

C L I F F O R D

C H A N C E



**BANK DEPOSITOR
PREFERENCE
REGIMES—
POLICY ADVANTAGES
AND DISADVANTAGES**



— THOUGHT LEADERSHIP

APRIL 2023



BANK DEPOSITOR PREFERENCE REGIMES – POLICY ADVANTAGES AND DISADVANTAGES

The policy debate is again turning to how best to protect depositors with failed banks by ranking their deposits above other senior unsecured creditors in the creditor hierarchy in insolvency. While many jurisdictions already have depositor preference regimes, some do not and others, in particular the EU, are reconsidering their design and scope.

This briefing reviews:

- the types of depositor preference regime that may be operated by banks' home countries;
- the application of depositor preference regimes by host countries in relation to local branches of foreign banks and by home countries in relation to foreign branches of domestic banks;
- the policy advantages and disadvantages of depositor preference regimes; and
- the interplay of the interests of home countries and host countries in, and the impact of industry structure on, the design and application of depositor preference regimes.

The design and application of depositor preference regimes is particularly important in relation to the failure of smaller or medium-sized banks with significant levels of deposit funding, especially where a large part of the deposit base is not covered by deposit insurance.

1. Summary overview

A depositor preference regime is not a substitute for deposit insurance. Insured depositors need the assurance that they will receive a prompt pay-out of their deposit if the bank fails, independent of the resources of the bank itself, to reduce the risk of a 'run' by those depositors.

However, a depositor preference regime can facilitate the resolution of smaller or medium-sized failed banks that are predominantly funded by deposits. These banks may not be so large or complex as to make bail-in the preferred resolution strategy. Instead, the preferred strategy may be to transfer the bank's book of deposits to a purchaser so as to ensure the continuation of the bank's critical functions. A depositor preference regime can facilitate a deposit book transfer by reducing the risks of claims by other senior unsecured creditors that they are worse off as a result of the transfer than they would have been if the failed bank's business had been wound up in liquidation (see the hypothetical worked examples in Annex A).

A depositor preference regime also reduces the losses of preferred depositors of a failed bank whose business is wound up in liquidation. It protects the interests of a deposit guarantee scheme that pays out insured depositors and takes over their claims against the failed bank (by subrogation or otherwise). It may also improve market discipline by enhancing the incentives for non-preferred depositors and other senior unsecured creditors to monitor the credit risk of a bank.

On the other hand, depositor preference can also limit the ability of deposit guarantee schemes to contribute resources to a resolution, can aggravate moral hazard and, by increasing the risk of loss to non-preferred depositors or other senior creditors, can increase the risk that those other depositors or creditors will 'run,' seek collateral for their claims or take other action to protect their interests which may adversely affect the interests of preferred depositors.

The design of the depositor preference regime will also affect the impact of the scheme. Broadening the deposit scope of the preference to cover deposits other than insured deposits may facilitate the use of a deposit transfer scheme to transfer all (or more of) the deposits of a failed bank to a purchaser. It may also improve the recoveries of other preferred depositors in a liquidation.

However, broadening the deposit scope of preferred deposits may increase the risk of losses to the deposit guarantee scheme in a liquidation (unless the depositor preference regime is a multi-tier regime in which insured deposits rank above other preferred deposits) and will exacerbate the impact of the regime on other non-preferred creditors.

In particular, if the territorial scope of depositor preference is restricted to depositors at a bank's branches in its home country, broadening the deposit scope of that preference will also exacerbate the impact of the scheme on depositors at foreign branches of the bank. Preferring deposits at a bank's domestic branches over deposits at its foreign branches discriminates against the depositors at the foreign branches based on the location of their claims.¹ Host countries may seek to mitigate the impact of preferential treatment for deposits at domestic branches of foreign banks by restricting the operations of foreign banks in the host country or adopting other measures which may adversely affect the recovery or resolution of foreign banks.

The bank's home country may mitigate the adverse impact of a depositor preference on depositors at foreign branches by including those deposits within the territorial scope of the preference. However, this may increase the risks of claims by those depositors that they have been disadvantaged in

circumstances where it is not practical to transfer those foreign deposits to the purchaser under a home country deposit book transfer scheme.

States which host local branches of foreign banks must also consider whether and, if so, how their own depositor preference regime will apply in local insolvency proceedings in relation to a foreign bank. This will be influenced by the way in which local insolvency proceedings operate in relation to foreign banks with local branches and the form of their home country depositor preference regime for domestic banks.

The structure of the local banking industry will also have an impact on the decision to adopt, and the design of, any depositor preference regime. In some cases, depositor preference may be relatively unimportant, e.g., if the predominant preferred resolution strategy is bail-in and there are no local branches of foreign banks. In other cases, the structure of the local industry may mean that depositor preference plays a more important role.

See the glossary in Annex B for terminology used in this paper.

