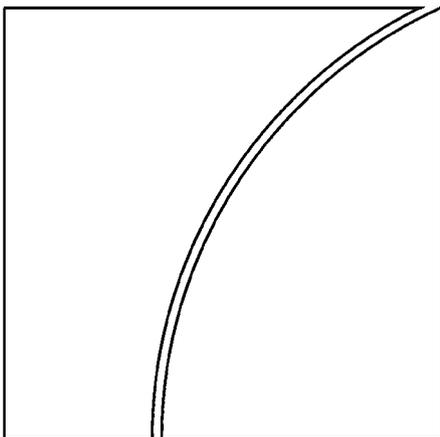


Basel Committee  
on Banking Supervision

International Association of  
Deposit Insurers



## Core Principles for Effective Deposit Insurance Systems

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# **Core Principles for Effective Deposit Insurance Systems**

## **Executive Summary**

### **Introduction and objectives**

1. The *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 2008) pointed out that events during the recent international financial turmoil illustrate the importance of effective depositor compensation arrangements. The report stressed the need for authorities to agree on an international set of principles for effective deposit insurance systems.

2. In July 2008 the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) decided to collaborate to develop an internationally agreed set of Core Principles using the IADI Core Principles for Effective Deposit Insurance Systems as a basis. A joint working group was established to develop Core Principles to be submitted to the BCBS and IADI for their respective review and approval. This joint working group is comprised of representatives from the BCBS's Cross-border Bank Resolution Group (CBRG) and IADI's Guidance Group. The following Core Principles for Effective Deposit Insurance Systems represent the work of the joint CBRG-IADI working group in developing Core Principles.

### **Core Principles and preconditions**

3. Policymakers have choices regarding how they can protect depositors and contribute to financial system stability. Explicit deposit insurance has become the preferred choice compared to other alternatives such as reliance on implicit protection. A deposit insurance system clarifies the authority's obligations to depositors (or if it is a private system, its members), limits the scope for discretionary decisions, can promote public confidence, helps to contain the costs of resolving failed banks and can provide countries with an orderly process for dealing with bank failures and a mechanism for banks to fund the cost of failures.

4. The introduction or the reform of a deposit insurance system can be more successful when a country's banking system is healthy and its institutional environment is sound. In order to be credible, and to avoid distortions that may result in moral hazard, a deposit insurance system needs to be part of a well-constructed financial system safety net, properly designed and well implemented. A financial safety net usually includes prudential regulation and supervision, a lender of last resort and deposit insurance. The distribution of powers and responsibilities between the financial safety-net participants is a matter of public policy choice and individual country circumstances.

5. A deposit insurance system is not intended to deal, by itself, with systemically significant bank failures or a "systemic crisis". In such cases all financial system safety-net participants must work together effectively. In addition, the costs of dealing with systemic failures should not be borne solely by the deposit insurance system but dealt with through other means such as by the state.

6. The Core Principles are reflective of, and designed to be adaptable to, a broad range of country circumstances, settings and structures. The Core Principles are intended as a voluntary framework for effective deposit insurance practices; national authorities are free to put in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions. The Core Principles are not designed to cover all the needs and circumstances of every banking system. Instead, specific country circumstances should be more appropriately considered in the context of existing laws and powers to fulfil the public policy objectives and mandate of the deposit insurance system.

7. An effective deposit insurance system needs to be based on a number of external elements or preconditions. These preconditions, although mostly outside the direct jurisdiction of the deposit insurance system, have a direct impact on the system. These preconditions include:

- an ongoing assessment of the economy and banking system;
- sound governance of agencies comprising the financial system safety net;
- strong prudential regulation and supervision; and
- a well developed legal framework and accounting and disclosure regime.

8. The 18 Core Principles are broadly categorised into ten groups: Setting objectives (principles 1 to 2); Mandates and powers (principles 3 to 4); Governance (principle 5); Relationships with other safety-net participants and cross-border issues (principles 6 to 7); Membership and coverage (principles 8 to 10); Funding (principle 11); Public awareness (principle 12); Selected legal issues (principles 13 to 14); Failure resolution (principles 15 to 16); and Reimbursing depositors and recoveries (principles 17 to 18).

