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Asian Banking Integration, Depositor Preference, and Deposit Insurance[*]

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ABSTRACT

The ASEAN Banking Integration Framework is one prominent example of regional interest in improving banking sector integration across Asia. Closer integration requires regulatory and supervisory coordination and cooperation on a number of fronts. This paper argues that a crucial required ingredient, not adequately recognised, is better alignment of depositor preference and deposit insurance arrangements. Issues involved in finding the optimal set of arrangements and the consequences of making the required changes for domestic banking systems are outlined.

KEYWORDS

Deposit Insurance, Depositor Preference, ASEAN, ASEAN Banking Integration Framework

JEL Categories: G21, G28

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1. Introduction

Around the globe, depositor preference (where at least some depositors rank ahead of other unsecured creditors) is becoming more common, and has been advocated in a number of recent Financial Sector Assessment Program reports by the IMF[1]. The consequences of depositor preference arrangements for the design and pricing of deposit insurance schemes is not widely appreciated, and the implications of differences in national depositor preference (where domestic depositors rank ahead of depositors in foreign branches of the domestic bank) for banking integration even less well appreciated.

This paper argues that understanding of these consequences and closer attention to the implications of national differences in arrangements is important for successful progress of regional initiatives to develop greater integration of Asian national banking markets. In particular, the recently agreed ASEAN Banking Integration Framework (ABIF) aims to achieve an outcome by 2020 of regionally headquartered banks operating in other ASEAN countries under the same regulatory conditions as home country domestic banks. But among the significant impediments to achieving such an outcome are differences in depositor preference and deposit insurance arrangements.[2] If not appropriately harmonised, such differences prevent true equality of treatment and create potential for significant future problems, which can be illustrated by reference to the consequences of the failure of Icelandic banks operating in the UK and elsewhere in 2008.

To develop these arguments, this paper first considers what is meant by depositor preference and explains different variants which can be found internationally. In doing so, it also considers the complications raised by national depositor preference. Then, the diversity of arrangements for depositor preference and deposit insurance arrangements within the Asian region are outlined. Next, the ASEAN Banking Integration Framework is briefly outlined and the relevance of ensuring suitable cross-border depositor preference and deposit insurance arrangements for its success argued. This is illustrated by a brief overview of the problems arising from the failure of the UK branch (IceSave) of the Icelandic Bank, Landsbanki, in 2008, followed by consideration of the potential complications facing the proposed Indonesian and Malaysian implementation of ABIF under a heads of agreement signed in December 2014.

[1] See, for example, recent IMF FSAP reports for Brazil and Canada.
[2] ADB (2013) for example notes issues of "(i) entry and licensing, (ii) capital stringency, (iii) supervision, (iv) empowerment of supervisors to take prompt corrective action, (v) restrictions on risk management procedures, and (vi) transparency" as relevant to ASEAN banking integration, but does not explicitly mention depositor preference and deposit insurance issues.

The following section then focuses upon the implications of depositor preference arrangements for the structure and pricing of deposit insurance design, arguing that the two matters need to be considered jointly. In particular, the rationale for ex ante premiums for deposit insurance may be removed by particular types of depositor preference. Also important are the implications of depositor preference arrangements for future financial stability and bank financial and organisational structure decisions, and possible consequences for such matters resulting from decisions about depositor preference are considered. Finally, the issue of implicit insurance in a regional banking market is addressed, and the role of Resolution Funds (as implemented in the EU) considered. It is concluded that current arrangements with regard to depositor protection and deposit insurance coordination are not adequate for successful Asian banking integration such as proposed by ASEAN ABIF framework, particularly if they are to eventually be extended to ASEAN+3. Possibilities for consideration for harmonisation are briefly outlined and assessed.

2. Depositor Preference: Concept and Types

Depositor preference relates to the priority ranking of claims of all bank creditors in event of bank failure, and specifically to the seniority of (different types of) depositors in the hierarchy of claimants. Priority of depositors over unsecured creditors has been in place for some time in a number of jurisdictions including Australia under the Banking Act since 1959 and in the USA since 1993 under the Omnibus Budget Reconciliation Act.[3] It has become more common in recent years, with the EU and the UK introducing depositor preference in 2015[4]. But around the globe, some jurisdictions place (some/all) depositors ahead of unsecured creditors, while others don't.

