

Financial Stability Forum

FSF

**GUIDANCE FOR DEVELOPING  
EFFECTIVE DEPOSIT  
INSURANCE SYSTEMS**

September 2001



FINANCIAL STABILITY FORUM

**GUIDANCE FOR DEVELOPING  
EFFECTIVE DEPOSIT INSURANCE  
SYSTEMS**

September 2001

© Financial Stability Forum 2001. All rights reserved. Brief excerpts may be reproduced or translated provided the source is cited.

Request for copies of publications should be sent to:

Financial Stability Forum  
CH-4002 Basel, Switzerland

Email: [FSForum@bis.org](mailto:FSForum@bis.org)

Fax: (+ 41 61) 280 9100 or (+ 41 61) 280 8100

# FINANCIAL STABILITY FORUM

## Preface

At its March 2000 meeting in Singapore, the FSF endorsed the report of a study group and concurred that, in light of the fact that many countries were considering implementing some form of deposit insurance, it would be desirable to set out some form of international guidance. Forum members underscored that the development of such guidance should be undertaken through a consultative process that would include all the parties that are interested in deposit insurance issues, so as to ensure that the guidelines are reflective of, and adaptable to, the broadest set of circumstances, settings and structures.

The Forum asked Jean Pierre Sabourin, President and Chief Executive Officer of the Canada Deposit Insurance Corporation, to chair a working group that would carry out the task of setting out guidance for effective deposit insurance systems. The final report of the Working Group on Deposit Insurance was discussed and endorsed by the Forum in London, on September 7, 2001.

The FSF report on deposit insurance is built on three general findings. First, explicit and limited deposit insurance is preferable to implicit coverage if it clarifies obligations to depositors and creditors and limits the scope for discretionary decisions that may result in arbitrary actions. Second, deposit insurance systems must be properly designed, well implemented and understood by the public to be credible and avoid moral hazard. Third, to be effective, the deposit insurance function needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced, and sound accounting and disclosure regimes.

The report proposes a general method for the benefit of countries considering the adoption or the reform of an explicit, limited-coverage deposit insurance system. It first presents the contextual issues related to different forms of depositor protection and identifies the issues that need to be addressed when adopting or reforming a deposit insurance system. It then sketches out the design features that help to ensure the effectiveness and credibility of a system, and finally outlines the key issues and considerations involved in resolution options, the reimbursement of depositors, and claims and recoveries.

It is the conviction of the FSF that this report, with such a pragmatic approach, will serve its role as a useful tool for policymakers who want to design deposit insurance systems that preserve the benefits of heightened financial stability and small depositors' protection, without at the same time increasing moral hazard or reducing market discipline.

Andrew Crockett  
Chairman



# FINANCIAL STABILITY FORUM

## Table of Contents

|             |  |           |
|-------------|--|-----------|
| <b>I.</b>   | <b>Executive Summary</b> .....   | <b>3</b>  |
| <b>II.</b>  | <b>Introduction</b> .....  | <b>5</b>  |
| <b>III.</b> | <b>Contextual Issues for Deposit Insurance Systems</b> .....   | <b>7</b>  |
| 1.          | The role of the banking sector and the financial safety net .....  | 7         |
| 2.          | Forms of depositor protection.....   | 7         |
| 3.          | Moral hazard.....  | 8         |
| <b>IV.</b>  | <b>Processes for Adopting and Maintaining a Deposit Insurance System</b> .....                                     | <b>11</b> |
| 1.          | Public-policy objectives.....  | 11        |
| 2.          | Situational analysis and implementation considerations .....   | 12        |
| (a)         | <i>Economic factors, the state and structure of the banking system and public attitudes and expectations</i> ..... | 12        |
| (b)         | <i>The state of legal, prudential regulatory, supervisory, accounting and disclosure regimes</i> .....             | 13        |
| 3.          | Transitioning from a blanket guarantee to a deposit insurance system .....   | 14        |
| 4.          | Self-assessment methodology (SAM).....   | 15        |
|             | <b>Figure 1 (SAM)</b> .....  | <b>16</b> |
| <b>V.</b>   | <b>Structure and Design Features</b> .....   | <b>16</b> |
| 1.          | Mandates, powers and structure.....  | 17        |
| (a)         | <i>Mandates and powers</i> .....   | 17        |
| (b)         | <i>Basic structure and operational issues</i> .....  | 18        |
| (c)         | <i>Basic governance arrangements</i> .....   | 18        |
| (d)         | <i>Human resources and statutory indemnification</i> .....   | 19        |
| 2.          | Interrelationships among financial safety-net participants .....   | 19        |
| 3.          | Membership and coverage .....  | 20        |
| (a)         | <i>Membership</i> .....  | 21        |
| (i)         | <i>Compulsory membership</i> .....   | 21        |
| (ii)        | <i>Considerations when granting membership to banks</i> .....  | 21        |
| (iii)       | <i>Foreign banks</i> .....   | 22        |
| (iv)        | <i>Non-bank financial institutions</i> .....   | 22        |
| (v)         | <i>State-owned banks</i> .....   | 22        |
| (b)         | <i>Coverage</i> .....  | 23        |
| (i)         | <i>Scope and level</i> .....   | 23        |
| (ii)        | <i>Coinsurance</i> .....   | 24        |
| (iii)       | <i>Adjusting coverage limits</i> .....   | 25        |
| (iv)        | <i>Foreign-currency deposits</i> .....   | 25        |
| 4.          | Funding .....  | 26        |
| (a)         | <i>Funding on an ex-ante or ex-post basis</i> .....  | 26        |
| (b)         | <i>Issues related to the establishment and size of a deposit insurance fund</i> .....                              | 27        |
| (c)         | <i>Deposit insurance assessments: flat-rate versus risk-adjusted differential premium systems</i> .....            | 28        |
| 5.          | Public awareness.....  | 29        |
|             | <b>Cross-Border Issues</b> .....   | <b>30</b> |





## FINANCIAL STABILITY FORUM

|   |           |
|---|-----------|
| <b>VI. Resolutions, Reimbursements, Claims and Recoveries</b> .....   | <b>31</b> |
| 1. Private-sector solutions.....                                      | 31        |
| 2. Resolving troubled banks .....                                     | 32        |
| (a) <i>Options</i> .....  | 32        |
| (i) <i>Liquidation and reimbursement of depositors' claims</i> .....  | 32        |
| (ii) <i>Purchase-and-assumption transactions (sales)</i> .....        | 32        |
| (iii) <i>Open-bank financial assistance</i> .....                     | 33        |
| (b) <i>Costs and other considerations</i> .....                       | 33        |
| 3. Reimbursing depositors .....                                       | 34        |
| (a) <i>Conditions for effective reimbursement</i> .....               | 34        |
| (b) <i>Eligibility for coverage</i> .....                             | 34        |
| (c) <i>Procedures for reimbursing depositors</i> .....                | 35        |
| (d) <i>Payments to depositors</i> .....                               | 35        |
| 4. Claims and recoveries.....   | 36        |
| (a) <i>General issues</i> .....                                       | 36        |
| (b) <i>Asset-management and disposition strategies</i> .....          | 36        |
| (c) <i>Marketing methods</i> .....                                    | 37        |
| (d) <i>Claims and litigation</i> .....                                | 37        |
| 5. Depositor ranking, collateralisation and rights of set-off .....   | 38        |
| (a) <i>Depositor ranking</i> .....                                    | 38        |
| (b) <i>Collateralisation</i> .....                                    | 39        |
| (c) <i>Rights of set-off</i> .....                                    | 39        |
| <b>VII. Key Points of Guidance</b> .....                              | <b>41</b> |
| <b>Annex I: Members of the Working Group</b> .....                    | <b>52</b> |
| <b>Annex II: Approach to Developing Discussion Papers</b> .....       | <b>53</b> |
| <b>Annex III: Organisations that Assisted the Working Group</b> ..... | <b>56</b> |
| <b>Glossary of Terms</b> .....  | <b>58</b> |



## I. Executive Summary

The Financial Stability Forum's Working Group on Deposit Insurance has developed guidance for the benefit of countries considering the adoption or the reform of an explicit, limited-coverage deposit insurance system (hereinafter referred to in this Report as "a deposit insurance system"). The guidance was developed through the preparation of a series of discussion papers and a consultative process that involved over 100 countries. In developing this guidance, the Working Group drew heavily on the practical experience of its members and other countries. Thus, the guidance is reflective of, and designed to be adaptable to, a broad range of country circumstances, settings and structures.

The principal objectives of a deposit insurance system are to contribute to the stability of a country's financial system and to protect less-financially-sophisticated depositors from the loss of their deposits when banks fail. There are a variety of options available for achieving these objectives.

