Briefing note
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Depositor Preference Issues

Depositor preference is an established part of the bank regulatory landscape in the US, but outside the US it is a relative rarity - Argentina, Australia and Switzerland are the primary non-US instances. This memorandum summarises some of the issues which arise from the use of depositor preference as a component of bank resolution policy.

Depositor Preference

When a bank fails in such a fashion as to leave an absolute shortfall in assets, the relevant loss must be allocated amongst its creditors. Basic principles of insolvency would dictate that all creditors should share equally in the shortfall. However there is broad agreement amongst policymakers that some creditors (generally retail depositors) should be given special protection in such situations. These depositors can be protected in one of three ways.

1. They can be made good out of public funds - thereby mutualising the loss amongst taxpayers as a whole;
2. They can be insured, thereby mutualising their loss amongst those who pay premiums to the insurance scheme;
3. They can be given a preferential claim on the remaining assets of the institution, thereby mutualising their loss amongst the other creditors of the bank.

The third of these is depositor preference.

The primary argument in favour of depositor preference is that it maximises market discipline on the institution concerned - by exposing unsecured creditors of an institution to the risk of a leveraged downside loss in the event of its failure, it incentivises them to deal appropriately (or to decline to deal) with the institution concerned. The other approaches, by contrast, impose these costs on third parties who are unable to take any steps to minimise their potential contribution.

This is in fact the history of depositor preference in the US. In the US depositor preference was introduced in 1993 in the Omnibus Budget Reconciliation Act. The rationale was a fear that FDIC could be exposed to large claims which would have to be met out of the public purse, and the introduction of depositor preference was intended to shift these costs from the public purse to private creditors.

Depositor Preference and Deposit Insurance

Logically deposit insurance and depositor preference are alternatives, and it would be possible to operate either without the other. However depositor preference

alone would be highly inefficient in practice, since it is unlikely to achieve a timely payout of depositors and thus is less efficient in reducing the risk of runs. As a result, depositor protection where it exists often operates in tandem with deposit insurance.

There is equally no reason why depositor preference protection and insurance protection should be coextensive. In the US depositor preference extends to both insured and uninsured deposits - thus for insured deposits FDIC pays out to depositors and is subrogated to their position as a preferred creditor of the failed bank, whilst for uninsured deposits the depositors are entitled to assert their insolvency preference but not to claim on the insurance fund. It is therefore clear that (at least as far as insured depositors are concerned) depositor preference really means deposit insurance protection scheme preference.

National Depositor Preference

Both the EU and the US deposit insurance arrangements apply to depositors globally, regardless of the place where they are. However there is an important difference between the scope of the EU and the US regimes. In the US deposits with non-US branches of US banks are not insured by FDIC, whereas in the EU deposit protection applies to all depositors in all branches of an EU bank within the EU. A consequence of this is that US depositor preference is limited in territorial scope, such that US depositors have an insolvency preference over non-UIS depositors in the insolvency of a US bank. This preference extends to uninsured deposits, so large corporate depositors at a US branch have preference over retail depositors at a non-US branch.

A territorial limit on preference increases the pressure on host state authorities to seek to protect depositors with a local branch by ringfencing assets in a separate insolvency or resolution process and so can undermine the ability of the home state authorities to control the overall resolution of the bank.

Consequences of Depositor Preference

A depositor preference regime usually places depositors below insolvency expenses and secured creditors, but above ordinary senior creditors. Thus for three equally sized hypothetical banks:-

	A	B	C
Secured creditors	$30	$30	$30
Preferred depositors	$60	$40	$20
Senior creditors	$10	$30	$50
Total	**$100**	**$100**	**$100**
Assume loss of equity + $10, Senior creditors recovery	0%	66%	80%

Thus it is clear that senior creditors of banks with large preferred deposit balances take on significantly higher risks than senior creditors of equally-sized banks with lower deposit balances.