There is a range of possible depositor preference arrangements which, at risk of generalisation, and focusing (for the moment) solely on domestic depositors can be classified as follows and are shown in Figure 1[5]:

- Tiered Depositor Preference: Insured Depositors rank above Uninsured Depositors who rank above unsecured creditors
- General Depositor Preference: Insured and Uninsured Depositors rank equally and above unsecured creditors

[3] The law firm Clifford Chance (2011) claimed that "outside the US it is a relative rarity - Argentina, Australia and Switzerland are the primary non-US instances"

[4] Under, respectively, the EU Directive 2014/59/EU (the Bank Recovery and Resolution Directive), and the Banks and Building Societies (Depositor Preference and Priorities) Order 2014 (SI 2014/3486)

[5] The Financial Stability Board have used a slightly different classification which includes "eligible" deposit preference (deposits eligible for insurance even if above the maximum cap) and national depositor preference (discussed later) but do not consider "tiered" preference. (FSB(2011, p68)

- Insured Depositor Preference: Insured Depositors ran above Uninsured Depositors and unsecured creditors who rank equally
- No Depositor Preference: All depositors rank equally with unsecured creditors.

Figure 1: Alternative Depositor Preference Regimes:
Priority Ranking – senior to junior

<table>
<tr><th>Tiered Depositor Preference</th><th>General Depositor Preference</th><th>Insured Depositor Preference</th><th>No Depositor Preference</th></tr>
<tr><td>Insured Deposits</td><td rowspan="2">Insured & Uninsured Deposits</td><td>Insured Deposits</td><td rowspan="3">Insured & Uninsured Deposits & Unsecured Creditors</td></tr>
<tr><td>Uninsured Deposits</td><td rowspan="2">Uninsured Deposits & Unsecured Creditors</td></tr>
<tr><td>Unsecured Creditors</td><td>Unsecured Creditors</td></tr>
<tr><td>Equity</td><td>Equity</td><td>Equity</td><td>Equity</td></tr>
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There are a range of variants on these types including the possibilities that depositors may rank behind unpaid obligations to employees, unpaid taxes, or amounts owed to the Central Bank (such as under liquidity support arrangements) etc. Depositors may be preferred claimants for the total amount owed, or only for some specified amount (such as the maximum amount which can be insured under an existing deposit insurance scheme). Depositors will also rank behind claims on “encumbered” assets, such as from secured (eg repo) funding, covered bonds, or because of netting/set-off arrangements under derivative contracts. There may also be netting of deposit claims against amounts owed to the bank on loan contracts. The priority arrangements may be based on banking and/or general insolvency law provisions or regulation.

Another complication arises regarding the priority accorded to the deposit insurance fund which may or may not assume the priority position of (be subrogated to) insured depositors of a failed bank whom it has paid out. This is particularly relevant for determining the potential exposure of the insurance fund to loss from bank failure and thus “fair” pricing of deposit insurance, and needs to be one consideration in determination of depositor preference arrangements and design of deposit insurance schemes.

Yet another complication, of particular importance for regional banking integration arises from the priority treatment of depositors in foreign branches of home country banks. National Depositor Preference refers to the situation in which depositors in the home jurisdiction have priority over depositors in a foreign branch of a failed bank. Such national depositor preference can be found in, for example, the USA, Australia, and Singapore, and creates complications through potential interaction with national deposit insurance schemes and their treatment of depositors in foreign branches of domestic banks.

For example, in 2012, the UK announced proposals (FSA, 2012) aimed at ensuring local (UK) depositors in bank branches of foreign banks from outside the EEA have equal priority with home country depositors of those foreign banks. If not, the proposals required achieving local depositor protection by means such as subsidiarisation (rather than location as a branch), ring-fencing of UK branch assets etc. This created complications for US regulators, since according depositors in foreign branches equal preference may have meant that foreign branch deposits would be insured under the home country (US) deposit insurance scheme.[6] The ability of the US deposit insurer (the FDIC) to rapidly access the foreign assets of the foreign branch was one potential complication.