A deposit insurance system is preferable to implicit protection if it clarifies the authorities' obligations to depositors and limits the scope for discretionary decisions that may result in arbitrary actions. To be credible, however, and to avoid distortions that may result in moral hazard, such a system needs to be properly designed, well implemented and understood by the public. A deposit insurance system needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced, and sound accounting and disclosure regimes.

The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public-policy objectives and to ensure that their implications are fully understood. In conjunction with identifying public-policy objectives, policymakers will need to assess a large variety of conditions and factors that can have a bearing on the design of the system. This self-assessment process is referred to in this Report as a situational analysis. Conditions and factors that should be taken into consideration include: the state of the economy, current monetary and fiscal policies, the state and structure of the banking system, public attitudes and expectations, the strength of prudential regulation and supervision, the legal framework, and the soundness of accounting and disclosure regimes. In many cases, country conditions may not be ideal and, therefore, it is important to identify gaps between existing conditions and more-desirable situations and thoroughly evaluate available options, since the establishment of a deposit insurance system is not a remedy for dealing with major deficiencies.

Countries transitioning from a blanket guarantee to a deposit insurance system should undertake the same type of situational analysis as countries moving from implicit protection.

## FINANCIAL STABILITY FORUM

The transition from a blanket guarantee should be as rapid as the country's circumstances permit, since adjustment can become more difficult the longer it is in place. Public awareness plays a particularly important role in enabling a smooth transition.

After the self-assessment process has been completed, policymakers should turn their attention to specific deposit insurance system design features. The starting point should be to address the mandates, powers and basic organisational structure of the deposit insurer. Although no single set of mandates, powers and structures is suitable in all circumstances, those elements should be well defined, understood, and consistent with public-policy objectives, and there should be clear oversight and accountability for the system. It also is critical to address explicitly interrelationship issues among safety-net participants by specifying clear mandates, effective information exchange, confidentiality of information, and close coordination of the activities relevant to the deposit insurer.

Policymakers then should consider membership and coverage issues. Explicit eligibility rules should exist and be transparent, and membership generally should be compulsory. When deciding on the scope and level of coverage, policymakers should consider the relative importance of different deposit instruments in relation to stated public-policy objectives and the effect that the level of coverage may have on moral hazard. The level of coverage can then be set through an examination of relevant data from banks.

Deposit insurance systems need to have access to adequate funds in order to reimburse depositors promptly. The characteristics of the system and its benefits and limitations should be publicised regularly so that its credibility can be maintained and strengthened.

There are a variety of methods available to safety-net participants for resolving failed banks or to deal with banks that are in danger of failing. The methods are: liquidation and reimbursement of depositors' claims, purchase-and-assumption transactions and open-bank financial assistance. Asset-management and disposition strategies should be guided by commercial considerations and their economic merits.

Finally, the Working Group recommends that a continuous-improvement process be instituted for reviewing the extent to which a deposit insurance system is meeting its objectives. In this way, a country can ensure that its deposit insurance system remains consistent with economic and social conditions and lessons learned, and is better able to deal with evolving challenges.

## II. Introduction

The Financial Stability Forum (FSF) was created in 1999 to promote international financial stability, to improve the functioning of markets, and to reduce systemic risk. In recognition of the increasing use of deposit insurance as an integral component of an effective financial safety net, the FSF established a Study Group on Deposit Insurance. The Study Group was asked to assess the desirability and feasibility of setting out international guidance on deposit insurance arrangements. The Study Group's report was tabled at a meeting of the FSF in March 2000. On the basis of the conclusions in that report, the FSF invited Mr. Jean Pierre Sabourin, President and Chief Executive Officer, Canada Deposit Insurance Corporation, to constitute a Working Group on Deposit Insurance (the Working Group) to develop such guidance and to deliver a final report to the FSF by September 2001.<sup>1</sup>

The mandate of the Working Group was to develop guidance on sound deposit insurance arrangements for countries considering the adoption of a deposit insurance system or the reform of an existing one. The mandate specified that such guidance should be developed through a consultative process that included countries interested in deposit insurance issues. The guidance was to be reflective of, and adaptable to, the broadest set of circumstances, settings and structures.

In fulfilling its mandate the Working Group engaged in a wide range of activities. These included: the publication of a series of business plans and discussion papers on specific issues<sup>2</sup>, outreach sessions, seminars, conferences, utilisation of a Web site to solicit feedback and share knowledge, and the production of this Final Report. The discussion papers identified critical issues associated with adopting an explicit, limited-coverage deposit insurance system or with reforming an existing one. The Working Group met with over 400 people from over 100 countries and they have been kept fully informed about the development of the guidance topics.

---

<sup>1</sup> The Working Group was comprised of representatives from Argentina, Canada, Chile, France, Germany, Hungary, Italy, Jamaica, Japan, Mexico, Philippines, the United States of America, the World Bank and the International Monetary Fund (cf Annex I). The approach that the Working Group used to develop discussion papers on the guidance topics and the techniques used in the outreach activities are set out in Annex II. Annex III contains the organisations and countries involved in the outreach sessions, seminars and conferences. A glossary of terms used in this report can be found at the end of this document. A separate volume to this report (Volume II), which can be downloaded from the Internet at the following Web site address ([www.cdic.ca/international](http://www.cdic.ca/international)), includes the research plan, the discussion papers on the 16 guidance topics, a bibliography and additional information on the outreach activities.

<sup>2</sup> Readers should consult the discussion papers for a more in-depth examination of the topics presented in this report.

## **FINANCIAL STABILITY FORUM**

This report is organised as follows. Section III explores the contextual issues related to forms of depositor protection. Section IV sets out the issues and processes that need to be addressed when adopting or reforming a deposit insurance system. Section V presents the design features that help to ensure the effectiveness and credibility of a system. Section VI outlines the key issues and considerations involved in resolution options, the reimbursement of depositors, and claims and recoveries. The final section summarises the key guidance points.

### **III. Contextual Issues for Deposit Insurance Systems**

This section discusses issues that policymakers should consider when adopting or reforming a deposit insurance system. The first part examines the role of the banking sector and the financial safety net. Next, there is a discussion on the forms depositor protection can take in different countries. The last part focuses on how the financial safety-net participants can mitigate moral hazard.

#### **1. The role of the banking sector and the financial safety net**

Financial institutions that accept deposits from the public (hereinafter referred to as banks) are important in the economy because of their involvement in the payments system, their role as intermediaries between depositors and borrowers, and their function as agents for the transmission of monetary policy. Banks are in the business of assuming and managing risks. By their nature, banks are vulnerable to liquidity and solvency problems, among other things, because they transform short-term liquid deposits into longer-term, less-liquid loans and investments. They also lend to a wide variety of borrowers whose risk characteristics are not always readily apparent.

The importance of banks in the economy, the potential for depositors to suffer losses when banks fail, and the need to mitigate contagion risks, lead countries to establish financial safety nets. 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. For example, some countries incorporate all financial safety-net functions within the central bank, while others assign responsibility for certain functions to separate entities.

#### **2. Forms of depositor protection**

Policymakers have many choices regarding how they can protect depositors. Some countries have implicit protection that 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 government's 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 or the form which reimbursement will take. By its nature, implicit protection creates uncertainty about how depositors, creditors and others will be treated when bank failures occur. Funding is discretionary and often depends on the government's ability to access public funds. Although

## FINANCIAL STABILITY FORUM

a degree of uncertainty can lead some depositors to exert greater effort in monitoring banks, it can undermine stability when banks fail.

Statutes or other legal instruments usually stipulate explicit deposit insurance systems. Typically, there are rules governing insurance coverage limits, the types of instruments covered, the methods for calculating depositor claims, funding arrangements and other related matters. A deposit insurance system is preferable to implicit protection if it clarifies the authorities' obligations to depositors and limits the scope for discretionary decisions that may result in arbitrary actions. A deposit insurance system can also provide countries with an orderly process for dealing with bank failures.

The introduction of a deposit insurance system can be more successful when a country's banking system is healthy. A deposit insurance system can contribute effectively to the stability of a country's financial system if it is part of a well-designed safety net. To be credible, a deposit insurance system needs to be properly designed, well implemented and understood by the public. It also needs to be supported by strong prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws. A deposit insurance system can deal with a limited number of simultaneous bank failures, but cannot be expected to deal with a systemic banking crisis by itself.

### **3. Moral hazard**

A well-designed financial safety net contributes to the stability of a financial system; however, if poorly designed, it may increase risks, notably moral hazard. 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. In these cases, depositors have less incentive to access the necessary information to monitor banks. As a result, in the absence of regulatory or other restraints, weak banks can attract deposits for high-risk ventures at a lower cost than would otherwise be the case.

Moral hazard can be mitigated 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. These elements involve trade-offs and are most effective when they work in concert.