2. Design of home country depositor preference regime

According to the International Association of Deposit Insurers, in 2019, 71% of its members operated under legal frameworks with some form of depositor preference regime.²

However, these regimes can take different forms:

¹ Paragraph 7.4 of the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (available [here](#)) states that "National laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim or the jurisdiction where it is payable". However, DGSs may not cover deposits at foreign branches of a bank and depositor preference regimes may not apply or may not apply equally to deposits at foreign branches of a bank. Similarly, host country DGSs and depositor preference regimes may exclude deposits at branches of the bank outside the host country.

² Research Unit of International Association of Deposit Insurers, Depositor Preference and Implications for Deposit Insurance (October 2020, available [here](#)).

Deposit scope	Territorial scope	Tiering
<p>Narrow: preference only applies to insured deposits.</p> <p>Intermediate: preference applies to insured deposits and some other categories of deposits.</p> <p>Broad: preference applies to all deposits.</p>	<p>Domestic-only: preference only applies to deposits at the domestic branches of the bank.</p> <p>Domestic/foreign: preference applies to deposits at both domestic and foreign branches of the bank.*</p>	<p>Single tier: all preferred deposits rank <i>pari passu</i> in priority to senior unsecured creditors.</p> <p>Multi-tier: insured deposits (and possibly some other classes of preferred deposits) rank ahead of other classes of preferred deposits (but all preferred deposits rank in priority to senior unsecured creditors).*</p>
<p>Notes</p> <p>Definitions of deposit may also differ, e.g., as to whether claims represented by certificates of deposit or other kinds of transferable debt instruments or claims of particular types of creditors, such as related parties or other banks or financial institutions, are regarded as deposits for these purposes.</p> <p>*These categories are unlikely to be relevant to narrow depositor preference regimes unless the bank's home country DGS also covers deposits at foreign branches of the bank.</p>		

For example, the US depositor preference regime is a broad, domestic-only, single-tier regime in that all deposits at a bank are preferred deposits unless they are payable solely at an office outside the US.³

In contrast, the current EU and UK depositor preference regimes are intermediate, domestic/foreign, multi-tier regimes in that:

- the class of preferred deposits covers both insured deposits and deposits of individuals and SMEs to the extent that they are not insured deposits;
- the class of preferred deposits includes deposits held by individuals and SMEs at foreign (third-country) branches of EU banks and foreign (non-UK) branches of UK banks;
- insured deposits rank ahead of other preferred deposits; and

- deposits that are not preferred deposits rank *pari passu* with other senior unsecured creditors.⁴

The European Commission has consulted on proposals to change the EU depositor preference regime to a broad, domestic/foreign, single-tier regime in which all deposits are preferred deposits, with a view to further harmonising the EU treatment of deposits in insolvency and to facilitate the use of the DGS in resolution and in insolvency.⁵ The EU Single Resolution Board and European Central Bank have supported this proposal.⁶

The design of the depositor preference regime will also be influenced by the design of the DGS and in particular by:

- the breadth of the classes of depositors covered by the DGS (e.g., whether the scheme covers deposits by governmental entities, financial institutions or non-financial companies);

³ See section 11(d)(11)(A) Federal Deposit Insurance Act (available [here](#)) and §330.3(e)(1) Federal Deposit Insurance Regulations (available [here](#)).

⁴ See Article 108 (ranking in insolvency hierarchy) of the EU Bank Recovery and Resolution Directive (available [here](#)) and Schedule 6 (categories of preferential debts) to the UK Insolvency Act 2006 (available [here](#)). However, some EU Member States may also treat other classes of deposits as preferred deposits.

⁵ European Commission, Targeted Consultation: Review of the Crisis Management and Deposit Insurance Framework (January 2021, available [here](#)). The proposal does not explicitly state that the expanded depositor preference regime would be a domestic/foreign regime but only that such a regime ensures that all depositors with a bank are preferred depositors.

⁶ The EU Single Resolution Board, A blueprint for the CMDI framework review (May 2021, available [here](#)) and ECB contribution to the European Commission's targeted consultation on the review of the crisis management and deposit insurance framework (July 2021, available [here](#)).

- the level of coverage of the DGS (i.e., the financial limit on the deposits covered by the scheme); and
- the territorial scope of the DGS (i.e., whether it only covers deposits at domestic branches of the bank or whether it also covers depositors at foreign branches).

These design features of a DGS will also affect the ratio of insured deposits, and thus of preferred deposits, to the total deposits of the bank and the impact of the depositor preference regime on other depositors, including depositors at foreign branches of the bank, and on other creditors of the bank.

