Deposit Insurance Systems: Addressing emerging challenges in Funding, Investment, Risk-based Contributions and Stress Testing

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Agenda

» World Bank Paper
» FSCS Experience
» Q&A
Alongside its operational readiness and technical capacity to payout, the DGS should also have Business Continuity (or “disaster recovery”) plans in place. These are important to any business - not unique to a DGS but are also critical to a DGS’s reputational risk. The issues can be wide and varied, and ever changing, and might include, for example:

- denial of access to premises e.g. natural event (flood), human intervention (terrorism, other intrusion), loss of supplies (electricity, water);
- information technology e.g. equipment functionality, cyber attack; or
- staff disruption e.g. transport, health pandemic outbreak, etc.
IADI Core Principles for Effective Deposit Insurance Systems

» IADI’s Core Principles explicitly require contingency planning - Core Principle 6; Essential Criteria 2 adds that the DGS develop and regularly tests its own contingency planning and crisis management plans.

» This is not limited to the DGS - “the [DGS] participates in regular contingency planning and simulation exercises related to system-wide crisis preparedness and management involving all safety-net participants” (Essential Criteria 4).
In its recently published Handbook, IADI’s guidance on Essential Criteria 2, and 4, of Core Principle 6 is as follows:

- “Plans should be tested on a regular basis. Testing is particularly important in systems where there have been few, if any, failures. Under such conditions, testing is the only means of ensuring that procedures and systems are effective. Such testing can take a variety of forms, from simple scenario planning and table top exercises to a comprehensive test of preparations for failure and other events and the collection of any necessary information. Not all systems need to be tested at once. For example, the DI can opt to test separately elements of its monitoring, such as the early warning system and payout procedures. Some testing of some components should be conducted every year, with a full test of all components every five years; the incidence of any actual reimbursement counts in lieu of a full test. Systems will be graded [Compliant] if they have a regular process of testing sub-systems and, occasionally, the full system. Systems that test irregularly may be graded [Largely Compliant] and those that do not test [Materially Non-Compliant] or [Non-Compliant]”; and

- “The DI should participate fully in coordination or contingency planning exercises on a system-wide scale. The assessors will have to determine if the DI is routinely included in all exercises, has full access to preparations and review of the results, and participates in the development of follow-up action plans”.

...
The Core Principles, and Essential Criteria, make clear that planning must also include communications - “participates in the development of pre and post crisis management plans involving the safety-net participants….”, as further elaborated in the Handbook (at Essential Criteria 5):

“The DI should participate in the development of communication plans that are part of the contingency planning process for all its banks. The DI has special knowledge of depositor behaviour and issues determining private sector confidence. The insurer should be frequently consulted, have input into communication strategies, and ensure a consistent communications strategy for a [Compliant] rating”.
The 2009 IADI Core Principles were applied by the Financial Stability Board in its Thematic Review on Deposit Insurance Systems - Peer Review Report (8 February 2012). The Core Principles were used as the benchmark for the FSB members. As well as endorsing the Core Principles themselves, the Report noted the “need to strengthen the degree of coordination between the [DGS] (irrespective of its mandate) and other safety net players to ensure effective resolution planning and prompt depositor reimbursement”.

Noting that some countries had not carried out a payout at all or for the same time, the FSB Report recommended “the conduct of simulation exercises to ensure readiness and effectiveness of the payout process”, particularly if a jurisdiction “has not triggered its [DGS] for some time”.

Testing - The Operational Principles

» Independence/separation of duties
» Time and Resource
» Conduct and the Cast List
» Governance
» Objectives, scale and scope
» The Results - recording, reporting and remedying
» Risks
» Reverse Stress Test
The Test Framework

» governing legislation and public policy objectives;
» legal powers and obligations (e.g. access to data);
» the scope of protection and depositor coverage (limits, timescales, eligibility);
» funding (ex ante, ex post, borrowing);
» the DGS’s information requirements and entitlement (depositor data); and
» third party dependencies for payout scenarios (IT systems, cheque providers, agent banks, communication (or call centre) resources).
Material External Factors

» the trigger for the DGS (e.g. court order of bank insolvency);
» the test bank corporate overview (e.g. business model, balance sheet, market position, geographical locations etc);
» key features of the deposit book (number, value, protected/unprotected, account types); and
» access to data - whereabouts, transferability and format (including IT systems).
EBA Guidelines on Stress Tests of Deposit Guarantee Schemes (24 May 2016)

» The EBA’s Guidelines identify 2 main “risk areas”:
  › “operational risks” (processes, staffing and systems); and
  › “funding risks” (funding sources to meet liabilities).

» These cover the principal risks to the delivery by a DGS of its particular paybox function.