Good corporate governance and sound risk management of individual banks help to ensure that business strategies are consistent with safe-and-sound operations, and thus can act as the first line of defence against excessive risk taking. Good corporate governance and sound risk



## FINANCIAL STABILITY FORUM

management includes standards, processes, and systems for ensuring appropriate direction and oversight by directors and senior managers, adequate internal controls and audits, management of risks, the evaluation of bank performance, the alignment of remuneration with appropriate business objectives, and management of capital and liquidity positions.

Moral hazard can be mitigated by market discipline exercised by shareholders as well as by larger creditors and depositors who are exposed to the risk of loss from the failure of a bank. However, for market discipline to work effectively, these groups must have the knowledge required to assess the risks they face. Information should be readily available and be generally understandable by the public. Sound accounting and disclosure regimes are required, as well as ongoing attention to a bank's soundness by ratings agencies, market analysts, financial commentators and other professionals.

Many countries rely heavily on prudential regulatory and supervisory discipline to mitigate moral hazard and control excessive risk taking. Regulatory discipline can be exercised through sound and effective regulations covering the establishment of new banks, the implementation of minimum capital requirements, the qualifications of directors and managers, sound-business activities, fit-and-proper tests for controlling shareholders, standards for risk management, strong internal controls, and external audits. Supervisory discipline can be exercised by ensuring that banks are monitored for safety and soundness as well as compliance issues and that corrective actions are taken promptly when problems surface, including the closure of banks when necessary.

Specific deposit insurance design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; using certain forms of coinsurance; implementing differential or risk-adjusted premium assessment systems; minimising the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts.

Many of the methods used to mitigate moral hazard require certain conditions to be in place. For example, differential or risk-adjusted differential premium assessment systems may be difficult to design and implement in new systems and in emerging or transitional economies. Early intervention, prompt corrective action and, when warranted, bank closure require that supervisors and deposit insurers have the necessary legal authority, in-depth information on bank risk, financial resources, and incentives to take effective action. Personal-liability provisions and availability of sanctions can reinforce incentives of bank owners, directors, and managers to control excessive risk, but they depend on the existence of an effective legal system that provides the necessary basis for action against inappropriate behaviour.

## **FINANCIAL STABILITY FORUM**

Policymakers should consider a country's conditions and factors that may determine the effectiveness of particular measures for mitigating moral hazard, the commitment and the ability to implement them, and the advancement of a reform agenda to eliminate gaps that may limit their effectiveness.

## **IV Processes for Adopting and Maintaining a Deposit Insurance System**

This section sets out the general policy issues and processes that need to be addressed when adopting or reforming a deposit insurance system. The discussion begins with a focus on the public-policy objectives of a deposit insurance system. It is then suggested that policymakers conduct a situational analysis to guide their deliberations. Some special issues related to transitioning from a blanket guarantee to a deposit insurance system are discussed in the penultimate part of this section. In the final part, a six-step iterative self-assessment methodology is presented.

### **1. Public-policy objectives**

The first step in designing a deposit insurance system is to identify the public-policy objectives that it is expected to achieve and these objectives must be well understood. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and to protect less-financially-sophisticated depositors. Although the determination of such objectives is the responsibility of governments, the private sector can play a role in their achievement. The choice of how a deposit insurance system is to be operated depends on many factors that are unique to each country and its governmental and financial systems.

A well-designed and well-understood deposit insurance system contributes to the stability of a country's financial system by reducing the incentives for depositors to withdraw their insured deposits from banks because of a loss of confidence. Policymakers should ensure that the authorities and the public view all components of the deposit insurance system as credible. The level and scope of coverage, the speed with which insured deposits are repaid, and the credibility of the underlying guarantee will affect the deposit insurance system's ability to enhance the stability of the financial system. Public attitudes and expectations play a particularly important role in reinforcing the credibility and the effectiveness of a deposit insurance system.

Deposit insurance protects insured depositors against the consequences associated with the failure of a bank but it is not designed to protect banks from failing. The provision of deposit insurance relieves insured depositors of the difficult tasks of monitoring and assessing the condition of banks and their asset quality. At the same time, deposit insurance contributes to the maintenance of confidence, so that less-financially-sophisticated depositors, or those who find it hard to assess the financial condition of a bank, are less likely to participate in bank runs.

## FINANCIAL STABILITY FORUM

A continuous-improvement process should exist for reviewing the extent to which a deposit insurance system is meeting its public-policy objectives and its mandate. Also, the appropriateness of the mandate, powers and elements that make up a deposit insurance system should be periodically reviewed. In this way, countries can ensure that their deposit insurance arrangements remain consistent with economic and social conditions and lessons learned, and that financial safety-net participants are better able to deal with the challenges they may encounter.

### **2. Situational analysis and implementation considerations**

In conjunction with the identification of public-policy objectives, policymakers should conduct a situational analysis to guide their decision-making. Among the conditions and factors that should be taken into consideration are: the level of economic activity; current monetary and fiscal policies; the state and structure of the banking system; public attitudes and expectations; the legal framework; prudential regulatory, supervisory, accounting and disclosure regimes. Where existing conditions and factors are not ideal, it is important to identify gaps and thoroughly evaluate the options available since the establishment of a deposit insurance system is not a remedy for dealing with major deficiencies. If actions are necessary, they can be taken before, or in concert with, the adoption or reform of a deposit insurance system.

#### *(a) Economic factors, the state and structure of the banking system and public attitudes and expectations*

The establishment of a deposit insurance system is more difficult if underlying issues relating to the stability of the financial system have not been addressed. Policymakers should undertake an analysis of conditions and factors such as the level of economic activity, current monetary and fiscal policies, inflation and the condition of financial markets. These conditions and factors affect the banking system and will influence the effectiveness of a deposit insurance system. A situational analysis also requires an assessment of 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. When problems exist, an assessment should be made as to whether they are confined to individual banks or are systemic in nature.

The number, type and characteristics of banks will have design implications for a deposit insurance system and so the structure of the banking system should be analysed. Policymakers also may need to examine the extent of competition, concentration, and the degree of state ownership as well as state direction. The issue of concentration is of growing importance for deposit insurance systems given the globalisation of capital markets and financial industry

## FINANCIAL STABILITY FORUM

consolidation. For example, in a concentrated system the capacity of a deposit insurance system to fund or cope with the failure of a large and complex bank may be problematic.

When resource distribution and credit decisions are directed mainly by the state, the state is viewed as being responsible for the results of such operations. Deposits in such systems generally are perceived as having a full government guarantee.

It is advisable to undertake an analysis of public attitudes and expectations before adopting or reforming a deposit insurance system. If there are significant gaps between expectations and planned systems or reforms, they will need to be addressed through greater public awareness. Public awareness plays a particularly important role in enhancing the credibility and the effectiveness of a deposit insurance system.

### *(b) The state of legal, prudential regulatory, supervisory, accounting and disclosure regimes*

It is important for policymakers to assess the state of legal, prudential regulatory and supervisory, accounting and disclosure regimes. Policymakers have a wider range of options available for designing a deposit insurance system if these regimes are robust.

A critical element of a sound legal regime is the ability to enforce laws. Deposit insurance systems cannot be effective if relevant laws do not exist or if the legal regime is characterised by inconsistencies. The situational analysis should focus on the level of enforcement, the efficiency of the judicial system, and the effectiveness of creditors' redress mechanisms. Additional factors that should be considered include: the ability of a legal regime to support early intervention and prompt corrective action, the ability to close troubled banks promptly, and provisions for the clear and orderly liquidation of assets and resolution of creditors' claims.

The strength of prudential regulation and supervision will have implications for the effectiveness of a deposit insurance system. Strong prudential regulation and supervision should allow only viable banks to operate. 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, and the risk assessment of individual banks.

Sound accounting and financial reporting 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.

## FINANCIAL STABILITY FORUM

Attributes of a sound accounting regime include accurate and meaningful assessments of information in areas such as asset valuation, the measurement of credit exposures, loan-loss provisioning, measurement of nonperforming loans, the treatment of unrealised losses, off-balance-sheet exposures, capital adequacy, and bank earnings and profitability. In many countries, increased market discipline has been fostered by the adoption of sound and prudent accounting principles and practices, and methods to ensure compliance with agreed-upon accounting conventions.

Comprehensive disclosure regimes also enhance the effectiveness of a deposit insurance system. This can be accomplished by requiring banks to release timely, detailed and useful financial information so the market can assess the performance of a bank.

### **3. Transitioning from a blanket guarantee to a deposit insurance system**

Some countries have introduced an explicit blanket guarantee during a financial crisis to fully protect all bank depositors and creditors. The provision of such guarantees may be unavoidable in periods of extreme financial distress to maintain domestic and international confidence in the banking system. However, blanket guarantees can have a number of adverse effects if retained too long, notably an increase in moral hazard. If a country decides to transition from a blanket guarantee to a deposit insurance system, the transition should be as rapid as a country's circumstances permit.