## Setting objectives

- **Principle 1 – Public policy objectives:** The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.
- **Principle 2 – Mitigating moral hazard:** Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net (see Preconditions paragraph 16).

## Mandates and powers

- **Principle 3 – Mandate:** It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.
- **Principle 4 – Powers:** A deposit insurer should have all powers necessary to fulfill its mandate and these powers should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal

operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.

## Governance

- **Principle 5 – Governance:** The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.

## Relationships with other safety-net participants and cross-border issues

- **Principle 6 – Relationships with other safety-net participants:** A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalised.
- **Principle 7 – Cross-border issues:** Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.

## Membership and coverage

- **Principle 8 – Compulsory membership:** Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (eg retail and small business depositors) to avoid adverse selection.
- **Principle 9 – Coverage:** Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.
- **Principle 10 – Transitioning from a blanket guarantee to a limited coverage deposit insurance system:** When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.

## Funding

- **Principle 11 – Funding:** A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system.

For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilising risk-adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.

## Public awareness

- **Principle 12 – Public awareness:** In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.

## Selected legal issues

- **Principle 13 – Legal protection:** The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.
- **Principle 14 – Dealing with parties at fault in a bank failure:** A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.

## Failure resolution

- **Principle 15 – Early detection and timely intervention and resolution:** The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety-net participants with the operational independence and power to act.
- **Principle 16 – Effective resolution processes:** Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other

wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (eg providing depositors with continuous access to their funds and maintaining clearing and settlement activities).

## **Reimbursing depositors and recoveries**

- **Principle 17 – Reimbursing depositors:** The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.
- **Principle 18 – Recoveries:** The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.

## Main Body

### Introduction and objectives

1. The *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 2008) pointed out that events during the recent international financial turmoil illustrate the importance of effective depositor compensation arrangements. The FSF Report recommended that: “*Authorities should agree on an international set of principles for effective deposit insurance systems. These principles should recognise that there may be a variety of different designs for deposit insurance arrangements that meet the objectives behind the principles, and therefore should be adaptable to a broad range of country circumstances. The development of the principles should also take close account of the broader characteristics of safety-net arrangements, including those of the regulatory and supervisory framework and of resolution procedures for failing institutions.*”

2. The Basel Committee’s Core Principles for Effective Banking Supervision (October 2006) acknowledge that a carefully designed system of deposit insurance can contribute to public confidence in the financial system and thus limit contagion from banks in distress, but do not currently provide guidance for effective deposit insurance systems.

3. The International Association of Deposit Insurers (IADI) developed a set of Core Principles for Effective Deposit Insurance Systems in February 2008.<sup>1</sup> The IADI Core Principles are designed to enhance the effectiveness of deposit insurance systems and are based on IADI research and guidance papers. In developing its Core Principles, the IADI drew heavily on the practical experience of its members.

4. In July 2008 the Basel Committee on Banking Supervision (BCBS) and IADI agreed to collaborate to develop an internationally agreed set of Core Principles for Effective Deposit Insurance Systems using the IADI Core Principles as a basis. A joint working group was established to develop Core Principles to be submitted to the BCBS and to IADI for their respective review and approval. This joint working group is comprised of representatives from the BCBS’s Cross-border Bank Resolution Group (CBRG) and IADI’s Guidance Group. The following document represents the work of the joint CBRG-IADI working group in developing the Core Principles and an accompanying set of Preconditions which address mainly external elements necessary to support effective deposit insurance systems.

### Core Principles and preconditions

5. Policymakers have choices regarding how they can protect depositors and contribute to financial system stability. Explicit deposit insurance has become the preferred choice compared to other alternatives such as reliance on implicit protection.<sup>2</sup> A deposit

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1 IADI was established in 2002 with a mission to contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation. The IADI Core Principles were developed for the benefit of countries considering the adoption or the reform of a deposit insurance system.