Another complication arises from the potential interrelationships between national deposit insurance schemes – as to whether depositors in local branches of foreign banks are covered under the local deposit insurance scheme or the bank's home country scheme. This is examined later by reference to the experience of the UK and Iceland following the failure of the UK IceSave branch of Landsbanki in 2008.

3. Depositor Preference Arrangements in the Asian region

IADI (the International Association of Deposit Insurers) has collected survey information on the prevalence of depositor preference arrangements among its members globally.[7] From its December 2013 survey, 62 respondents had depositor preference, while 37 did not, and it should be noted that this data predates the adoption by the UK and EU jurisdictions of tiered depositor preference in 2015.[8] Amongst those respondents, 31 had preference arrangements determined under banking law, 25 under insolvency law, while for others the preference was from a mix of such legislation or by regulation.

Table 1 provides information on the deposit insurance and depositor preference arrangements in the Asian region. The majority of jurisdictions have explicit deposit insurance schemes, but among those, not all have depositor preference arrangements (and different types can be found).

[6] US deposit insurance does not apply to depositors in foreign branches. In contrast the EU requires that depositors of branches of EU banks in other EU jurisdictions should be covered under the home country scheme.

[7] I am grateful to IADI for making the following information available.

[8] It should be noted that there were some cases of multiple responses from some jurisdictions where more than one deposit insurance scheme operates.

Table 1: Deposit Insurance and Depositor Preference in Asia (ASEAN countries highlighted)

	Explicit deposit insurance from	Insurance Cap (USD) 2013	Depositor Preference
Afghanistan	2009		Yes
Australia	2008	221,625	Yes (Tiered)
Bangladesh	1984	1,287	No
Brunei Darussalam	2011	39,392	Yes
Hong Kong	2004	64,516	Yes (Tiered)
India	1961	1,613	Yes (General, limited) from 2014
Indonesia	2004	162,999	Yes (Tiered)
Japan	1971	94,967	No
Korea, Rep.	1996	47,366	No
Lao PDR	1999	2,498	?
Malaysia	2005	75,896	Yes (General)
Mongolia	2013	12,202	Yes
Nepal	2010	2,021	?
Philippines	1963	11,258	No
Singapore	2006	39,392	Yes (Tiered)
Sri Lanka	2012	1,528	?
Taiwan	1985	100,000*	Yes
Thailand	2008	1,523,322**	No
Vietnam	2000	2,369	Yes (insured only)
Bhutan	No		?
Cambodia	No		?
China	No		Yes
Myanmar	No		?
Pakistan	No		?
PNG	No		?
New Zealand	No		No

Sources: World Bank Deposit Insurance database; ASIFMA, IADI. (Taiwan coverage of NT 3 million converted at NT30 = USD1).** Thailand's coverage cap was reduced to 25mill Baht (USD 702,839 on August 11, 2015, and is scheduled to decline further to 1 million Baht (USD 28,114) in August 2016.*

Identifying the precise nature of depositor preference arrangements in many Asian (and other) countries is difficult. Also often difficult is identifying where the deposit insurer ranks in the creditor hierarchy. To illustrate, Australia has general depositor preference under the provisions of its Banking Act, but the Financial Claims Scheme legislation provides for APRA to have priority over other uninsured depositors in respect of amounts it has paid out to insured depositors in a failed bank. Thus, the effective outcome is one of tiered depositor preference. In Singapore and Malaysia, general depositor preference applies and the deposit insurer ranks equally with uninsured deposits in Malaysia, but ahead in Singapore. In Indonesia, the insurer ranks ahead of uninsured depositors. In India, depositor preference is subject to a cap on the amount given preference, and the insurer has no priority.

Similarly, the extent to which national depositor preference applies is also not always clear. It applies in the cases of Australia and Singapore, but explicit information is difficult to find for other jurisdictions. Where integration of banking, involving foreign bank access via branch, is proposed as is the case in ASEAN, this is clearly a matter of importance. If, for example, country A had national depositor preference and country B did not, country A depositors in a branch of a bank from country B located in A, would not have the same level of protection as if they were depositors in a local country A bank. Complications would also flow through to the priority status of the deposit insurer in country A if insurance covered local depositors in the foreign bank's local branch and the parent bank in country B failed.