3. Host country depositor preference regimes

Different states also have different approaches to the insolvency of foreign banks with local branches and to the application of host country depositor preference regimes in local insolvency proceedings in relation to those banks.⁷ For example, the local insolvency regime for foreign banks with local branches may take one of the following forms (simplified for ease of presentation):

- **Deference to home country insolvency proceedings.** No local proceedings can be started against the foreign bank or, to the extent that local proceedings are permitted, the regime defers to the home country regime as regards the distribution of net realisations (e.g., the regime that applies to EU banks within the EU under the Credit Institutions (Winding up) Directive⁸). In this case, a host country depositor preference regime does not serve any purpose.
- **Local proceedings without a host country depositor preference regime or a host country creditor preference regime.** Local proceedings can be started against the foreign bank and any net realisations in those

proceedings are distributed to all creditors of the insolvent bank, including creditors of the head office and other branches of the bank, in accordance with the local insolvency creditor hierarchy and subject to any local preferential claims, but without giving any preference to depositors at the local branch (e.g., the UK regime that applied to foreign banks before the introduction of the UK depositor preference regime in 2013).

- **Local proceedings with a host country depositor preference regime but without a host country creditor preference regime.** Local proceedings can be started against the foreign bank and any net realisations in those proceedings are distributed to all creditors of the insolvent bank, including creditors of the head office and other branches of the bank, in accordance with the local insolvency creditor hierarchy but subject to any local preferential claims, including the preferential claims of preferred depositors under a host country depositor preference regime (e.g., the UK regime that currently applies to foreign banks).
- **Local proceedings with a host country creditor preference regime (with or without a host country depositor preference regime).** Local proceedings can be started against the foreign bank and net realisations in those proceedings are distributed first to creditors of the local branch according to the local insolvency creditor hierarchy and subject to any local preferential claims (including the preferential claims of preferred depositors under a host country depositor preference regime, if one exists), with distributions to other creditors, or to the home country liquidator or receiver, only if the depositors at, and other creditors of, the branch have been paid in full (e.g., the New York regime that applies to local branches of foreign banks).

⁷ In relation to the EU, references to foreign banks are to banks whose head office is in a third country. The EU Bank Recovery and Resolution Directive (above) and the EU Credit Institutions (Winding Up) Directive (available [here](#)) ensure that, for EU banks, liquidation and resolution and other reorganisation proceedings are applied across the EU in accordance with the law of the bank's home country (with only limited exceptions). However, EU Member States have different approaches to the insolvency of third-country banks with local branches.

⁸ The EU has not harmonised the local insolvency regimes in Member States which host local branches of foreign (non-EU) banks.

There are also other ways in which host countries may secure protection for depositors at local branches of foreign banks, even if the host country insolvency regime defers to the home country regime or does not include a host country depositor preference regime or a host country creditor preference regime. For example, host countries might require a local branch to hold branch endowment capital or other assets in a segregated account with the local central bank or a local financial institution subject to a security interest or other similar arrangement in favour of depositors at, or creditors of, the local branch.⁹

However, even without any such arrangements, requiring a local branch to hold branch endowment capital in the host country or otherwise to maintain specified levels of assets in the host country may bolster the protection provided to local depositors at, or other creditors of, the local branch of a failed foreign bank if there is a host country depositor preference regime or a host

country creditor preference regime. Such requirements may increase the likelihood that there will be net realisations in any local insolvency proceedings that are available for distribution to preferred depositors or branch creditors under a host country depositor preference regime or a host country creditor preference regime – but would provide little or no protection to depositors at, or other creditors of, a local branch in the absence of such a regime (as any net realisations from locally held assets in local proceedings would then be distributed to the bank's creditors generally without any preference for depositors at the local branch). Such requirements may also reduce the ability of the foreign bank freely to deploy its resources to recover from financial stress and may impede any home country resolution action.¹⁰

⁹ See, e.g., new Articles 48e(3), 48f(3) and 48g of the EU Capital Requirements Directive proposed to be added by Article 1(8) of the European Commission's legislative proposal for a Directive amending the Capital Requirements Directive as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks (COM/2021/663 final, [here](#)).

¹⁰ Compare D. Wilson Erwin, *The Risky Business of Ring-Fencing* (last revised 2019, available [here](#)).

4. Policy advantages of a home country depositor preference regime

Discussion	Other considerations
Facilitates deposit book transfers	
<p>A depositor preference regime may reduce the risk that a deposit book transfer gives rise to NCWOL claims (or other legal challenges) by other senior unsecured creditors where the purchaser does not assume the bank's liabilities to those creditors.¹¹ See hypothetical worked examples in Annex A.</p>	<p>It may be easier to execute a deposit book transfer under an intermediate or a broad depositor preference regime. It may not be practical to exclude some non-preferred deposits from the transfer and including non-preferred deposits in the transfer may increase the risk of NCWOL claims (or other legal challenges) from other creditors. See the hypothetical worked examples in the Annex for an illustration of this.</p> <p>A domestic/foreign depositor preference regime may give rise to NCWOL claims (or other legal challenges) by depositors at foreign branches of the bank if their claims cannot be transferred to the purchaser under the deposit book transfer. However, a domestic-only depositor preference regime discriminates against depositors at foreign branches and increases the risk that host countries take steps to protect their interests (see below).</p>