2 Implicit deposit protection arises when the public, including depositors and perhaps other creditors, expect some form of protection in the event of a bank failure. This expectation usually arises because of the governments past behaviour or statements made by officials. Implicit protection is, by definition, never formally specified. There are no statutory rules regarding the eligibility of bank liabilities, the level of protection provided

insurance system clarifies the authority's obligations to depositors (or if it is a private system, its members), limits the scope for discretionary decisions, can promote public confidence, helps to contain the costs of resolving failed banks and can provide countries with an orderly process for dealing with bank failures and a mechanism for banks to fund the cost of failures.<sup>3</sup>

6. The introduction or the reform of a deposit insurance system can be more successful when a country's banking system is healthy and its institutional environment is sound. In order to be credible, and to avoid distortions that may result in moral hazard, a deposit insurance system needs to be part of a well-constructed financial system safety net, properly designed and well implemented. A financial safety net usually includes prudential regulation and supervision, a lender of last resort and deposit insurance. The distribution of powers and responsibilities between the financial safety-net participants is a matter of public policy choice and individual country circumstances.

7. A deposit insurance system is not intended to deal, by itself, with systemically significant bank failures or a "systemic crisis". In such cases all financial system safety-net participants must work together effectively. In addition, the costs of dealing with systemic failures should not be borne solely by the deposit insurance system but dealt with through other means such as by the state.

8. The Core Principles are reflective of, and designed to be adaptable to, a broad range of country circumstances, settings and structures. The Core Principles are intended as a voluntary framework for effective deposit insurance practices; national authorities are free to put in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions. The Core Principles are not designed to cover all the needs and circumstances of every banking system. Instead, specific country circumstances should be more appropriately considered in the context of existing laws and powers to fulfil the public policy objectives and mandate of the deposit insurance system.

9. A high degree of compliance with the Core Principles should contribute to financial system stability and enhance depositor protection.

## **Preconditions**

10. An effective deposit insurance system needs to be based on a number of external elements or preconditions. These preconditions, although mostly outside the direct jurisdiction of the deposit insurance system, have a direct impact on the system. These preconditions include:

- an ongoing assessment of the economy and banking system;
- sound governance of agencies comprising the financial system safety net;
- strong prudential regulation and supervision; and
- a well developed legal framework and accounting and disclosure regime.

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or the form which reimbursement will take. Funding is discretionary and often depends on the government's ability to access public funds.

<sup>3</sup> In this paper the term "bank" is used to denote financial institutions which accept insured deposits.

Where existing conditions are not ideal, it is important to identify them. If actions are necessary, they can be taken before, or in concert with, the adoption or reform of a deposit insurance system.

11. The establishment or reform of a deposit insurance system is more difficult if underlying issues relating to the health and stability of the economy and the banking system have not been addressed. Policymakers should undertake a situational analysis of the economic environment as it affects the banking system and will influence the effectiveness of a deposit insurance system. The soundness of the banking system, including a detailed evaluation of the condition of banks' capital, liquidity, credit quality, risk management policies and practices, and the extent of any problems should be assessed. The structure of the banking system should be considered since the number, type and characteristics of banks will have design implications for the deposit insurance system.

12. Deposit insurance systems cannot be effective if relevant laws do not exist or if the legal regime is characterised by inconsistencies. A well developed legal framework should include a system of business laws, including corporate, bankruptcy, contract, consumer protection and private property laws, which is consistently enforced and provides a mechanism for the fair resolution of disputes. Additional factors that should be considered include: the ability of a legal regime to support the intervention or closure of troubled banks in a timely manner; that there be provisions made for the clear and orderly liquidation of assets and resolution of creditors' claims; and that financial system safety net participants and those individuals working for them be provided with legal protection.

13. The sound governance of agencies comprising the financial system safety net strengthens the financial system's architecture and contributes directly to financial system stability. The four major elements comprising sound governance are: operational independence, accountability, transparency and disclosure, and integrity. All are equally important, and reinforce each other in supporting sound governance.

14. The strength of prudential regulation and supervision will have direct implications for the effectiveness of a deposit insurance system. Strong prudential regulation and supervision should allow only viable banks to operate and be members of the deposit insurance system. Banks should be well capitalised and follow sound-and-prudent risk management, governance and other business practices. Other characteristics include an effective licensing or chartering regime for new banks, regular and thorough examinations, the risk assessment of individual banks and a framework for the early detection and timely intervention and resolution of troubled banks.