4. ABIF

The ASEAN Banking Integration Framework (ABIF) was endorsed by ASEAN Central Bank Governors in December 2014. Aimed at achieving the benefits of increased financial integration (and effectively providing advantages to regional versus non-regional banks in cross-border expansion in the region) it introduces the concept of Qualified ASEAN Banks (QABs).[9] Banks so designated will be able to operate branches in other ASEAN countries under the same regulations as host country branches:

> "any two ASEAN countries may enter into reciprocal bilateral agreements to provide QABs with greater market access, and operational flexibilities consistent with those of domestic banks in the respective host countries. The implementation of the Framework will be accompanied by the strengthening of home-host regulatory and supervisory cooperation arrangements to support the effective surveillance and supervision of QABs." (AFMGM,2015)

Initially, this is to be achieved through Reciprocal bilateral agreements among the "ASEAN-5" nations (Indonesia, Malaysia, Philippines, Singapore, Thailand) and Indonesia and Malaysia signed a heads of agreement to pursue this in December 2014. The ultimate objective is multilateral agreement on

[9] Support for a policy of encouraging regional foreign bank entry might be inferred from the finding of Claessens and Van Horen (2013) of empirical support for the theoretical prediction that presence of foreign banks from nearby jurisdictions is more valuable due to greater ability to process "soft" information in lending decisions.

ASEAN banking sector integration to be achieved by 2020, with this timetable reflecting, *inter alia*, the marked differences across the region in the current state of financial and banking sector development.[10]

Achieving ABIF objectives will involve substantial supervisory and regulatory cooperation across a number of dimensions. One relates to the consistent cross border application of Basel regulatory standards and home-host allocation of supervisory responsibilities. Under the conventional approach, operation in the host country as a branch implies supervision by the home country regulator, thus requiring mutual confidence in supervisory capacity and intensity amongst jurisdictions. A second area where agreement must be reached is in the area of resolution arrangements in the event of a bank failure. By implying that the legal structure will involve branches rather than subsidiaries, the ABIF framework appears to be adopting the single point of entry (SPE) rather than multiple point of entry (MPE) approach to cross border resolution arrangements.[11] Unless resolution arrangements (including depositor preference) are common across jurisdictions, this means that there are potentially significant differences between foreign branches of QABs and their host country competitors.[12]

In that regard, a further area for coordination is that of deposit insurance. Whether depositors in a foreign bank branch are insured under the host or home country scheme needs to be made explicit. If the latter, differences in coverage limits would create competitive inequalities between foreign branches of QABs and their host country competitors. If the former, host country insurers are subject to risks of inadequate supervision by home country supervisors. This has led some researchers to suggest that “it may be necessary to put in place a single resolution mechanism that includes a single resolution agency, and a common deposit guarantee scheme” (Almekinders et al, IMF, 2015)

Table 2 shows the differences in deposit insurance coverage levels applying in a number of Asian countries.

[10] AMRO (2015) provides information on recent developments in ASEAN+3 banking markets and on the cross border penetration of banks from within the region, as well as foreign ownership restrictions.
[11] Mayes (2015) discusses the difference in these approaches, and considers lessons which can be learnt from EU approaches to banking integration.
[12] The FSB (2011, p69) noted that “[d]ifferences in the ranking of claims across jurisdictions will affect the willingness of national authorities to cooperate and achieve coordinated cross-border solutions.”