A country considering transitioning from a blanket guarantee to a deposit insurance system should undertake the same type of situational analysis as a country moving from implicit protection. In addition, 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 other creditors is being reduced. This may present a concern to the public. Therefore, policymakers should pay particular attention to public attitudes and expectations. In addition, 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 final issue concerns how fast the transition should proceed. 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. When a fast-track

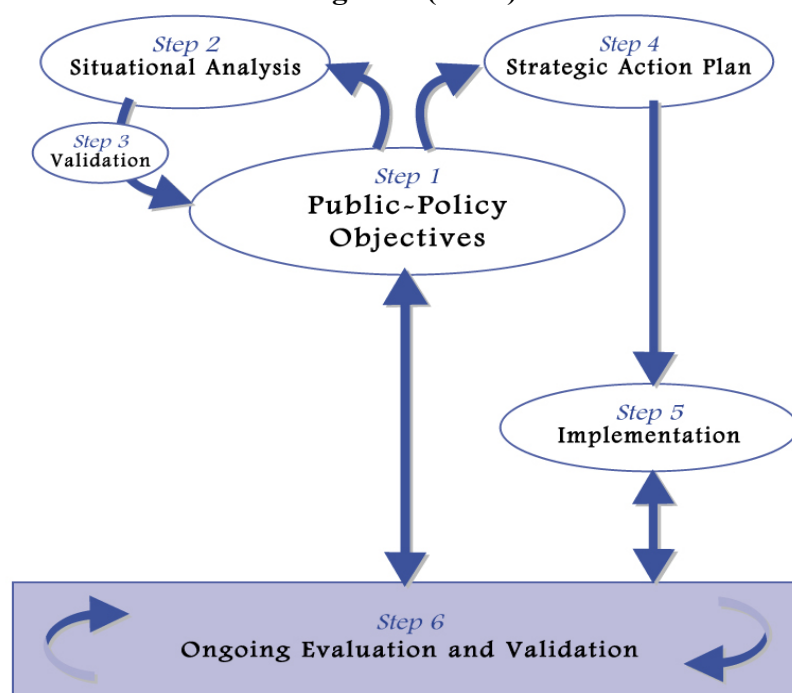
approach is adopted, policymakers should consider phase-in provisions such as continuing to protect deposits with maturities extending beyond the expiration date of a blanket guarantee.

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 new prudential standards. 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.

#### **4. Self-assessment methodology (SAM)**

In its outreach sessions the Working Group suggested that policymakers use an iterative “self-assessment methodology” as a tool to design, implement, modify and continually assess a deposit insurance system. The six-step methodology presented below allows policymakers to begin from general principles and then modify, as appropriate, the specific design features to meet their own country's needs.

Figure 1 (SAM)



**1. Setting out the public-policy objectives.** The process begins with an articulation of the relevant public-policy objectives to be attained. This analysis should take into account the conditions and factors that are present in a given country. A public-policy paper should outline the mandate and the role that the deposit insurer is expected to achieve within the financial safety net and set out the key attributes and important elements of the system.

**2. Situational analysis of conditions and factors.** The analysis should consider: economic factors, current monetary and fiscal policies, the state and structure of the banking system, public attitudes and expectations, the state of the legal, prudential regulatory and supervisory, and the accounting and disclosure regimes. The analysis should expose the strengths, weaknesses, opportunities and threats of the system and identify the changes required in constructing a deposit insurance system.

**3. Validation.** A review and validation process of the proposed public-policy objectives, key attributes and important elements should be undertaken and adjustments made if necessary.

**4. Strategic action plan.** A strategic action plan should be developed after the validation phase has been completed. This plan should set out the goals and their priorities, time frames, critical paths, communication strategies, and consultative processes. It should define how the deposit insurance system will be made operational and how it will deal with transitional issues. When transitioning from a blanket guarantee, care must be taken to ensure that the banking system is not disrupted. Policymakers should have contingency plans to deal with any adverse developments. It is critical that the public understand the planned changes and the time frame for completion.

**5. Implementation and acceptance phase.** Implementation and other changes should be supported by mechanisms to track progress and identify required adjustments. The purpose of this phase is to make the system operational and deal with transitional issues. For example, appropriate corporate governance arrangements (the governing body, senior management, internal controls, and an accountability regime) will need to be put in place. Also, budgets, funding, and access to information, including information-exchange arrangements, will need to be addressed at the outset.

**6. Ongoing evaluations and validation.** Ongoing evaluation and validation is needed to ensure the effectiveness of a deposit insurance system, and to make changes when required. This continuous-improvement process should incorporate new developments in the financial system and the lessons learned at home and abroad. Deposit insurance systems should be reviewed in a timely fashion. Benchmarking against core principles, guidelines and best practices enhances the continuous-improvement process.



## V. Structure and Design Features

This section focuses on the structure and design features of a deposit insurance system. After policymakers have completed a situational analysis, as part of a self-assessment process, attention should turn to issues such as the mandate, powers and structure of the deposit insurance system. In recognition of the interconnectedness of a deposit insurance system with the other safety-net functions, it is critical to address interrelationship issues among financial safety-net participants. Once those issues have been addressed, design features such as membership, coverage, funding and public awareness can be considered. At the end of this section there is a discussion of cross-border deposit insurance issues.

### 1. Mandates, powers and structure

#### *(a) Mandates and powers*

A mandate 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 risk-minimisation, with a variety of combinations in between. Whatever the mandate selected, it is critical that there be consistency between the stated objectives and the powers and responsibilities given to the deposit insurer.

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 authority, as well as access to deposit information and adequate funding, for the timely and efficient reimbursement of depositors when banks fail.

A “risk-minimiser” deposit insurer has 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 also may provide financial assistance to resolve failing banks in a manner that minimises losses to the deposit insurer. Some risk-minimisation systems have the power to set regulations, as well as to undertake enforcement and failure-resolution activities.

Formally specifying the mandate of a deposit insurer (either in law, in a formal policy statement, an agreement, or by private contract) clarifies the role of deposit insurance within the financial safety net. Clarity of the mandate reinforces the stability of the financial system and contributes to sound governance and greater accountability.

## FINANCIAL STABILITY FORUM

As a general principle, a deposit insurer should have all powers necessary to fulfil its mandate. All deposit insurers require the ability to enter into contracts, set appropriate requirements, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.

### *(b) Basic structure and operational issues*

Regardless of the scope of a deposit insurer's mandate, there are certain structural and operational issues that must be addressed. One of the first tasks is to determine whether the deposit insurance function should be assigned to an existing organisation or whether a separate entity should be established.

Assigning the deposit insurance function to an existing entity, (for example adding a department to a central bank), has the advantage of allowing the deposit insurer to draw on staff resources and skills from the larger organisation. However, this approach also has drawbacks. The primary disadvantage is that a larger organisation may have difficulties separating its other responsibilities and interests from the deposit insurance function. Whether or not the deposit insurer is a separate organisation, it is vitally important to set clearly the responsibility and accountability of each safety-net function.

### *(c) Basic governance arrangements*

There are a variety of forms of governance that can be used by a deposit insurance system. The form of governance utilised should reflect the mandate and the degree to which the deposit insurer is legally separated from the other financial safety-net participants.

The governing body of the deposit insurance system should include individuals with the requisite knowledge who understand the organisation's activities as well as the environment in which it operates, and they should have the authority to make decisions. The deposit insurer should have access to the input and views of the other safety-net participants and relevant interested parties. Members of the governing body and management of the deposit insurer should be subject to a fit-and-proper test, and they should be free from conflicts of interest.

Governance systems and practices should be developed on the basis of sound strategic planning, risk-management processes, and good internal control and audit systems. The governance structure should be transparent and subject to clear oversight and accountability. Rules specifying corporate governance practices should be developed.

*(d) Human resources and statutory indemnification*

The ability to attract and retain qualified employees is a key challenge for most deposit insurers. Indeed, a lack of skilled staff, capable of dealing with the complex and rapidly evolving issues that characterise periods of financial stress, has increased costs for a number of governments and deposit insurers.

Several approaches have been employed to ensure the availability of qualified people to meet the operational objectives of deposit insurance systems. They include the use of dedicated resources, access to the resources of other financial safety-net participants and/or reliance on outside service providers.

The importance of statutory indemnification should be recognised and employees should receive legal protection against lawsuits for their actions taken in good faith. The lack of legal protection for employees can reduce incentives to be vigilant in carrying out their responsibilities, particularly in cases where mandates emphasise early detection, intervention and closure of troubled banks.

**2. Interrelationships among financial safety-net participants**

Policymakers should address the deposit insurer's relationships and coordination with the other safety-net participants. A need for close coordination exists in any institutional setting and information sharing among safety-net participants is essential.

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.

The supervisory authority usually is the primary source of information on banks. 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. Depending on the breadth of their individual mandates, deposit insurers may need to supplement information provided by supervisors with information collected directly from banks.