» Operational capabilities are broken down by the EBA into different categories:
  › access to data - information on the institution, and access to and testing of depositor data (the ‘single customer view’), and the arrangements for early warning of problems to the DGS;
  › staff and operational resources;
  › communication with depositors and the wider public (e.g. website, call centres);
  › payment instruments (processes and instruments);
  › repayment and contribution periods (time to payment); and
  › home-host cooperation (payment to depositors at branches in other EU Member States).
Testing – Key Impacts

» Pre-default planning
» Operational processes
» Capacity to execute a payout
» Funding of the payout
» Timeframes for executing a payout
» DGS governance / decision making
» Third party stakeholder management (i.e. service dependency external to the DGS)
» Communications
Testing – Additional Impacts

» Operational business disruption
» Data issues/data errors
» Multiple firm failures
» Adverse media coverage
» Cross border complexity
» Inadequate co-operation with other organisations
» Payment scheme access
» Post-default legal issues
Assessment and Reporting

» when it is difficult for a DGS/when it would be unable to meet its obligations,

» highlight operational and financial weaknesses, risk issues and ‘stress points;,

» challenge existing business contingency plans and operational capacity assumptions; and

» identify improvements to the DGS operational (and risk management) framework
FSCS Experience - Tests

» Mandate - paybox plus - a paybox mandate with some additional resolution responsibilities

» Board – decision making (and funding)

» Social media crisis

» Multiple incidents: office closure and firm failure

» Authorities walkthroughs
  › IP process
  › Authorities decision making and dependencies

» 2017-19 Plan - tested
  › SCV verification
  › cross border data exchange

» In addition, low level, team based reviews of contingency plans
Westeros Depositors Sucking the Country Dry

Westeros has been trying for the last four months to reserve the six years of post-crash austerity policies while extracting a better deal from the European Union.

Westeros owes now owes approximately 320bn (£234bn) to the European Commission, the International Monetary Fund and the European Central Bank following further bailouts in 2012.

Following a coordinated attack by different Presidents and Prime Ministers, outflow of funds from Westeros bank accounts has been accelerating rapidly.

December 2014, saw the biggest monthly outflow of funds since crisis of €17.8bn (£12.8bn). £5bn (£3.6bn) was withdrawn from Westros banks during April 2015.

Some £2bn of deposits have been withdrawn from the Westros banks so far this week – including a record £1bn yesterday – triggering fears that a breakdown in talks would spark a further flight of funds.

Since 2010, the country Westeros has borrowed nearly €240bn (£185bn; $278bn) under a debt restructuring (bailout) plan.

Since the start of the crisis and the country seems to have an out of control debt appetite (currently debt stands at around 175% of GDP).

Unemployment is still very high at 25.5%, especially among 25-35 year olds where it hits just under 50%, and recent emergency taxes, mainly on property, have further squeezed the middle class.

Westeros entered into talks for a multibillion-pound rescue deal.
Board – Decision Making (and funding) (2)
Board – Decision Making (and funding) (3)

» Detailed/existing (and cross border) scenario
  › fast moving interventions(video/news/press/politicians/industry)
» Refresh Board awareness
» Test decision making process
» Explore need for and access to funding
» Tight timeframe – focus on 7 day payout
Social media crisis

» Narrow/focused exercise – just communications contingency plan test
  › controlled injection of developments to script
» Reinforced need for plan and teamwork
» Fallback plan in case of leak
Multiple Incidents (1)

HBS ‘Error’ Reveals Building Society – ‘Set to Collapse’

The FT can reveal that Leeds based Hastings Building Society have notified the Prudential Regulatory Authority (PRA) of a significant accounting error in the commercial loan book. This error has been uncovered by newly appointed auditors, and leaked by an internal source.

Correction of this valuation error will result in a significant write-down of asset values, and will significantly reduce Hastings’s capital adequacy.

The FT have been trying to contact HBS for a statement but so far, calls haven’t been returned. The PRA have also remained silent on the matter so far. It is expected that HBS will default within a matter of days or weeks, leaving their approximate 70,000 strong customer base of savers at the hands of the Financial Services Compensation Scheme. FSCS will protest savings up to £75,000, and call for the Building
Multiple Incidents (3)

This mornings newspapers have revealed an accounting error and customer base decline in one of the UK’s oldest Building Societies - Hastings.

The Financial Times uncovered leaked information which indicated the building society is on the verge of collapse, and customers should expect Hastings to default within days or weeks. The FTSE 100 has dropped 2.1% in early morning trading. Customers are now looking to the Financial Services Compensation Scheme (FSCS) - a government backed scheme to protect customers savings up to the value of £75,000. Following an incident in the Aldgate area of the City of London, FSCS have evacuated from their usual offices and are unable to react to this event due to the disruption. #John99993, FSCS employee, tweeted: '#FSCS #Aldgate evacuation, unable to work today'. READ MORE
Multiple Incidents (2)

» Combined operational disruption and firm failure
» Directed to internal resilience plans and roles
  › externally devised and supported – and witnessed
» Validated incident management
» Tactical lessons learnt – allocation of responsibilities and roles/internal support/communications
Authorities Walkthroughs

» Carefully plotted steps
» Designed to step through each institution’s decisions and actions
  › role of the insolvency practitioner
» Opportunities to pause and explore issues
» Develop common ‘playbook’
» Enhance personal relationships
Payout stress test – September 2017

» “top 10” bank/real data set

» 3 week exercise
  › notification/planning
  › 7 day payout
  › THBs/other payment
  › emergency funding

» FSCS wide exercise

» Next - Authorities’ funding exercise – H1 2018
Common themes

» Preparation time and effort
  › use existing opportunities/methodologies
  › need for resource – and senior commitment
» Independent/arms length support – separation of duties
» Clear scope/objectives
» Realistic scenarios
» Feedback/lessons learnt
  › authorities playbook
  › internal governance/decision making
  › refresh plans
  › regular testing
Lessons Learned and next steps

» To discuss
Thank You

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