Table 2: Deposit Insurance Coverage: Selected Asian countries

Country	Coverage level USD, 2010	% of Deposit Value Covered	Bank Assets / Bank Deposits**	Covered Deposits / Bank Assets	Depositor Preference*
Australia	1010300	61	1.3	46	Yes (tiered)
Hong Kong	64000	20	0.7	29	Yes (insured only)
India	2240	33	1.0	32	Yes (general)
Indonesia	235294	61	0.9	66	Yes (tiered)
Japan	122775	71	0.9	83	No
Korea	43902	27	1.6	17	No
Singapore	38835	19	1.0	19	Yes (tiered)

**As at mid 2015; ** calculated from WB SFD Database as (Deposit Money Bank Assets/GDP)/(Bank Assets/GDP),*

Source: FSB (2012), Clifford Chance (2013), ASIFMA (2013), World Bank Financial Structure and Development Database 2013, updating by author

As noted earlier depositor preference arrangements are also an important feature of cross-border banking integration, and also relevant for the design and pricing of national (or regional) deposit insurance schemes. By way of illustration, the next subsection provides an example of the complex problems arising from inconsistencies between national deposit insurance and preference arrangements, drawing on the failure of *IceSave* in 2008

The IceSave Failure

IceSave was a business name of branches of the Icelandic bank Landsbanki operating in the UK and the Netherlands. The parent failed in October 2008 imposing losses upon depositors in the UK and the Netherlands. The UK and Dutch deposit insurance schemes paid out their domestic depositors up to amounts covered by the Icelandic scheme in anticipation of reimbursement from that scheme. The UK and Dutch governments paid out the rest of the retail deposits, thus becoming claimants on the estate of the parent bank. (There were also similar issues with the failure of the Kaupthing Edge bank which had (branches in Finland, Norway, Germany and, Austria).

Under the European Union directive 94/19/EC, national deposit insurance schemes were to provide protection for their banks' depositors anywhere in EU, although the Icelandic deposit insurance cap was less than UK, and the scheme had inadequate funds to provide reimbursement to the UK authorities. Moreover, the scale of the Icelandic banking failures meant that the ability of that government to provide compensation to the British and Dutch governments was also a problem. After subsequent drawn out political and legal disputes (including the UK government invoking anti-terrorism laws to seize the UK assets of Landsbanki) a settlement was finally reached in September

2015 which leaves the UK scheme out of pocket, but around 85% of the GBP 4.5 bill deposits reimbursed by UK authorities has been recouped from the Landsbanki liquidation.

This case illustrates the complexities which can arise if there is not appropriate harmonisation of deposit insurance and depositor preference arrangements across jurisdictions where host countries admit foreign banks as branches. As well as problems for the deposit insurance arrangements, one of the claims of the UK government was that, contrary to EU requirements, the Icelandic actions were effectively applying national depositor preference over depositors in other countries.

Indonesia-Malaysia ABIF Heads of Agreement

The details of the heads of agreement signed by Indonesia and Malaysia to effect bilateral implementation of ABIF are not readily available. However, it is clear that there are a number of barriers to effective implementation and designation of banks from each country as QABs. One complication which has been raised is the size of the minimum capital requirement required by the Malaysian authorities which precludes smaller Indonesian banks from accessing that market. But Table 3 also illustrates a number of other complications. The caps on deposit insurance coverage differ quite substantially. Malaysia currently requires foreign bank entry via subsidiarisation and thus its deposit insurance scheme does not currently cover foreign bank branches. In contrast, Indonesia currently covers branches of a number of foreign banks previously established in the country – but is reported to be in the process of legislating to generally require local incorporation and impose limits on foreign ownership. Indonesia appears to have tiered depositor preference compared to general depositor preference operating in Malaysia. The situation regarding whether national depositor preference operates is not clear.

Table 3: Indonesian and Malaysian Banking Market Characteristics

	Indonesia	**Malaysia**
Insurance Cap USD '000 equiv (2013)	163	76
Foreign Bank Branches	Covered	Not covered
Local Incorporation required	??*	Yes
Foreign currency deposits covered	Yes	Yes
Depositor Preference	Tiered	General

* Historically some long-established foreign banks operate as branches. Legislation is under consideration to require incorporation and limits on foreign ownership.