A deposit insurer's information needs vary significantly according to its mandate and powers. All deposit insurers need information to be able to reimburse depositors' claims when

## FINANCIAL STABILITY FORUM

necessary, including information on the amount of insured deposits held by individual depositors. A deposit insurer should have ready access to specific information related to banks' deposit base, including the amount of insured and total deposits, so that plans for resources and funding needs can be developed. Accordingly, guidelines may need to be issued to ensure that banks maintain and safeguard appropriate records.

A deposit insurer with a risk-minimisation mandate must have access to timely and accurate information so that it can assess the financial condition of individual banks, as well as the banking industry. It also must anticipate the financial troubles of individual banks and deal with them effectively when they arise. The deposit insurer also needs information regarding the value of the bank's assets and the expected time frame for the liquidation process, given that the value of a bank's assets depends, in part, on the time necessary to liquidate them.

Although informal arrangements for information sharing and coordination can work well, clearly specified agreements are highly desirable, given the sensitivity of bank-specific information and the need to maintain confidentiality. The challenge of maintaining open communication channels suggests that it may be useful to formalise these arrangements 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. Rules regarding confidentiality of information should apply to all safety-net participants.

### **3. Membership and coverage**

This subsection deals with specific design features, such as which institutions should be eligible for membership, what financial instruments should be covered, and the level of coverage. A number of different factors should be taken into consideration to determine which financial institutions should be members of a deposit insurance system. Of particular importance is whether they are subject to strong prudential regulation and supervision. Explicit eligibility rules for membership should exist and membership should be compulsory, in most circumstances. In addition, it is important to define clearly in law or private contract what is an insurable deposit.

## FINANCIAL STABILITY FORUM

### *(a) Membership*

#### *(i) Compulsory membership*

In general, membership should be compulsory to avoid adverse selection. There are some cases, however, where a strong commitment of banks to participate in a deposit protection system can be observed and broad participation of banks may be achieved without a legal obligation. This can occur if depositors are aware of and sensitive to the existence of deposit insurance, thus creating strong incentives for banks to be part of a system. In other cases, if depositors are less concerned about deposit insurance or are not aware that coverage is limited to certain banks, then the stronger banks may opt out. Further, in a voluntary system strong banks may opt out if the cost of failures is high and this may affect the financial solvency and the effectiveness of a deposit insurance system.

#### *(ii) Considerations when granting membership to banks*

There are two circumstances that may require different approaches to granting membership to banks. First, when a deposit insurance system is established and second, when membership is granted to new banks in an existing system.

When a deposit insurance system is created, policymakers are faced with the challenge of minimising the risks to the deposit insurer, while granting extensive membership. Generally, two options are available: automatic membership or requiring banks to apply for entry.

Automatic membership for all banks may be the simplest option in the short term. However, the deposit insurer may then be faced with the difficult task of having to accept banks that create an immediate financial risk or that pose other adverse consequences for the deposit insurance system.

Alternatively, banks may be required to apply for membership. This option provides the deposit insurer with the flexibility to control the risks it assumes by establishing entry criteria. It also can 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. The criteria should be transparent.

The way that policymakers grant membership in existing deposit insurance systems varies. In some countries, the licensing or chartering of new banks and the granting of membership in a deposit insurance system are separate functions of different safety-net participants. In other countries the relevant safety-net participants jointly approve new members and in others, membership is automatic with the issuance of a bank charter or license. Whichever option is

## FINANCIAL STABILITY FORUM

chosen, appropriate mechanisms are necessary to ensure that membership requests are handled expeditiously and effectively, and that eligible banks meet minimum prudential standards and entry requirements.

### *(iii) Foreign banks*

Although domestically incorporated or chartered banks are the principal members of most deposit insurance systems, some countries require foreign-bank subsidiaries and branches to participate in the system as well. Several arguments are made for their inclusion: the stability of the domestic financial system; the goal of providing a minimum level of deposit insurance to all depositors; the notion that foreign banks benefit from a stable domestic financial system and should therefore participate in the deposit insurance system as part of doing business in a country; the desire to minimise competitive issues by placing foreign banks on the same footing as domestic banks; and the diversification that arises from wider membership and expansion of the funding base.

### *(iv) Non-bank financial institutions*

Policymakers take different approaches to non-bank financial institutions that offer deposits and deposit-like products. The rationales for expanding membership beyond banks 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.

There are many cases, however, where non-bank financial institutions are excluded from membership. The most common reasons are that such institutions may not be as relevant as banks to a country's financial stability, that they may be subject to different regulatory and supervisory standards, and they may have different authorities overseeing their affairs. In such circumstances, policymakers may establish separate protection schemes to cover non-bank financial institutions.

### *(v) State-owned banks*

State-owned banks present unique issues for deposit insurance systems. These banks are usually the beneficiaries of an implicit or full government guarantee that may make their inclusion in a deposit insurance system appear unnecessary. Nevertheless, some countries have chosen to include them in their systems. Some of the reasons are: to facilitate privatisation; to ensure competitive equality with private-sector banks in terms of the level of coverage and premium contributions; to provide a mechanism to bring such banks under the

## FINANCIAL STABILITY FORUM

same prudential regulatory and supervisory rules applicable to other banks; and to diversify the deposit insurer's risks and increase its funding base.

### *(b) Coverage*

#### *(i) Scope and level*

Policymakers should define clearly in law or by private contract what is an insurable deposit. In doing so, they 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. Once the relevant deposits are selected, exclusions of specific deposits and/or depositors can be determined.

Many deposit insurance systems exclude deposits held by depositors who are deemed capable of ascertaining the financial condition of a bank and exerting market discipline. Examples include deposits held by banks, government bodies, professional investors such as mutual funds, and deposits held by bank directors and officers. In some cases, deposits held by individuals who bear responsibility for the financial well-being of a bank are excluded from reimbursement. Also, deposits with extremely high yields are sometimes excluded from coverage; or reimbursement may be limited to the principal owed, with a lower rate of interest applied. Many countries exclude bearer deposits because it is difficult to establish ownership of the account and to ensure that coverage limits are respected.

Once the scope is determined, the level of coverage can be set. This can be done 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. Whatever coverage level is selected, it must be credible and internally consistent with other design features, and meet the public-policy objectives of the system. Policymakers should consider the relationship between coverage levels and moral hazard.

There are a number of ways to apply coverage limits. Usually coverage limits are applied per deposit or per depositor. Using the per deposit method may be incompatible with ensuring limited coverage since a depositor can easily circumvent the limit by opening multiple accounts in a single bank for an amount equal to or below the insured limit. Focusing the coverage limit solely on the depositor avoids that pitfall but information requirements are greater since all deposit accounts held by a single depositor need to be identified and aggregated for deposit insurance purposes.

## FINANCIAL STABILITY FORUM

Coverage limits can also be applied per bank or across all member banks. Although coverage across all banks is likely to instill more market discipline, depositors may be affected by multiple bank failures even though they had diversified their risks among member banks. As a result, this approach may increase the potential for bank runs. Providing deposit insurance across all member banks requires detailed data of all depositor accounts in all banks. This type of coverage is highly difficult and costly to administer as it requires not only a great deal of information regarding ownership of deposit instruments but also requires a process for combining depositor accounts at different banks when they fail. It also requires that a time element be attached to the coverage limit- such as per calendar year. A mechanism would also be needed to track depositor reimbursements to determine when a particular depositor reached the coverage limit. This option is seldom used because of its complexity and its potential to undermine depositor confidence.

Given the importance of effectively limiting coverage and contributing to financial system stability, as well as keeping the requirement for information reasonable, it is preferable to apply deposit insurance on a per depositor per bank basis.

### *(ii) Coinsurance*

One approach to foster market discipline and to reduce somewhat the costs of deposit insurance is the use of coinsurance, whereby a pre-specified proportion of deposits is insured. Depositors in a limited-coverage deposit insurance system should be aware that they may suffer losses if their deposits exceed the limit when a bank fails. This awareness will be heightened under coinsurance because depositors may suffer losses if their deposits are below the insurance limit. However, even under a coinsurance system, individuals who have small account balances may not exercise market discipline because of a lack of financial incentives or sophistication, or because the costs of doing so exceed the benefits. In this case, individuals bear a cost for bank failure without increasing market discipline. As well, for coinsurance to be effective, extensive information needs to be provided to the public regarding the financial condition of banks.

A negative consequence of coinsurance is that depositors may opt out of the banking system. One way to protect against these potentially adverse effects is to apply it above a certain amount so that individuals holding small account balances are protected fully against the risk of loss, while maintaining the incentive for depositors holding larger account balances to monitor banks.



## FINANCIAL STABILITY FORUM

### *(iii) Adjusting coverage limits*

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 may require the adjustment of coverage limits. A trade-off exists, however, between the goal of maintaining the level of deposit insurance constant for a sufficiently long period of time so that depositors know the coverage limit with certainty, and the goal of setting the level of coverage that is appropriate to meet the objectives of the system. This problem is especially acute for high-inflation countries.