15. Sound accounting and disclosure regimes are necessary for an effective deposit insurance system. Accurate, reliable and timely information reported by these regimes can be used by management, depositors, the marketplace, and authorities to make decisions regarding the risk profile of a bank, and thereby increase market, regulatory and supervisory discipline. A sound accounting and disclosure regime should include comprehensive and well defined accounting principles and rules that command wide international acceptance. A system of independent audits is needed for companies of significant size, to ensure that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work.

16. A well designed financial system safety net contributes to the stability of the financial system; however, if poorly designed it may increase risks, notably moral hazard. In addition to addressing moral hazard in the design features of the deposit insurance system, moral hazard should be mitigated through other elements of the financial system safety net by

creating and promoting appropriate incentives through good corporate governance and sound risk management of individual banks, effective market discipline and frameworks for strong prudential regulation, supervision and laws (including minimisation of the risk of loss through the timely resolution of troubled banks). These elements involve trade-offs and are most effective when they work in concert.

## **Core Principles: Explanations and supporting guidance**

### **Setting objectives**

- **Principle 1 – Public policy objectives:** The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.

### ***Explanations and supporting guidance***

Public policy generally involves the selection of goals and the means of achieving them within a specified context. Public policy objectives are a component of public policies, and normally involve formal and informal expressions of intent and are meant to provide purpose and focus. Public policy objectives should be formally specified; for example, through legislation or a preamble to legislation.

The focus of protection should be on those depositors who are generally not in a position to make an informed assessment of the risk that the bank to which their funds are entrusted may fail (eg retail and small business depositors). The policy objective is therefore also about protecting those who most need protection (and cannot afford any loss of funds).

Although these are the most prominent and generally applicable public policy objectives for deposit insurance systems, there are other objectives which are less common and generally applicable. Some examples include: providing a mechanism for banks to fund the cost of failures; promoting competition in the financial sector by mitigating competitive barriers in the banking industry; and facilitating the transition from a blanket deposit guarantee to limited coverage.

- **Principle 2 – Mitigating moral hazard:** Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net (see “Preconditions” paragraph 16).

### ***Explanations and supporting guidance***

Moral hazard refers to the incentive for excessive risk taking by banks or those receiving the benefit of protection. Such behaviour may arise, for example, in situations where depositors and other creditors are protected, or believe they are protected, from losses or when they believe that a bank will not be allowed to fail.

Ensuring that a deposit insurance system contains appropriate design features such as: placing limits on the amounts insured; excluding certain categories of depositors from coverage; and implementing differential or risk-adjusted premium systems can mitigate moral hazard.

In addition to the design of the deposit insurance system, moral hazard should be mitigated through other elements of the financial system safety net by creating and promoting appropriate incentives through good corporate governance and sound risk management of individual banks, effective market discipline and frameworks for strong prudential regulation, supervision and laws.

### **Mandates and powers**

- **Principle 3 – Mandate:** It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.
- **Principle 4 – Powers:** A deposit insurer should have all powers necessary to fulfill its mandate and these should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.

### ***Explanations and supporting guidance***

The mandate of an organisation is a set of official instructions or statement of purpose. There is no single mandate or set of mandates suitable for all deposit insurers. Existing deposit insurers have mandates ranging from narrow, so-called “paybox” systems to those with broader powers and responsibilities, such as loss or risk-minimisation/management, with a variety of combinations in between.

Paybox systems largely are confined to paying the claims of depositors after a bank has been closed. Accordingly, they normally do not have prudential regulatory or supervisory responsibilities or intervention powers. Nevertheless, a paybox system requires appropriate legal authorities, as well as access to deposit information and adequate funding, for the timely and efficient reimbursement of insured depositors when banks fail.

A deposit insurer charged with loss or risk-minimisation/management is likely to have a relatively broad mandate and accordingly more powers. These powers may include: the ability to control entry and exit from the deposit insurance system; the ability to assess and manage its own risks; and, the ability to conduct examinations of banks or request such examinations. Such systems may provide financial assistance to troubled banks.

### **Governance**

- **Principle 5 – Governance:** The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.