¹¹ Depositor preference may also facilitate the use of a deposit book transfer to transfer deposits to a bridge bank. However, it may then also be necessary to consider the impact of a transfer of sufficient assets to ensure that the bridge bank has a surplus of assets over liabilities to provide capital for its ongoing operation. Depositor preference is less likely to be relevant in relation to resolution by bail-in of large banks with adequate subordinated loss-absorbing capacity except in the unlikely case where bail-in is used to reduce the claims of senior unsecured creditors after writing down the claims of those providing subordinated loss-absorbing capacity. In that case, depositor preference would protect preferred depositors from bail-in unless and until the claims of senior non-preferred creditors have been written down (at least if the bail-in rules require write-downs to be applied in the order of the insolvency hierarchy).

Discussion	Other considerations
Improves the recoveries of the DGS in a liquidation	
<p>A depositor preference regime will improve the recoveries of insured depositors – and thus the DGS – in a liquidation where net realisations are insufficient to pay all senior unsecured creditors in full (and will shift losses to non-preferred depositors and other senior unsecured creditors). This may:</p> <ul style="list-style-type: none"> • reduce the need for <i>ex ante</i> funding of the DGS and the level of <i>ex ante</i> premiums charged to member banks;¹² • reduce the risk that the funding mechanism of the DGS will transmit the shock of the failure of one or more banks to other member banks that ultimately fund the DGS;¹³ and • be fairer to the DGS and the other member banks that ultimately fund the DGS and that are (in effect) 'involuntary creditors' of a failed bank (with only a limited ability to protect themselves against the risk of loss arising from the failure). 	<p><i>Ex ante</i> funding may still be necessary to ensure that the DGS has adequate liquidity to ensure a rapid pay-out of depositors¹⁴ and <i>ex ante</i> premiums may – at least if the premiums are risk-based – deter 'free riding' by member banks on a DGS.</p> <p>An intermediate or a broad depositor preference regime (or a domestic/foreign depositor preference regime) will adversely affect the recoveries of insured depositors – and thus the DGS – in a liquidation where net realisations are insufficient to pay all preferred depositors in full, unless the regime is also a multi-tier regime in which insured depositors rank ahead of all other preferred depositors.</p>
Improves the recoveries of other preferred depositors in a liquidation	
<p>An intermediate or a broad depositor preference regime will improve the recoveries of preferred depositors other than insured depositors in a liquidation where net realisations are insufficient to pay all senior unsecured creditors in full. This may:</p> <ul style="list-style-type: none"> • reduce the propensity of those depositors to 'run'; and • reduce the bank's cost of funding via those deposits. <p>However, this depends on preferred uninsured depositors having a sufficient level of understanding of the impact of the insolvency hierarchy on their likely recoveries (or this information being made visible via differential third-party credit ratings).</p>	<p>See above regarding the impact of an intermediate or a broad depositor preference regime on the recoveries of insured depositors.</p> <p>See below as regards the impact on depositors at foreign branches.</p> <p>A depositor preference regime may not prevent losses being borne by depositors in the case of deposit-funded retail banks where the bulk of claims are for insured or other preferred deposits. Where a bank is mainly funded by deposits, it may not be possible to prevent some depositors or the DGS incurring losses if the bank fails (unless a resolution fund or the state absorbs those losses).</p>

12 Reducing *ex ante* funding also reduces the deadweight cost of a DGS resulting from requirements to invest DGS funds in low-risk assets (often government bonds).

13 This is most likely to be a factor where the DGS can call for *ex post* funding by member banks to replenish a fund depleted by losses incurred by the DGS as a result of reimbursement of depositors or contributions to resolution action. However, regimes that rely exclusively on *ex ante* funding may also need to increase annual contributions significantly where the fund has been depleted by one more or bank failures and this may also transmit the shock of a failure of one or more banks to other member banks.

14 However, the DGS may be able to use the liquid assets of the failed bank or borrow against the security of the assets of the failed bank or its claims on member firms to provide a rapid pay-out.

Discussion	Other considerations
Improves market discipline	
Because a depositor preference regime may reduce the recoveries of non-preferred depositors and other creditors in a liquidation, it increases their incentives to monitor the credit risk of the bank and to take action to prevent excessive risk-taking (e.g., by seeking appropriate compensation for the increased risks that they face or not transacting with the bank).	These benefits may be limited by the lack of information about the volume of preferred deposits. See below for potential adverse impacts of market discipline.