Adjustments to the level of deposit insurance coverage may take place either on a discretionary basis or they may be made systematically through automatic or periodic indexing. Indexed adjustments may be automatically implemented, which requires care in choosing the frequency and amounts of adjustments. If adjustments occur too often, or for odd amounts, this could confuse the public. Alternatively, if adjustments occur too infrequently, the deposit insurance system may be unable to meet its stated public-policy objectives.

### *(iv) Foreign-currency deposits*

The decision whether to cover deposits denominated in foreign currencies depends heavily on a country's usage of foreign currency. When usage is high, it would be of little value to institute a deposit insurance system without covering these deposits.

If foreign-currency deposits are to be covered by deposit insurance, it is important to consider whether these deposits are to be reimbursed in local or foreign currency when a bank fails. This decision is important because it has implications as to who bears the foreign-exchange risk. If reimbursements are made in foreign currency, the deposit insurer may bear this risk. If foreign-currency deposits are converted into local currency before reimbursing depositors after a bank failure, the risk is transferred to the depositors. If reimbursements are made in local currency, a transparent rule should be set out in advance with respect to the date chosen for the exchange rate that will be used to calculate the amount to be reimbursed. At a minimum, a system that offers to repay depositors in a foreign currency must have access to sufficient foreign assets or other sources of foreign-currency funding to make this commitment credible.

To mitigate foreign-exchange risk, policymakers should ensure that banks have sound foreign-exchange risk-management systems and controls in place. Furthermore, the deposit insurer should develop sound policies and procedures to prudently manage any foreign-exchange risk it faces. In designing such policies and procedures, the deposit insurer may wish to draw on the expertise residing in banks.

#### 4. Funding

Sound funding arrangements are critical to the effectiveness of a deposit insurance system and the maintenance of public confidence. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims after a bank failure. Inadequate funding can lead to delays in resolving failed banks, to significant increases in costs and a loss of credibility of the deposit insurance system. Funding can be assured in many ways, such as government appropriations, levies or premiums assessed against member banks, market borrowings, or a combination thereof.

Premiums or levies can be assessed on an *ex-ante* or *ex-post* basis. Beyond the decision of how to fund a deposit insurance system, some additional issues should be considered by policymakers. Among these are: how deposit insurance assessments should be determined, verified, and collected; and whether it is appropriate to establish separate deposit insurance funds for different types of deposit-taking institutions.

Member banks should pay the cost of deposit insurance since they and their clients directly benefit from having an effective deposit insurance system. Policymakers should consider the effect of premium levels on the financial health of the banking industry, and an assessment base should be chosen against which a given premium rate will be applied. One choice is insured deposits; alternatively, a bank's total deposit liabilities may be used. Although the use of total deposit liabilities may be easier administratively, there may be issues of equity since banks that rely more heavily on uninsured deposits for funding could be required to pay a disproportionate share of premiums.

##### (a) *Funding on an ex-ante or ex-post basis*

*Ex-ante* funding, which refers to the accumulation of a reserve or a fund, provides an opportunity to smooth the premiums paid by banks over the course of a business cycle. Because all banks contribute to building and maintaining a reserve or fund, banks that subsequently fail will have contributed to paying for the cost of their failure. *Ex-ante* funding sources may be supplemented by measures such as *ex-post* levies or premium assessments on member banks, draws on government lines of credit, and/or government guarantees. *Ex-ante* funding has the potential to remove capital from the banking system because premiums paid to the deposit insurer cannot be used for other purposes. If policymakers decide to use *ex-ante* funding, the deposit insurer should ensure that funds are well managed and readily available to cover losses as they arise. This can be accomplished by implementing appropriate investment policies and procedures, and by instituting sound internal controls, disclosure and reporting systems.

## FINANCIAL STABILITY FORUM

*Ex-post* funding requires member banks to pay premiums or levies only after failures occur and are most likely to be assessed during an economic downturn. *Ex-post* funding may improve inter-bank monitoring because each bank has an incentive to avoid the costs associated with the failure of a member. Such incentives may be particularly strong in banking systems characterised by a small number of large banks. Because assessments and collections occur post-failure, prompt reimbursement of insured depositors may be more problematic if other funding mechanisms are unavailable at the time. Moreover, banks that fail will not have contributed to funding the costs associated with their failure.

Failures often occur during an economic downturn and, in some circumstances, this may create pressure to provide forbearance because the banking system's ability to pay is weakened. In some cases, this can be offset if the deposit insurer has access to other resources such as government assistance through temporary funding mechanisms, guarantees or backstops. The costs associated with providing such assistance should be recovered through future assessments against banks.

In practice, deposit insurance systems often are funded on a combined *ex-ante* and *ex-post* basis. The advantages and disadvantages associated with *ex-ante* and *ex-post* funding are generally applicable to hybrid funding arrangements.

### *(b) Issues related to the establishment and size of a deposit insurance fund*

In principle, there are two approaches available to establishing a deposit insurance fund. First, banks may be assessed a steady premium rate over a long period. This approach allows a deposit insurance fund to fluctuate in response to insurance losses and movements in the deposit insurance fund do not trigger automatic changes in premium rates. Using this approach the insurer could be dependent on government or other financial support in times when the fund is inadequate to meet obligations to depositors.

Second, a premium assessment system can be designed to maintain a target fund ratio or range. Using this approach, premiums could be set and adjusted over time by taking into account some ratio of the deposit insurance fund to insured deposits, for example. This approach helps to mitigate the loss exposure that the deposit insurer is assuming. In principle, the target fund ratio should be sufficient to reduce the probability of the fund's insolvency to an acceptable minimum, although estimating probabilities of loss is very complicated in practice. Policymakers in economies that are subject to greater financial-system volatility should take this into account when determining their funding needs.

Using a target fund ratio method could lead to a *de facto ex-post* system after the deposit insurance fund achieves a certain level. This method can also result in banks paying few

## FINANCIAL STABILITY FORUM

premiums in good economic times, but paying higher premiums during an economic downturn.

A case can be made either for establishing and maintaining one fund or for establishing and maintaining separate funds for different types of financial institutions that accept deposits from the public. If separate funds are established, policymakers should ensure that distinctions among the institutions and their funds do not contribute to competitive distortions.

### *(c) Deposit insurance assessments: flat-rate versus risk-adjusted differential premium systems*

Policymakers have a choice between adopting a flat-rate premium system or a premium system that is differentiated on the basis of individual-bank risk profiles. The primary advantage of a flat-rate premium system is the relative ease with which assessments can be calculated and administered. However, in a flat-rate system, low-risk banks effectively pay for part of the deposit insurance benefit received by high-risk banks.

Most newly established systems initially adopt a flat-rate system given the difficulties associated with designing and implementing a risk-adjusted differential premium system. However, because flat-rate premiums do not reflect the level of risk that a bank poses to the deposit insurance system, banks can increase the risk profile of their portfolios without incurring additional deposit insurance costs. As a result, flat-rate premiums may be perceived as encouraging excessive risk taking by some banks, unless there is a mechanism to impose financial sanctions or penalties.

Risk-adjusted differential premium systems can mitigate such criticisms and may encourage more prudent risk-management practices at member banks. When the information required to implement a risk-adjusted differential premium system is available, relating premiums to the risk a bank poses to the deposit insurer is preferable.

The information-intensive nature of the intermediation process, however, makes risk measurement a complicated task. The particular difficulties related to risk-adjusted differential premium systems include: finding appropriate and acceptable methods of differentiating bank risk; obtaining reliable and timely data; ensuring that rating criteria are transparent; and examining the potential destabilising effects of imposing high premiums on already troubled banks. As well, risk-adjusted differential premium systems require resources necessary to administer the system appropriately. An important but delicate issue that policymakers should consider is whether to allow the release of information related to the risk profile of each bank, or to restrict this information for confidentiality or other reasons.

## 5. Public awareness

In order for a deposit insurance system to be effective, it is essential that the public be informed about its benefits and limitations. Experience has shown that the characteristics of a deposit insurance system need to be publicised regularly so that its credibility can be maintained and strengthened.

A well-designed public-awareness program can achieve several goals, including the dissemination of information that promotes and facilitates an understanding of the deposit insurance system and its main features. Also, a public-awareness program can build or help restore confidence in the banking sector. Additionally, such a program can help to disseminate vital information when failures occur, such as guidance regarding how to file claims and receive reimbursements.

When designing a public-awareness program, it is critical to identify the target audience. Bank employees, especially those in operations, as well as those on the front-line, are important conduits for providing information about deposit insurance.

Care should be taken to select strategies that meet the goals set in the public-awareness program. A public-awareness plan that addresses issues related to failures should be carefully developed before an actual failure occurs. A well-designed public-awareness program helps to counteract the potentially disruptive effects of bank failures and helps maintain confidence in the stability of the financial system.