### ***Explanations and supporting guidance***

Governance refers to the processes, structures, and information used in directing and overseeing the management of an organisation. It concerns the relationship between the organisation and the authority from which it receives its mandate or to which it is accountable. The four major elements comprising sound governance are: operational independence, accountability, transparency and disclosure, and integrity. All are equally important, and they reinforce each other in supporting sound governance.

## **Relationships with other safety-net participants and cross-border issues**

- **Principle 6 – Relationships with other safety-net participants:** A framework should be in place for close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information sharing and coordination arrangements should be formalised.
- **Principle 7 – Cross-border issues:** Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.

### ***Explanations and supporting guidance***

A deposit insurer's interrelationship management needs vary according to its mandate and powers. When a single organisation performs all of the safety-net functions the smooth resolution of potential tensions is dependent on clarity of mandates and an adequate accountability regime among the relevant departments. However, when the functions are assigned to different organisations, issues related to information sharing, allocation of powers and responsibilities, and coordination of actions among different functions are more complex and need to be addressed clearly and explicitly.

In addition to the banks themselves, the supervisory authority usually is the primary source of information on banks. Such information can include that needed to meet depositors' claims when necessary. A deposit insurer with a risk-minimising mandate will require access to timely and accurate information so it can assess the financial condition of individual banks. The central bank can also be a source of information in many deposit insurance systems with respect to financial system issues that could have an impact on the deposit insurer. In order to ensure that the deposit insurer obtains the information it needs, while minimising reporting burdens on banks, it is important to closely coordinate the collection and sharing of information.

Although informal arrangements for information sharing can work, information sharing should be formalised either through legislation, memoranda of understanding, legal agreements, or a combination of these techniques. These arrangements also may be useful in providing a general framework for safety net participants to coordinate their related activities.

The close coordination and information sharing among deposit insurers and other financial system safety net participants is also significant from a cross-border perspective on a routine basis as well as in relation to particular banks. In circumstances where more than one deposit insurer provides coverage, it is important to determine which deposit insurer or insurers will be responsible for reimbursement and it is advisable to have in place appropriate bilateral/multilateral agreements. Care should be taken also to ensure that information provided to depositors on the reimbursement process (eg applicable coverage limits, claims procedures) in the jurisdictions affected is done so in a clear and easily understood manner.

## Membership and coverage

- **Principle 8 – Compulsory membership:** Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (eg retail and small business depositors) to avoid adverse selection.

### *Explanations and supporting guidance*

Adverse selection is the tendency for higher-risk banks to opt for deposit insurance and lower-risk banks to opt-out of deposit insurance when membership in a system is voluntary.

Unless banks included in the deposit insurance system are subject to strong prudential regulation and supervision, the deposit insurance system will be exposed to unacceptable risk. This is of particular importance where the deposit insurance system may be directed to include non-traditional banks such as micro-lending or credit institutions that may not be under the same form of regulation as existing member banks.<sup>4</sup>

Policymakers should determine whether eligible banks will be given membership automatically or whether they should be required to apply for entry. The latter option provides a degree of flexibility for the deposit insurer to control the risks it assumes by establishing entry criteria. It can also serve to enhance compliance with prudential requirements and standards. In such cases, an appropriate transition plan should be in place that details the criteria, process and time frame for attaining membership and the criteria should be transparent.

In some deposit insurance systems membership is a condition of a bank carrying on business and it is not possible for the deposit insurer to refuse admission if the regulator has authorised the bank to carry on the business. In such systems, the regulator, rather than the deposit insurer, decides whether the bank is suitable to be granted authorisation. In these circumstances the deposit insurer should be consulted or informed of the application in advance in order to prepare for the new bank.

In situations where a bank in the deposit insurance system has its authorisation to conduct business withdrawn by the supervisory authority, the bank's deposit insurance should be terminated at the same time (or if its membership is terminated by the deposit insurance system, its operating license should be withdrawn by the relevant authority).

- **Principle 9 – Coverage:** Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.

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<sup>4</sup> The rationale for policymakers considering expanding membership in the deposit insurance system to these institutions may include: the desire not to introduce competitive distortions among different types of institutions offering similar products; the objective of enhancing the stability of the financial system by including all institutions that accept deposits or deposit-like products; and the desire to apply prudential regulatory and supervisory rules to all such institutions.

