the development of the Special Resolution Regime and Deposit Insurance proposals, we should seize the opportunity to improve both our banks' future prosperity and the confidence of depositors.

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