5. Depositor Preference Implications for Banking Integration

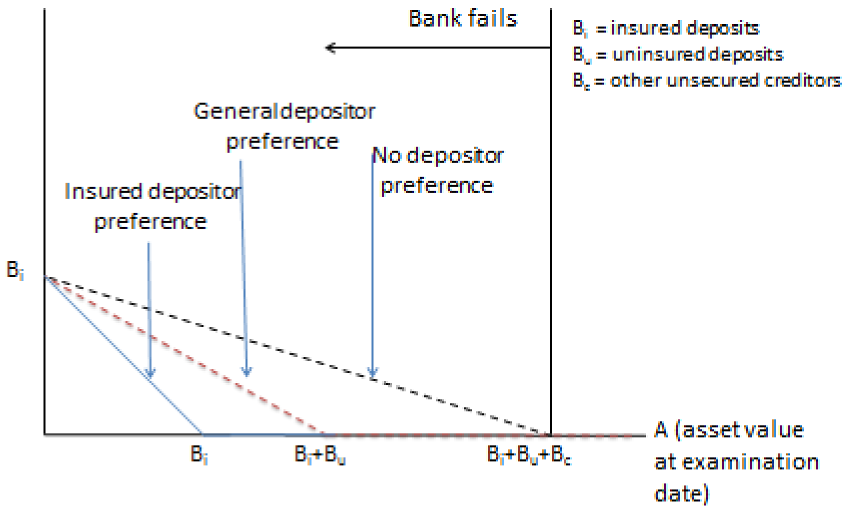
The nature of depositor preference arrangements has a number of important implications relevant to banking sector integration. One relates to the design and pricing of deposit insurance arrangements which are clearly an important consideration in cross-border banking arrangements. A second relates to potential impacts on the cost of bank funding, and bank choices regarding organisational structure. A third relates to the effects on incentives of different categories of creditors to "run" and consequences for bank stability.

Deposit Insurance

Depositor Preference dramatically affects net payouts by the deposit insurer in event of failure. In particular tiered preference may make the probability of the deposit insurer losing money, and the expected loss, in a bank failure infinitesimal (assuming robust supervision), whereas without depositor preference these may be significant. The reason lies in the fact that, in the event of a bank liquidation, the likelihood of the insurer recouping amounts paid out to insured depositors depends on its priority in the queue of creditors with claims on the failed bank's assets. With no preference, the insurer only recoups a pro rata share of assets proportional to the size of insured deposits relative to other creditors. At the other extreme, under tiered (or insured depositor) preference, the insurer has first claim on the failed bank's assets and thus will (for a given level of assets available to creditors) recoup a larger amount.

Figure 2 illustrates, within the context of an option pricing framework, where it is assumed that the solvency of the bank is assessed at an examination date, eg at the end of a one year horizon. If assets at that date exceed creditor claims, the bank is solvent and continues operations. If not, the bank fails, the insurer pays out insured depositors and becomes a claimant on the remaining assets. In the case of tiered/insured depositor preference it is only if the bank's assets are below B_i, (the amount owed to insured depositors) that the insurer will not recoup all it has paid out. In the case of general depositor preference, remaining bank assets need to be in excess of B_i+B_u (amount owed to insured and uninsured depositors) for the insurer to recoup the amount paid out. If assets are below this amount, the insurer only gets a pro-rata share of the assets which is less than the amount paid out, with the net payout increasing as the value of assets remaining falls. In the case of no depositor preference, the insurer faces a more substantial risk of net losses.

Figure 2: Net Insurer Payouts under Different Preference Arrangements



It is possible to compare the "actuarially fair price" of deposit insurance under the alternative depositor preference arrangements, reflected in the net payout schedules of Figure 1. Davis (2015) demonstrates how, for reasonable assumptions, the "fair" price is reduced substantially from the price under no preference when general depositor preference applies, and become infinitesimal if tiered preference applies. The intuition is straightforward. Consider, for example a bank which has $30 of insured deposits, $30 of uninsured deposits, $30 of other unsecured creditors (bond holders) and $10 of equity capital. When asset values fall below $100 the bank fails. But under tiered/insured depositor preference, asset values would need to have fallen to below $30 before the insurer faces a net loss. In contrast, without depositor preference, the insurer would be subject to losses at all levels of asset value below $100.