### ***Explanations and supporting guidance***

In defining what is an insurable deposit policymakers should consider the relative importance of different deposit instruments, including foreign-currency deposits and the deposits of non-residents, in relation to the public policy objectives of the system.

The level of coverage should be limited and can be set through an examination of relevant data such as statistical information describing the size distribution of deposits held in banks. This gives policymakers an objective measure, such as the fraction of depositors covered, with which to assess the adequacy of a certain level of coverage. The same coverage limit should apply to all banks in the deposit insurance system.

Coverage limits may need to be reviewed and when necessary adjusted because of factors such as: inflation, the growth of real income, the development of new financial instruments, and the way in which these factors influence the composition and size of deposits.

- **Principle 10 – Transitioning from a blanket guarantee to a limited coverage deposit insurance system:** When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably an increase in moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.

### ***Explanations and supporting guidance***

Some countries have introduced an explicit blanket guarantee during a financial crisis to fully protect certain bank depositors and possibly other creditors.<sup>5</sup> The provision of such guarantees may be unavoidable in periods of extreme financial distress to maintain domestic and international confidence in the banking system.

A country considering transitioning from a blanket guarantee to a limited coverage deposit insurance system should undertake the same type of situational analysis as a country moving from implicit protection. Countries transitioning from a blanket guarantee will need to consider three special issues. The first issue arises from the fact that protection for depositors and possibly other creditors is being reduced. This may present a concern to the public. Therefore, policymakers should pay particular attention to public attitudes and expectations. Countries with a high level of capital mobility, and/or a regional integration policy, should consider the effects of different countries' protection levels and other related policies.

Second, policymakers should consider the capacity of the banking system to fund a new deposit insurance system. The transition to limited coverage usually involves the imposition of new or revised premiums or levies on banks. If those funds are insufficient to pay for the cost of the blanket guarantee – especially if it stems from a systemic crisis – the cost usually is shared between banks and the government. The latter can resort to budgetary resources (ie higher taxes), asset sales, or debt issues. In any case, it is important to have a clear

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<sup>5</sup> A “blanket guarantee” is a declaration by authorities that in addition to the protection provided by limited coverage deposit insurance or other arrangements, certain deposits and perhaps other financial instruments will be protected. A wide range of factors need to be considered when introducing blanket guarantees, including decisions on the scope of the guarantee (eg the type of institutions, products and term maturities covered) and whether the banks utilising the guarantees will be required to contribute in some manner to the costs of providing the guarantees.

mechanism in place to ensure that the deposit insurance system will have access to adequate funding during and after the transition.

The final issue concerns how fast the transition should proceed. In general, the transition should be as rapid as a country's circumstances permit. Some countries have implemented so-called fast-track transitions successfully soon after the crisis has passed. These are countries that have restored the banking system to financial health rapidly; and where strong prudential regulation and supervision, effective legal frameworks, and sound accounting and disclosure regimes were already in place.

In other countries, the implementation of a blanket guarantee has been associated with a comprehensive post-crisis bank restructuring strategy and measures to improve prudential regulation and supervision, the legal framework, and the accounting and disclosure regimes. This has implications both for the length of time that the blanket guarantee needs to stay in place and for the speed of the transition. The gradual removal of a blanket guarantee allows banks time to adjust to necessary institutional changes which could include legal and supervisory reforms. In addition, a gradual transition permits bank managers to be trained in a risk-management culture and gives depositors time to become accustomed to the new arrangements. A major disadvantage, however, is that the transition period might be perceived as being too long, raising doubts among depositors and creditors about the government's commitment to withdraw the blanket guarantee. In addition, the longer the blanket guarantee remains in place, the more likely it is to give rise to additional moral hazard.

## **Funding**

- **Principle 11 – Funding:** A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system.

For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilising risk-adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.

### ***Explanations and supporting guidance***

Sound funding arrangements are critical to the effectiveness of a deposit insurance system.

Policymakers can choose among ex-ante, ex-post and hybrid (ie combined ex-ante and ex-post) funding mechanisms.