It has frequently been suggested that creditors of banks with significant deposit bases have responded to the introduction of depositor preference in the US by switching their lending from an unsecured to a secured basis through the repo markets. This may well be true. However it will never be possible to secure more than a proportion of the liabilities of a bank, and it is likely that all banks will always have at least some significant level unsecured non-depositor creditors.

Group Issues

Depositor preference applies at the level of the insolvent bank. Thus a person who is unwilling to become an unsecured creditor of a bank entity which has a high level of deposits should have no difficulty in becoming an unsecured creditor of a different member of that group which did not hold deposits provided that that other entity was appropriately capitalised. Although it would be awkward to split a bank in this way between insured and uninsured deposits, it would be entirely possible to place unsecured creditors arising out of commercial activity (transactional creditors, merchant banking and similar activity) in a different legal entity. It is interesting to note that this separation was to some extent already embedded in US law (in the form of Glass-Stegall) at the time when depositor preference was introduced, and it is an interesting speculation that had this not been the case, it is entirely possible that the response of US banking groups to the introduction of depositor preference might well have been to restructure themselves along these lines. Since US bank groups are still to some extent functionally divided by regulation, the US experience provides no insight as to the potential response of a genuinely integrated bank model to the institution of depositor preference.

If depositor preference were introduced into a jurisdiction in which a universal bank operated, the universal bank (assuming it maintained a significant level of preferred deposits) would rationally segregate its deposit taking business into a separate subsidiary in order to minimise the increase in cost that it would otherwise expect to be applied to its unsecured funding (either because creditors would perceive an increase in risk and increase funding costs or through having to incur the cost of securing such funding). This is, of course, the opposite of depositor preference, since the effect of such an arrangement is to deprive depositors of any access to the assets of the remainder of the group beyond those of the deposit taking institution. Thus the segregation of depositors in this way within the group could be used to negate the impact of depositor preference. (Somewhat curiously, this is precisely the proposal put forward by the UK Independent Commission on Banking as a depositor protection measure!). The effect of such an arrangement would be to relieve the remainder of the institution from any liability to contribute to a shortfall within the deposit taking subsidiary, and to allocate that shortfall through the insurance scheme to the contributories to that scheme.

Depositor Preference and Bail-in

Bail-in is a resolution technique whereby the losses of the institution concerned are allocated to some but not all of the senior creditors. Since it is a common element of all bail-in proposals that depositors should not be amongst the class of creditors bailed-in, it could be argued that bail-in is itself a species of depositor preference, with the distinction being that whereas depositor preference subordinates all other senior creditors, bail-in is a mechanism for establishing depositor preference and extending it to other classes of creditors (notably trading counterparties) as well.

This is broadly true at a high level, but it illustrates one of the key distinctions between bail-in and depositor preference. The basis of bail-in proposals is that the regulator should retain at least a degree of discretion as to both the extent and the quantum of the bail-in. Depositor preference, by contrast, is highly predictable as to its incidence. More importantly, since depositor preference is backed up by an insurance scheme, depositor preference creates confidence and certainty in at least the class of creditors formally protected, and thereby (arguably) improves systemic stability and inhibits retail bank runs. One aim of bail-in, by contrast, is providing confidence to trading counterparties and thereby avoiding wholesale runs (that is, exercise of termination and close-out rights in trading positions). The two objectives are comparable but not identical, and the two tools therefore can and should coexist. It could be argued that they should be harmonised, with bail-in morphing into a concept of "trading counterparty preference" to mirror the concept of depositor preference. However, no matter how appealing this may seem to the tidy-minded, it is open to significant practical objections; the most important of which it that it is unlikely that lawmakers and others could easily be persuaded that derivatives counterparties should be entitled as of right to the same level of protection as is provided to retail investors.

In addition, there is an interrelationship between bail-in (and other resolution tools) and depositor preference where creditors affected by a resolution tool are protected by a "no creditor worse off" promise of the kind enshrined in the UK Banking Act and the European Commission's consultation proposals. Since depositor preference will reduce the recoveries of non-preferred senior creditors in liquidation, the introduction of depositor preference reduces the impact of this constraint on the use of resolution tools.

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