5. Policy disadvantages of a home country depositor preference regime

Discussion	Other considerations
Reduces the ability of a DGS to contribute funds to a resolution	
Some resolution regimes limit the amount that a DGS can contribute to facilitate a resolution of a failed bank so that it must not exceed the amount of the loss the DGS would have incurred if the bank had been liquidated in insolvency proceedings. ¹⁵ Depositor preference regimes improve the recovery of the DGS in liquidation and thereby reduce the extent to which it can contribute resources to a resolution where such a limit applies.	
Aggravates moral hazard of behaviour of uninsured preferred depositors	
The improvement of the recoveries of preferred depositors in a liquidation may enhance a belief by preferred depositors that their deposits will not bear any losses if the bank fails, thus reducing their incentives to take the risk of loss into account when selecting banks to hold their deposits.	<p>This is more likely to be the case in relation to an intermediate or a broad depositor preference regime (as insured depositors are already protected from the risk of loss by the DGS).</p> <p>Preferred depositors that are not insured depositors still risk loss of prompt access to their funds in the event of insolvency proceedings which may offset the moral hazard resulting from the preference.</p>

¹⁵ See, e.g., Article 109 EU Bank Recovery and Resolution Directive (above).

Discussion	Other considerations
Adverse impact on behaviour of non-preferred depositors and other creditors	
<p>Any depositor preference regime will have an adverse impact on the recoveries of non-preferred depositors and other senior unsecured creditors in a liquidation where net realisations are insufficient to pay all senior unsecured creditors in full. This may:</p> <ul style="list-style-type: none"> • increase the propensity of those depositors and creditors to 'run'; • increase the bank's cost of, or access to, non-preferred deposit and other unsecured funding; and • cause those other depositors or creditors to take other measures to protect themselves against the risk of loss (e.g., by taking collateral or otherwise seeking to ring-fence assets available to them if the bank fails via securitisation or covered bond financing). This may have an adverse impact on the recoveries of preferred depositors and increase the fragility of the bank in the face of shocks (e.g., because of the reduced ability to borrow against assets). <p>Under a multi-tier depositor preference regime, similar issues arise in relation to depositors ranking below the first ranked class of deposits.</p> <p>To address these issues, banks may restructure to carry on a greater part of their business in entities which are not subject to depositor preference (which may reduce the assets available for depositors and have an adverse impact on efficiency and robustness).</p>	<p>An intermediate or a broad depositor preference regime will have a greater adverse impact on non-preferred depositors and other creditors than a narrow depositor preference regime.</p> <p>These adverse impacts may be exacerbated by non-preferred depositors' and other creditors' lack of information on the volume of a bank's preferred deposits. This information may not be available from the bank's existing public disclosures.¹⁶ Uncertainty as to the volume of preferred deposits may cause non-preferred depositors or other creditors to assume that they are subject to a greater degree of subordination to preferred depositors than may in fact be the case.</p> <p>However, the adverse impact on non-preferred depositors and other creditors will be reduced by requirements on the bank to maintain high levels of loss-absorbing liabilities that rank below senior unsecured creditors in the creditor hierarchy (and thus these adverse impacts may be less relevant to banks for which the primary resolution strategy is bail-in of subordinated loss-absorbing liabilities).</p>

¹⁶ These are similar to the information issues that arise in relation to the levels of a bank's asset encumbrances (depositor preference has a similar impact on non-preferred creditors as asset encumbrances have on unsecured creditors).

Discussion	Other considerations
Reduces the recoveries of depositors at foreign branches of the bank	
<p>A domestic depositor preference regime or a domestic-foreign multi-tier depositor preference regime under which deposits at domestic branches rank ahead of other preferred deposits will reduce the recoveries of depositors at foreign branches where net realisations in a home country liquidation are insufficient to pay all depositors in full.¹⁷ This may:</p> <ul style="list-style-type: none"> • have an adverse impact on the host country DGS (and its member banks); • increase the propensity of depositors at foreign branches to 'run'; • increase the bank's cost of, or access to, funding via deposits at foreign branches; and • cause those depositors to take other measures to protect themselves against the risk of loss (e.g., by taking collateral or otherwise seeking to ring-fence assets available to them if the bank fails) which may have an adverse impact on the recoveries of preferred depositors. 	<p>Host countries may seek to mitigate the impact of preferential treatment for deposits at domestic branches of foreign banks by:</p> <ul style="list-style-type: none"> • requiring foreign banks to operate through local subsidiaries instead of local branches; • restricting the ability of local branches to take insured or other deposits; • maintaining a host country depositor preference regime and/or a host country creditor preference regime; and/or • requiring a local branch to maintain branch endowment capital or otherwise to maintain specified levels of locally held assets. <p>However, the last measure may not be an effective mitigant in the absence of a host country depositor preference regime and/or a host country creditor preference regime.</p> <p>An intermediate or broad, domestic/foreign, single tier home country depositor preference regime mitigates the impact of the regime on depositors at foreign branches. However, it may adversely affect the ability to execute a deposit book transfer which does not include deposits at foreign branches, because those depositors may have NCWOL claims as a result of the effective preference given to depositors at domestic branches.</p>

¹⁷ See, e.g., the concerns expressed in the UK Financial Services Authority Consultation Paper 12/23, Addressing the implications of non-EEA national depositor preference regimes (April 2013, available [here](#)).