Ex-ante funding requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure occurring. It is principally funded by its members through contributions, insurance premiums and other means. Funds can be accumulated during stronger economic conditions, when losses may be low, as a hedge against future needs when economic circumstances may be less favourable and losses higher, thus reducing the pro-cyclicality of funding. Ex-ante funding can help lessen the reliance of the deposit insurance system on public funds during periods of financial stress and crisis. For countries utilising an ex-ante target fund ratio or range the method chosen

should be sufficient to reduce the probability of the fund's insolvency to an acceptable minimum.

In ex-post funding systems, funds to cover deposit insurance claims are only collected from member banks when the bank fails and the need to cover claims develops. Ex-post systems may be less onerous on member banks (leaving more funds available to the banking system) when there are little or no failures because fewer premiums are being collected and administrative costs associated with the collection of premiums and fund management is less. In order to be effective ex-post systems require virtually immediate access to back-up funding (since they have little or no funding of their own).

It is important to note that many ex-ante systems incorporate elements of ex-post systems (eg the ability to increase premiums, charge additional levies and receive the proceeds of liquidations) and thus can be considered as combined or hybrid funding systems.

Whether an ex-ante, ex-post or a hybrid system is chosen, primary responsibility for paying the costs of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. However, it should be understood that in special situations such as a systemic crisis where the stability of the financial system is in jeopardy this may not be the case.

### **Public awareness**

- **Principle 12 – Public awareness:** In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.

### ***Explanations and supporting guidance***

Public awareness of deposit insurance, its existence and how it works (including the level and scope of coverage and how the claims process operates), plays a significant role in underpinning a sound deposit insurance system.

All deposit insurers should promote public awareness about the deposit insurance system on an ongoing basis to maintain and strengthen public confidence. The objectives of the public awareness program should be clearly set out and consistent with the public policy objectives and mandate of a deposit insurer.

When designing a public awareness program, deposit insurers should clearly define the principal target audience groups and subgroups (eg the general public, depositors, member banks etc). Employing a wide variety of tools and channels of communication can help ensure that the deposit insurers' messages are conveyed to the target audience.

In general, the deposit insurer should be the primary party responsible for promoting public awareness about deposit insurance and should work closely with member banks and other safety net participants to ensure consistency in the information provided and maximise synergies. All these bodies and their staff have a role to play.

Budgets for public awareness programs should be determined on the basis of the desired level of visibility and awareness about deposit insurance among the target audience. And, it is an effective practice for a deposit insurer to conduct a regular independent evaluation of awareness levels.

The deposit insurer should develop ahead of time a public awareness contingency program to address individual bank failures, multiple bank failures and the occurrence of a systemic crisis.

### **Selected legal issues**

- **Principle 13 – Legal protection:** The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.
- **Principle 14 – Dealing with parties at fault in a bank failure:** A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.

### ***Explanations and supporting guidance***

The lack of legal or statutory protection can reduce incentives for individuals to be diligent in the carrying out of their mandates - particularly in cases where deposit insurers and other financial system safety net participants’ mandates emphasise timeliness in the detection, intervention and resolution of troubled banks. There are a variety of approaches available to provide legal protection. Some of the most common include:

- granting legal protection to individuals from civil and criminal liability for their decisions, actions or omissions taken in the normal discharge of their legal responsibilities;
- granting statutory immunity to the deposit insurance organisation;
- including appropriate indemnification provisions in employment contracts; or
- a combination of these approaches.

To provide incentives for good conduct, however, the relevant statutory or contractual provisions for individuals must be wide and unambiguous. They should also not qualify the protection by requiring the individual to establish that their actions and decisions (including decisions not to take action) were reasonable or not negligent.

Although there are numerous approaches to legal protection, at a minimum the deposit insurer and those individuals working for the deposit insurer and other financial system safety net participants should be protected against lawsuits for their decisions and actions (or decisions taken not to act) taken in “good faith” while discharging their mandates. Legal protection, however, should not extend to protecting individuals where they have acted in bad faith; for example, where they have acted fraudulently or maliciously.

Legal protection must coexist in an environment where there is clear accountability. This means that while individuals should be legally protected, they must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Finally, legal protection must also be compatible with the right of individuals to be compensated by the deposit insurer or other authorities according to the country specific liability regimes.