These results depend on the composition of bank balance sheets, and it is worth noting that there are substantial differences between ASEAN banking systems in this respect. In some jurisdictions, funding is primarily by way of deposits, whereas in others non-deposit funding is significant. Table 4 illustrates the differences across the Asian region.

Table 4: Asia - Bank Reliance on Deposit Financing (2013)

	Bank (Domestic) Assets / GDP	Bank Deposit / GDP	Deposits / (Domestic) Assets
Vietnam	91.6	12.1	0.1
China	128.5	45.9	0.4
Australia	121.7	94.0	0.8
Korea, Rep.	111.8	95.9	0.9
Singapore	120.0	122.6	1.0
Thailand	115.9	118.4	1.0
Cambodia	40.5	43.0	1.1
Indonesia	31.3	34.6	1.1
Malaysia	117.9	130.3	1.1
Bhutan	44.9	51.5	1.1
Bangladesh	45.5	53.6	1.2
Sri Lanka	28.4	33.9	1.2
Nepal	53.8	65.2	1.2
India	49.4	63.2	1.3
Hong Kong SAR, China	204.3	322.6	1.6
Philippines	33.1	54.4	1.6
Papua New Guinea	26.6	47.1	1.8
Pakistan	15.3	29.2	1.9
Brunei Darussalam	33.9	65.2	1.9
Japan	108.4	225.7	2.1
Lao PDR			na
Myanmar			na
New Zealand			na

Source: World Bank Financial Structure Database 2015

Harmonising depositor preference arrangements across the region has implications for the pricing of deposit insurance and relevance of *ex ante* fees which are found in several jurisdictions. Where there is tiered/insured depositor preference and a significant amount of other funding, it is effectively the other creditors (rather than the insurance scheme / taxpayers) who are, by way of subordination, providing the “insurance” to insured depositors. This, in turn has potential implications for bank funding decisions and costs.

Bank Funding Costs and Bank Structure

One consequence of depositor preference (compared to no preference) is that subordinated creditors could be expected to demand higher rates of return to reflect the greater loss they will incur should the bank fail. Of course, this depends on perceptions of whether government “bail out” and protection of all creditors exist. Assuming that is not the case, and in the absence of an explicit deposit insurance scheme, theoretical arguments can be advanced to suggest that the average cost of bank funding would be unchanged if depositor preference arrangements change. The explanation is that the effect is to alter the allocation of default risk among bank creditors, prompting corresponding changes in the relative rates of return they require to provide funding to the bank, but no change in the average. In practice, funding costs could increase following introduction of stronger depositor preference arrangements, because explicit or implicit insurance had already removed any risk premium from those deposit interest rates. While required returns of the now less preferred creditors would increase, there would be no offsetting decline in the returns demanded by depositors. (Of course, a reduction in fees charged for explicit deposit insurance, reflecting its now lower "fair value" could provide some offset). Alternatively, and found to apply in a study of introduction of depositor preference by US States by Danisewicz et al (2015) funding costs could fall due to greater reliance on, now, lower cost uninsured deposits rather than other less preferred, higher cost, creditors.

Consequently there may be incentives to adjust funding patterns and/or organisational structure to minimise those consequences. A number of possible responses can be identified:

- More use of deposit rather than other forms of financing with lower priority ranking
- Transfer of "non-banking" business to an entity outside of the bank such that it can be financed by non-deposit financing which is not junior to depositors
- Increased use of secured /collateralised financing – such as repurchase agreements, covered bonds
- Other increases in asset encumbrance such as through netting and set-off arrangements
- Less preferred creditors shortening the maturity of their investments
- Use of holding company structures such that debt financing is undertaken by the holding company rather than the bank – where it would otherwise be junior to depositor claims.
- Reduced incentive to leverage[13]

These are just some examples of potential consequences of changes in depositor preference arrangements which need to be considered when contemplating changes to increase cross-border harmonisation.

[13] Helberg and Lindset (2013) examine theoretically the potential consequences of introduction of depositor preference arrangements and argue that reduced bank incentive to leverage is one effect.