6. Policy advantages and disadvantages of a host country depositor preference regime

As already noted, there will be little need to consider the policy advantages and disadvantages of a host country depositor preference regime if the host country:

- requires foreign banks to operate in the host country through local subsidiaries rather than local branches; or
- has an insolvency regime for local branches of foreign banks that defers to the foreign bank's home country insolvency regime.

However, where foreign banks can take deposits through local branches and can be liquidated under local insolvency proceedings, the policy advantages and disadvantages of a host country depositor preference regime are similar, as regards the impact of the regime on a host country DGS and depositors at, and other creditors of, a local branch of a foreign bank, to the policy and advantages and disadvantages discussed above of a home country depositor preference regime, as regards the impact of a home country regime on the home country DGS and depositors at, and other creditors of, a bank generally. In particular, a host country depositor preference regime may facilitate a host country deposit book transfer where the host country's resolution or insolvency regime allows a deposit book transfer of deposits at a local branch of a failed foreign bank as one way of ensuring the continuity of the critical functions of that branch.¹⁸

A host country depositor preference regime also has the policy advantage, from the perspective of the host country, of offsetting the potential discriminatory impact of a home country (domestic-only or multi-tier) depositor preference regime on the host country DGS and depositors at the branch in the circumstance where the foreign bank goes into liquidation in its home country (unless this is accompanied by a deposit book transfer

scheme in the home country which also transfers depositors at the local branch to a purchaser). A host country depositor preference regime may improve the recoveries of depositors at the local branch in the liquidation of the failed bank, assuming that the liquidator in any local insolvency proceedings can realise assets to meet their preferred claims. This may also reduce their ability to make NCWOL claims (or other legal challenges) resulting from discriminatory treatment in the home country (depending on whether the comparison of outcomes in the home country for the purposes of those claims takes account of the impact of local insolvency proceedings in the host country).

On the other hand, a host country depositor preference regime has the policy disadvantage, from the perspective of the bank's home country, of potentially incentivising the host country to take premature independent resolution or other action (such as a deposit book transfer or local insolvency proceedings) in relation to a local branch in a way that 'ring-fences' local branch assets for the benefit of local depositors and undermines the home country recovery or resolution strategy (especially where that strategy takes the form of a 'single point of entry' bail-in or similar action with respect to the bank's creditors). Host countries may also seek to bolster the effectiveness of their host country depositor preference regimes or host country creditor preference regimes by requiring the foreign bank to maintain higher levels of branch endowment capital or other locally held assets in ways that may reduce the flexibility of the foreign bank to recover from financial stress and may impede any home country resolution action.

7. Impact of industry structure

The structure of the local banking industry will also affect the decision whether to adopt a depositor preference regime and, if so, the design of the regime.

Where a country has only a few large banks and bail-in is the preferred resolution strategy for those banks (which

¹⁸ See, e.g., Article 96 of the EU Bank Recovery and Resolution Directive (above) and section 89JA UK Banking Act 2009 (available [here](#)).

are all required to maintain sufficient subordinated loss-absorbing capacity to enable the implementation of that strategy), the potential adverse impacts of a depositor preference regime on those banks may outweigh the potential advantages of such a regime. Those adverse impacts may be exacerbated where the major banking groups are structurally separated into retail deposit funded banks with high levels of preferred deposits and wholesale banks with low levels of preferred deposits.

In contrast, states with many small and medium-sized banks may be more concerned with how to resolve a failure of those banks without significant cost to their DGS, even if a depositor preference regime may have some adverse impacts on their large banks for which bail-in is the preferred resolution strategy

Home countries may also be less concerned about the impact of their depositor preference regime on depositors at the foreign branches of their banks if the only banks with foreign branches are large banks for which bail-in is the preferred resolution strategy. However, host countries which allow foreign banks to operate through local branches may have concerns about the potential impact of the home country depositor preference on depositors at those branches and the host country DGS, even if the home country's preferred resolution strategy for those banks is a bail-in (which would also benefit depositors at the local branch).

The host country authorities will be concerned that the preferred resolution strategy may, in the event, not be followed or may fail, shifting the burden of protecting local depositors back to the host country.