A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure. For example, seeking legal redress

from such parties as officers, directors, managers, auditors and related parties of the failing/failed bank can help improve recoveries for an insurer and can mitigate moral hazard problems by providing strong incentives against malfeasance.

### **Failure resolution**

- **Principle 15 – Early detection and timely intervention and resolution:** The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety net participants with the operational independence and power to act.
- **Principle 16 – Effective resolution processes:** Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (eg providing depositors with continuous access to their funds and maintaining clearing and settlement activities).

### ***Explanations and supporting guidance***

The responsibilities of deposit insurers for various aspects of supervision, prudential regulation and the resolution of troubled banks are country specific, reflecting the particular mandates of financial safety net participants. However, regardless of the specific responsibilities of the deposit insurer in any particular country, the manner in which banks are supervised and regulated and how troubled banks are resolved has a major impact on the costs and other aspects of the deposit insurance system.

What is important is that whoever has responsibilities in this regard recognise that the determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and that the intervention and resolution process be initiated on the basis of well-defined criteria. This can help reduce the cost of resolutions and avoid unnecessary confusion. Criteria vary between countries and include concerns over a bank's ability to meet capital requirements; low levels of accessible liquidity; deterioration in the quality or value of assets; and a finding that the bank is operated in an unsafe and imprudent manner.

The resolution of troubled banks involves three basic options: liquidation and reimbursement of depositors' claims (which typically involves the closure of the bank), purchase-and-assumption transactions (sales) and open-bank financial assistance. In addition, the deposit insurer or other relevant financial system safety net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (eg through the use of a bridge bank, assisted acquisition or provisional administration).

Bankruptcy/insolvency and other laws may heavily influence the choice of resolution methods since such laws vary considerably among countries and, in some cases, may make

a particular resolution method difficult to implement. Because of the special significance of banks and bank failures, policymakers may wish to review whether bankruptcy/insolvency laws facilitate the orderly exit of troubled banks. In this regard, establishing a separate insolvency regime for banks should be considered.

### **Reimbursing depositors and recoveries**

- **Principle 17 – Reimbursing depositors:** The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.
- **Principle 18 – Recoveries:** The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.

### ***Explanations and supporting guidance***

Access to the necessary depositor information (eg records) before the bank is closed lessens the risk of record manipulation, shortens the time for completing the reimbursement process and helps preserve public confidence. The deposit insurance system should be provided with necessary systems and processes to undertake a timely preparatory review of depositor information held by troubled banks in order to determine such issues as who should be reimbursed, the amount of individual deposits which are below the deposit insurance limit, and depositor claims remaining following netting/set-off (for those deposit insurance systems utilising this mechanism).

There is considerable variation in the asset management role and in the responsibility for handling claims and recoveries played by deposit insurers and other safety net participants. Where deposit insurance payments are generally made upon the liquidation of a bank, the deposit insurer usually is subrogated to the rights of the insured depositors, and is likely to file and actively manage the claim arising from the deposit insurance payment. If the depositor has not been reimbursed quickly or the quality of depositor records held by the bank is very poor, then the depositor may need to file a claim with the deposit insurer.<sup>6</sup>

In some instances, deposit insurers have significant roles in the recovery process, for example as a lender, creditor, or possibly liquidator and receiver. And, even if not, the deposit insurer may nominate a liquidator or have a significant role in the liquidation process through other means such as oversight over the liquidator or participation on creditor committees. In other cases, these functions are the responsibility of other entities within the safety net. Whatever the case, the deposit insurer should share in the proceeds of the recoveries arising from the failure of its member banks.

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<sup>6</sup> In such cases there should be time limits on the period of time over which depositors may make claims on the deposit insurer.

In countries with depositor preference laws, uninsured depositors and the deposit insurer (through subrogation) will generally have precedence over other creditors in recovering funds from the estate of the failed bank. In countries where netting or set-off is applied to depositors' claims its use should be consistent with insolvency law.

Finally, the management of the assets of the failed bank and the recovery process should be guided by commercial considerations and their economic merits. This means consideration of factors such as the quality of the assets, the depth and condition of markets, the availability of expertise in asset management and disposition, legal requirements relating to the disposition of assets, and public policy objectives.

# Annex

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