In countries where public confidence in the banking system is high and awareness of an existing deposit insurance system is very low, special communication strategies need to be developed to ensure that the stated goals are achieved while public confidence is maintained.

## **Cross-Border Issues**

Deposit taking is usually a domestic business, but cross-border issues are increasing in many jurisdictions. In some countries, cross-border issues already play a considerable role in the creation and design of a deposit insurance system. This is the case, for example, where banking systems are characterised by a significant presence of foreign-bank branches. In weak banking systems (especially after a crisis), the outflow of deposits to other countries may have to be taken into account when establishing or reforming a deposit insurance system. In regions where economies are closely related, or in closely integrated regions, such as in the European Union (EU), special considerations may apply. The EU minimum requirements for deposit insurance are harmonised and the responsibility for providing deposit insurance rests primarily with the home country.

Relevant laws, regulations and other provisions applicable to banks, their customers and deposit insurers are generally those of the bank's country of incorporation or charter. However, if a bank operates branches in other jurisdictions or provides services to customers' abroad, the laws and regulations of other countries may apply. Depending on the volume of these activities, the implementation of policies by home and host countries regarding issues such as coverage and asset disposition can be crucial for the effective operation of deposit insurance systems and for the achievement of public-policy objectives.

Deposits collected from individuals located in countries where a bank has not established a physical presence (that is, a branch or subsidiary) normally are covered by the deposit insurance system the bank belongs to in its home country. Deposits at foreign branches may be protected by the bank's home-country

deposit insurance system, by the host-country system where the branch is located, by a combination of both systems, or not protected at all. Where deposits are covered by a combination of both systems, the home-country system may provide basic coverage that is supplemented by the host country.

Foreign banks may expose the deposit insurer to risks that it has a limited capacity to mitigate. Additionally, they may complicate the recovery process in the event of a failure, because assets located abroad may be subject to another country's bankruptcy/insolvency regime.

Foreign branches participating in a host country deposit insurance system should conform generally to the membership criteria of the host-country system, which may possibly include the application of supervisory requirements on a stand-alone basis. If the host-country system provides supplementary coverage, multiple reimbursements of insured depositors should be avoided. The deposit insurance already provided by the home-country system should be recognized in the determination of levies and premiums.

In general, information received by safety-net participants in other jurisdictions should be subject to the same strict confidentiality rules applicable to information received from other domestic safety-net participants. 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 any case, deposit insurers should receive all information necessary to enable a prompt reimbursement of claims of depositors and to enable them to meet their mandate.

## VI. Resolutions, Reimbursements, Claims and Recoveries

Timely and effective exit strategies for handling failed banks enhance confidence in a deposit insurance system, help contain costs, and avoid adverse effects on other safety-net participants, the government, the public, the banking industry, and the economy. Cooperation among the various financial safety-net participants, both before and after a failure, is essential if these results are to be achieved.

It is critical to determine when a bank is in serious financial difficulty. This determination should be made on the basis of well-defined and transparent criteria by a safety-net participant with authority to act. Prompt and decisive actions are crucial to reduce the cost of a bank failure but care needs to be taken to address confidentiality issues to protect the exchange of information among financial safety-net participants. There are a number of steps necessary to liquidate a bank's business and affairs. These steps include the resolution or disposition of the failed bank, reimbursement of insured depositors, liquidation of the bank's assets, settlement of claims in accordance with applicable laws, and disposition of pending or outstanding litigation.

From a deposit insurance perspective, the objectives of an effective failure-resolution process are to: meet the deposit insurer's obligations; ensure depositors are reimbursed promptly and accurately; minimise resolution costs and disruption of markets; maximise recoveries on assets; settle *bona-fide* claims on a timely and equitable basis; and reinforce discipline through legal actions in cases of negligence or other wrongdoings. There are potential tensions and trade-offs among these objectives that need to be addressed by policymakers.

### 1. Private-sector solutions

Before a troubled bank reaches the point of failure, it usually has been the subject of various efforts to strengthen its operations. Such actions may have included restructuring efforts that are broadly similar to resolution transactions, in that they involve a merger with, or acquisition by, a healthy bank. These efforts are frequently described as private-sector solutions and do not impose a cost on the deposit insurer.

Private-sector solutions require that action be taken early while acquirers are still willing to take over the troubled bank. They also require the existence of healthy banks, which have the financial and managerial capabilities to combine with weaker ones and that can continue to comply with regulatory and supervisory requirements. Finally, the responsible authority must be prepared to close a troubled bank if the private-sector solution fails, otherwise the bank's bondholders and shareholders may have little incentive to make the financial concessions necessary to help make a solution work.

## 2. Resolving troubled banks

A resolution may be defined as a method of disposing of a failed bank, which is directed by the responsible safety-net participant, and generally is designed to reimburse insured depositors while minimising costs to the deposit insurer.

### *(a) Options*

Three basic resolution options exist: liquidation and reimbursement of depositors' claims, purchase-and-assumption transactions (sales) and open-bank financial assistance. 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.

#### *(i) Liquidation and reimbursement of depositors' claims*

Reimbursement of depositors' claims occurs when an acquisition or merger is unattractive to potential acquirers or merger partners. The failed bank is closed and the assets and uninsured claims are transferred to a receiver/liquidator for liquidation and settlement. Reimbursing claims may be accomplished by directly paying depositors or by transferring their insured deposits to another bank.

#### *(ii) Purchase-and-assumption transactions (sales)*

In a purchase-and-assumption transaction, a healthy bank or group of investors assumes some or all of the obligations, and purchases some or all of the assets, of the failed bank. Assets purchased by the acquirer typically include performing loans and other good-quality investments. Assets not sold to the acquirer at resolution are passed on to the receiver/liquidator for disposition. Clearly, acquirers must have sufficient resources to absorb the acquisition, sufficient capital to handle the new bank's costs, and qualified management.

Variants of the purchase-and-assumption method include the "bridge bank," or other interim arrangements, which have been used primarily to manage failures of large and complex banks. In such arrangements, the responsible safety-net participant takes ownership or control of the failed bank and operates it for a period of time. The goals are to prevent further deterioration of the bank, give the authorities more time to seek a permanent resolution, and provide potential acquirers a greater opportunity to review the quality of the bank's assets. If the bank



## FINANCIAL STABILITY FORUM

remains too long under official control, however, it may lose value and may draw deposits away from other banks. The authorities, as well, may be tempted to postpone a permanent solution unduly. As a result, it may be desirable to establish limits on the length of time that such arrangements remain in operation.

### *(iii) Open-bank financial assistance*

Financial assistance may be provided to an operating bank that is in danger of failing. The deposit insurer may retain ownership rights in the bank and additional capital from outside investors and replacement of managers and directors may be required. Uninsured depositors and certain other creditors are generally fully protected, although bondholders and shareholders may be required to bear significant losses.<sup>3</sup> Open-bank assistance usually is provided to banks when it is believed that closing them would pose significant risks for the stability of the financial system.

Open-bank assistance has features that some countries regard as undesirable. Bondholders and shareholders, while suffering losses, may receive compensation or benefits that they would not otherwise receive. Depending on the legal system, closed-bank transactions also may have other advantages. For example, the appropriate authority may have the right to abrogate certain contracts without penalty. Finally, where small banks are generally ineligible for open-bank assistance, they may believe that they are being treated unfairly.

### *(b) Costs and other considerations*

Choices among resolution methods involve various considerations, including statutory requirements and mandates. Where least-cost resolutions are mandated to the deposit insurer, the chosen method must be demonstrated to be less costly than any other possible method. Alternatively, a less-stringent cost test might require that the chosen method be less expensive than a liquidation and reimbursement of depositors' claims. An implicit assumption in cost-test calculations is that the resolution of one failed bank will not affect the cost of subsequently resolving other banks. This is most likely to be true in countries where occasional bank failures are regarded as a normal occurrence and the failed bank does not represent a major proportion of the banking industry.

There may be special provisions for large and complex banks that are perceived to have special significance from the standpoint of financial-system stability or for banks whose closure would result in a harmful interruption of banking services in particular markets or regions. Such banks often have been resolved in ways that are not designed primarily to

---

<sup>3</sup> In some countries the deposit insurer may have significant legal exposure to dissatisfied creditors.

minimise resolution costs. In such circumstances, consideration should be given as to how these costs should be allocated.

### **3. Reimbursing depositors**

Determining who should be reimbursed and ensuring that deposit insurance limits are respected are the most crucial steps in the reimbursement process and are important to the effectiveness of a variety of resolution methods. This is most evident in a liquidation process where depositors' claims need to be reimbursed up to their insured limits. In other resolution transactions, determining the insurance status of individual accounts is also necessary, if such resolutions are to meet a least-cost test or when acquirers of failed banks assume only insured deposits. A determination of the status of individual accounts is also necessary when applicable statutes mandate the priority of insured depositor claims.