Financial Stability[14]

Depositor preference arrangements could affect the relative propensity of different creditor groups to "run" on banks in response to adverse news (or perceptions of weakness). To the extent that non-depositors are not able to demand immediate payment of their claims, their exit mechanism is through sales of their claims in secondary markets. This changes the nature of the response from one of a liquidity crisis to a market value crisis – with the value of bonds issued by the bank falling in value, and its refunding cost increasing. But also importantly, the monitoring incentives of different stakeholders are affected, and Danisewicz et al (2015) argue that introduction of depositor preference by a number of US States (prior to national depositor preference laws) led to reductions in bank risk because of an increase in market discipline exerted by the more junior claimants.[15]

6. Implicit Insurance and Resolution Funds

National governments can be prone to respond to financial crises by "bailing-out" insolvent domestic banks (such as by equity injections) to avoid political costs and economic and financial disruption. Not only do such reactions create potential government budgetary problems, public expectations of such likely behaviour undermine market discipline of banks, can create moral hazard, and distort competitive neutrality.

Much of the recent global regulatory agenda, driven by the G20, has been focused on removing perceptions of "too big to fail" and implicit government insurance of banks. Higher capital requirements, total loss absorbing capacity (TLAC) for systemically important banks, and new liquidity requirements developed by the Basel Committee and the Financial Stability Board are among the responses.

In addition, and arguably inconsistent with some of these regulatory changes, a number of jurisdictions have introduced "resolution funds", with the EU developing a single resolution fund to replace national resolution funds of its members (EU, 2014). Such resolution funds are separate from explicit deposit insurance schemes and are established by levies on non-insured liabilities of member banks. The potential inconsistency with regulatory changes lies in the development of proposals for the "bail-in" of certain stakeholders of a distressed (non-viable) bank via mandatory conversion into equity or write-off of contingent capital instruments issued by the bank. Since this would prevent

[14] Depositor Preference arrangements can make it easier for national authorities to transfer some assets and deposit liabilities of a failed bank to a bridge bank.

[15] Birchler (2000) presents a theoretical model to show that imposing a particular form of debt priorities, of the same form as depositor preference, can reduce socially wasteful information gathering by investors.

the failure of the bank, it would – assuming it is politically feasible to achieve - obviate the need for "bail-out", the costs of which provide the rationale for a resolution fund.

Regional banking integration, in which QABs operate branches in host country markets, raises a number of complications in this regard. To the extent that a national government is unwilling to allow uninsured depositors and possibly other creditors to suffer losses due to a failure of banks operating in its jurisdiction, it faces the risk of incurring taxpayer costs from "bailing out" stakeholders in a local branch of a failed foreign bank. Whether a regional resolution fund can, or should, be established to deal with such potential eventualities (and what governance and administrative arrangements would apply) is one among many decisions needing to be considered.

7. Conclusion

This paper has argued that appropriate harmonisation of depositor preference and deposit insurance arrangements is a critical component of proposals for regional banking integration, and that decisions made in that regard have important implications for the development of regional banking markets and regulation. Harmonisation of depositor preference arrangements, including removal of national depositor preference, is needed to ensure true equality of competitive position (via equivalent protection of stakeholders) of branches of QABs operating in other regional markets. Also necessary is some form of harmonisation of deposit insurance schemes such that insurance of local depositors in a branch of a QAB is the same as for a domestic bank. This could be achieved by the foreign QAB branch having membership of the domestic insurance scheme (and that currently occurs in a number of ASEAN jurisdictions) – but premiums would need to reflect risk of the parent bank, not just the local branch position, and the host country insurance fund would be exposed to the supervisory intensity and resolution arrangements of the home country regulator. Alternatively, the foreign QAB branch could be covered under its home country insurance scheme – but this would need to provide equivalent coverage to the foreign scheme, implying harmonisation of scheme coverage among member countries.

Tiered depositor preference, with no national depositor preference (such that depositors in foreign branches rank equally with those at home) would appear to be the simplest approach for facilitating regional harmonisation. That, in turn, reduces the significance of any differences in explicit deposit insurance scheme arrangements across jurisdictions. It does, however, have potentially significant implications for future developments in bank financing and structure and for financial stability which warrant detailed attention.

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