8. Conclusion

Authorities have a complex set of choices when deciding to adopt and, if so, how to design a depositor preference regime. However, most countries have concluded that the advantages of a depositor preference regime outweigh the potential disadvantages, in particular because depositor preference regimes facilitate the use of deposit book transfers to resolve failed smaller and medium-sized banks and reduce the costs to the DGS and other preferred depositors if those banks have to be liquidated. In addition, after the global financial crisis, many countries have reduced the extent to which foreign banks can operate through local branches, which reduces the complexities arising from the interplay of home country and branch depositor preference regimes.

Further reading from Clifford Chance:

- *Depositor preference issues* (2011, available [here](#))
- *Depositor preference in the G20* (2011, available [here](#))
- *Deposits, deposit guarantee schemes and bank resolution* (2013, available [here](#))



ANNEX A

DEPOSIT BOOK TRANSFER – HYPOTHETICAL WORKED EXAMPLES

This Annex sets out hypothetical worked examples illustrating how a depositor preference scheme may reduce the risk that a deposit book transfer gives rise to NCWOL claims (or other legal challenges) by other senior unsecured creditors of a failed bank where the purchaser does not assume the bank's liabilities to those creditors. The examples assume that the bank is predominantly funded by deposits and suffers a significant loss event after which its home country resolution authority, liquidator or receiver or other authority uses a deposit book transfer to transfer all the bank's deposits to a purchaser to ensure the continuation of the bank's critical functions.

Bank's balance sheet before loss event

Liabilities		Assets	
Deposits	70	Loans and other assets	100
Other senior unsecured liabilities	20		
Equity and subordinated liabilities	10		
Total	100	Total	100

Bank's balance sheet after loss event (fair value of assets)

Liabilities		Assets	
Deposits	70	Loans and other assets	85
Other senior unsecured liabilities	20		
Equity and subordinated liabilities	(5)		
Total	85	Total	85

Bank's balance sheet after deposit book transfer

After the loss event, a purchaser assumes the bank's liability for all its deposits in consideration of a transfer of assets of the failed bank with a fair value equal to the amount of the deposits.¹⁹ The failed bank is then placed in liquidation.

Liabilities		Assets	
Deposits	0	Loans and other assets	15
Other senior unsecured liabilities	20		
Equity and subordinated liabilities	(5)		
Total	15	Total	15

Comparison of senior creditors' recovery levels

Table 1 below compares the level of recovery of senior creditors in the liquidation of the bank after the deposit book transfer with their level of recovery in a hypothetical liquidation of the bank assuming that there had been no deposit book transfer (disregarding any liquidation expenses), showing how this varies depending on the coverage level of the depositor preference regime.

¹⁹ Alternatively, a resolution fund or the DGS might pay the purchaser an amount equal to the amount of the deposits and have a preferred claim in the liquidation of the bank for the amount paid. This does not affect the calculations below as the assets available for other senior unsecured creditors would remain the same.

Table 1

	Preferred deposit coverage*	Senior creditors [†]	Assets available for senior creditors [‡]	Senior creditors' recovery level
After deposit book transfer	N/A	20	15	75%
No deposit book transfer (hypothetical liquidation)	0%	90	85	94%
	50%	55	50	91%
	75%	37.5	32.5	87%
	90%	27	22	81%
	100%	20	15	75%

Notes

*Percentage of preferred deposits to total deposits (0% indicates no depositor preference regime and 100% indicates that the depositor preference regime covers all deposits).

†In a hypothetical liquidation, excluding preferred depositors but including any non-preferred depositors.

‡After recoveries of preferred depositors.

Red indicates that senior creditors may have NCWOL claims (or other legal challenges) as a result of the deposit book transfer.

Table 2 makes the same comparison as in Table 1 but assumes that:

- The transferee of the deposit book effectively pays a premium (2) for the transfer so that the transferee only receives assets with a fair value of 68 (and the bank retains assets with a fair value of 17 before liquidation expenses).
- The liquidation expenses of the bank are higher (4) if there is no deposit book transfer but lower (1) if there is a deposit book transfer.

Table 2

	Preferred deposit coverage*	Senior creditors [†]	Assets available for senior creditors [‡]	Senior creditors' recovery level
After deposit book transfer	N/A	20	16	80%
No deposit book transfer (hypothetical liquidation)	0%	90	81	90%
	50%	55	46	84%
	75%	37.5	28.5	76%
	90%	27	18	67%
	100%	20	11	55%

Notes

*Percentage of preferred deposits to total deposits (0% indicates no depositor preference regime and 100% indicates that the depositor preference regime covers all deposits).

†In a hypothetical liquidation, excluding preferred depositors but including any non-preferred depositors.

‡After recoveries of preferred depositors and deduction of liquidation expenses.

Red indicates that senior creditors may have NCWOL claims (or other legal challenges) as a result of the deposit book transfer.

The tables assume that all senior creditors are unsecured, that there are no other claims ranking ahead of depositors (e.g., claims of employees or tax authorities), that assets are realised at their fair value at the time of the bank's failure and that the bank has no foreign branches and is not subject to insolvency proceedings outside its home country.

These tables disregard other possible effects of a liquidation, e.g., there may be additional liabilities that crystallise in the liquidation, assets may be realised at lower prices in a liquidation than if sold in a deposit book transfer, creditors may be able to prove for interest on their claims and a liquidation may benefit from income received on the bank's assets.

Discussion

The above illustrates that a depositor preference regime may reduce the risk that a deposit book transfer gives to rise to NCWOL claims (or similar legal challenges) by senior unsecured creditors, even if the depositor preference regime does not cover 100% of deposits. However, this is contingent on other factors such as the consideration paid to the transferee of the deposits for its assumption of the failed bank's liability for the deposits and the relative levels of liquidation expenses.

ANNEX B GLOSSARY

bail-in	A resolution tool under which a failed bank is recapitalised by the reduction of the amount of its liabilities, but otherwise continues to perform its critical functions as a going concern.
deposit book transfer	A transaction executed by a resolution authority, receiver or liquidator or other authority under which a commercial purchaser (or a bridge bank) assumes the liabilities of a failed bank in respect of all or some of its deposits, in consideration of a payment or transfer of assets from the failed bank, the DGS or a resolution fund (sometimes called a purchase and assumption transaction).
depositor preference regime	A regime under which some or all depositors at a bank rank above other senior unsecured creditors of the bank in relation to the distribution of assets in insolvency proceedings relating to the bank in the bank's home country.
DGS	A deposit guarantee or similar scheme.
domestic branch	In relation to a bank, a branch of the bank in its home country (or, in relation to an EU bank, a branch of the bank in the EU).
EU bank	A bank incorporated and authorised in an EU Member State.
foreign bank	In relation to a jurisdiction, a bank that has a branch in that jurisdiction and whose home country is in another jurisdiction (or, in relation to the EU, a bank that has a branch in a Member State and whose head office is in a third country).
foreign branch	In relation to a bank, a branch of the bank a jurisdiction other than its home country (or, in relation to an EU bank, a branch of the bank in a third country).
home country	In relation to a bank, the jurisdiction in which the bank is incorporated and authorised (or, in relation to an EU bank, the EU).
host country	A jurisdiction in which a foreign bank maintains a branch.
host country creditor preference regime	A regime under which net realisations in local proceedings against a foreign bank in a host country are distributed first to creditors of the local branch according to the local insolvency creditor hierarchy (and subject to any local preferential claims), with distributions to other creditors only if the branch creditors have been paid in full.
host country depositor preference regime	A regime under which some or all depositors at a local branch of a foreign bank rank above other senior unsecured creditors in relation to the distribution of assets in local proceedings relating to the bank in the host country.
insolvency proceedings	Proceedings involving the winding up of an insolvent bank and the distribution of its assets to its creditors.
insured deposit	A deposit covered by a DGS to the extent of that coverage (including a claim of a DGS against the bank where the DGS has paid the depositor under the scheme and is able to enforce the claim of the depositor against the bank).
local branch	In relation to a jurisdiction, a branch of a foreign bank in that jurisdiction.
local proceedings	Insolvency proceedings in a host country in respect of a foreign bank with a local branch in that host country.
NCWOL claim	A claim by creditors of a failed bank that a resolution or similar action results in their receiving worse treatment than they would have received if the bank had been wound up in insolvency proceedings and its assets distributed to creditors in accordance with the creditor hierarchy.
net realisations	The amounts realised in a liquidation of a bank after paying liquidation expenses and any claims preferred over the claims of depositors.
preferred deposit	A deposit given a preference under a depositor preference regime.
SMEs	Small and medium-sized enterprises.

CONTACTS



Chris Bates
Special Counsel,
Consultant
London
T: +44 207006 1041
E: chris.bates@
cliffordchance.com



Marc Benzler
Partner
Frankfurt
T: +49 69 7199 3304
E: marc.benzler@
cliffordchance.com



Jeff Berman
Partner
New York
T: +1 212 878 3460
E: jeffrey.berman@
cliffordchance.com



Caroline Dawson
Partner
London
T: +44 207006 4355
E: caroline.dawson@
cliffordchance.com



Simon Gleeson
Partner
London
T: +44 207006 4979
E: simon.gleeson@
cliffordchance.com



Caroline Meinertz
Partner
London
T: +44 207006 4253
E: caroline.meinertz@
cliffordchance.com



Jurgen van der Meer
Partner
Amsterdam
T: +31 20 711 9340
E: jurgen.vandermeer@
cliffordchance.com

C L I F F O R D

C H A N C E

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2023

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels •

Bucharest • Casablanca • Delhi • Dubai • Düsseldorf •

Frankfurt • Hong Kong • Istanbul • London • Luxembourg •

Madrid • Milan • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.