Systems and processes should be developed in order to undertake preparatory reviews of deposit liabilities held by troubled banks. This requires development of administrative practices and procedures and the ongoing review of the quality and security of bank deposit records.

#### *(a) Conditions for effective reimbursement*

Depositors need to know when and under what conditions the deposit insurer will start the reimbursement process, as well as the applicable coverage limits. If reimbursement does not occur immediately after closure of the bank, depositors should be told the time frame over which reimbursement will take place. The deposit insurer should know, as soon as possible, when a bank will be closed. Access to the necessary deposit data 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 insurer must decide whether to maintain adequate resources internally or whether it will outsource the function by employing contractors to handle reimbursements as they arise.

#### *(b) Eligibility for coverage*

The deposit insurer must assess the amount in each deposit account at the time of closure and determine whether the accounts are within the scope and limits of the deposit insurance system. In making such a determination, the deposit insurer must apply the laws governing ownership rights and capacities with respect to coverage of single accounts, joint accounts, business accounts, retirement accounts, and fiduciary accounts. In some countries, the deposit insurance limit is applied by combining all deposit accounts held by a depositor, while in others, deposit accounts held under different rights and capacities are insured separately. Other

## FINANCIAL STABILITY FORUM

important steps in the reimbursement process include the need to reconcile suspense accounts, process deposit and other items in transit and deal with clearing and settlement issues.

As discussed later in this section, rules regarding set-off and collateral must be applied in determining the amount of coverage. If the depositor reimbursement and claims/liquidation functions are administered separately, close cooperation between the responsible organisations is necessary in applying any set-off and collateralisation rules.

### *(c) Procedures for reimbursing depositors*

The deposit insurer's administrative practices and procedures should specify the necessary steps to ensure the accuracy of the reimbursement process. An important consideration is whether the verification and reconciliation of accounts can be achieved on the basis of the bank's own records, or whether the depositor is required to submit a claims form, effectively proving ownership of the account. In some cases requiring submission of a claims form may be inconvenient for depositors and can delay the reimbursement process, but this procedure may be necessary if the quality of the bank records is suspect or poor, or if bank-secrecy laws prevent accurate identification of depositors and their accounts.

Another important consideration is whether to pay depositors quickly or only after extensive verification of account data. A reasonable position would be to issue payments after best efforts to ensure accuracy and completeness have been made. In some situations, a possible remedy is to make partial payments to insured depositors before all the steps necessary for an accurate reimbursement process have been completed. The final action before reimbursement is the preparation of reconciliation statements specifying the amount to be paid to depositors and claimed from the liquidator/receiver. The reimbursement process should be evaluated *ex-post* to incorporate lessons learned.

### *(d) Payments to depositors*

Actual reimbursement can proceed after the deposit records, claims and rights have been reconciled. Reimbursements may be simplified if another bank agrees to make the payments. If this option is not available, the deposit insurer must select a method of payment such as: providing cash or issuing some other form of payment; mailing cheques; transferring funds to another bank designated by the depositor; issuing a debit card; or making a postal transfer.

Open communication channels through press releases, the news media, advertisements, posters, the Internet, and other means are crucial in maintaining public confidence in the deposit insurance system. The public should receive practical and accurate information about

when and how they will receive reimbursement of their claims. Direct communication through letters and telephone calls are necessary to respond to depositors' questions and complaints.

#### **4. Claims and recoveries**

##### *(a) General issues*

After a troubled bank has been closed, the responsible entity effectively inherits the bank's assets and liabilities. The remaining tasks in winding up the affairs of the bank are the management and liquidation of its assets and settlement of *bona-fide* claims. The ability to accomplish these tasks effectively is an essential part of a country's financial safety net. The powers provided to the entity responsible for the claims-and-recoveries function should be guided by applicable laws and should include control of the failed bank's assets; contract rights and privileges; the ability to allow or disallow claims; the capability to enforce or repudiate certain contractual obligations; and the ability to challenge fraudulent transfers and transactions. At the same time, fiduciary responsibilities imposed on the entity may limit its ability to fulfil other responsibilities.<sup>4</sup>

##### *(b) Asset-management and disposition strategies*

Asset-management and disposition strategies should be guided by commercial considerations and their economic merits, given 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. The goal of maximising recoveries may conflict with other goals, such as environmental considerations, or the pursuit of actions to enhance standards of business conduct.

Performing assets may be sold as part of the resolution transaction or as soon as possible thereafter, because they are marketable and have little or no potential for additional value. This also has the advantage of returning assets to the market quickly, thereby, distributing funds earlier to the deposit insurer, minimising carrying costs while assets are in the hands of the receiver/liquidator, and minimising government involvement. Other assets may be sold or otherwise liquidated over a period of time under professional management, with a view to optimising recoveries and reducing costs. Negotiations with borrowers also may be effective in the disposition of hard-to-sell assets. With respect to assets not sold immediately, it is vital

---

<sup>4</sup> There is considerable variation in the claims-and-recoveries roles played by deposit insurers and other safety-net participants. Where deposit insurance payments are 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. In some instances, deposit insurers have significant roles in the risk-

## FINANCIAL STABILITY FORUM

that their value be preserved through effective asset-management procedures in an effort to minimise costs to the financial system.

Effective asset management should include tools for validating assumptions used in valuing assets and developing disposition plans. Risks relating to market fluctuations, particular asset-disposition strategies, and asset-specific and legal issues should be identified, quantified, managed or hedged. The use of discounted cash-flow analysis or other appropriate valuation techniques is required to take into account differences in timing of recoveries and expenses and differences in risk among asset types. Consideration also may be given to differences in valuation among potential purchasers that arise from differences in plans and financing costs.

### *(c) Marketing methods*

Transparency and access to information are key factors in marketing failed-bank assets. The quality of the information may have an important bearing on the price. Therefore, information should be available, complete and arranged in as orderly a manner as possible.

In principle, a wide range of methods is available for disposition of the assets of failed banks. They include: asset-by-asset sales; auctions or sealed bids; asset pools; securitisation; asset-management companies; and equity partnerships.

In some instances, recoveries may be enhanced with seller financing, put-back arrangements that provide the buyer with the option of returning certain assets for refund within a specified period, or limited guarantees against loss. Guarantees will generally result in increased market prices because of the reduced risk to the purchaser, but have the disadvantage of creating contingent liabilities, which may be mitigated by limiting their duration and total value.

### *(d) Claims and litigation*

Claims and litigation advanced by the failed bank or the receiver/liquidator against directors, officers, auditors and other parties related to the bank failure are potentially important assets. These claims may result in significant recoveries and may serve as a tool for fostering discipline in the banking sector. For these reasons, potential claims should be identified and investigated carefully to determine the appropriateness and potential for recovery before being pursued.

---

minimisation or recovery processes, for example as a lender, creditor, or possibly receiver. In other cases, these functions are the responsibility of other entities.

## FINANCIAL STABILITY FORUM

It is important to identify claims and to distribute the proceeds of the liquidation of assets in a fair and cost-effective manner, and in accordance with applicable laws. This involves notifying potential claimants of the reimbursement process, reviewing and resolving asserted claims, distributing dividends to proven claimants, and transferring unclaimed dividends to the appropriate authority. Claims include those of the deposit insurer, uninsured depositors, and other unsecured creditors. They also include legal actions against the failed bank and the cost of any financial assistance that may have been provided by safety-net participants. Litigation instituted by creditors, shareholders, or other claimants and plaintiffs against the failed bank or the liquidator/receiver may result in significant costs and delays. In this regard, it may be advisable to conduct regular evaluation of the claims in order to estimate the potential liability exposure and consider alternative means for resolution.

### **5. Depositor ranking, collateralisation and rights of set-off**

How funds are distributed among claimants is heavily influenced by legal provisions regarding the ranking of depositors and other creditors, collateralisation of the bank's obligations, and the extent to which a creditor's debts to a bank are set-off against the creditor's claims. The rules governing these matters vary among countries, reflecting differences in laws, traditions and public-policy objectives, and are typically not subject to change by the deposit insurance system. Such rules can have important effects on the deposit insurer's costs and on the behaviour of safety-net participants, depositors and other creditors.

#### *(a) Depositor ranking*

Policymakers should be aware of the potential effects of existing depositor priority laws or statutes on failure-resolution costs and the incentive for depositors or other creditors to exert market discipline. If depositors rank equally with other unsecured creditors, they will receive *pro-rata* shares of recoveries from asset liquidation. If depositors and the deposit insurer are accorded some superior right to share in such recoveries, their claims must be paid in full before other unsecured claimants are compensated. However, depositor priority does not necessarily reduce the losses of uninsured depositors or the deposit insurer. Lower-ranking creditors have incentives to protect themselves by collateralising their claims, shortening terms of maturity, exercising early-withdrawal provisions, or imposing additional penalties or charges. Such actions may offset the effects of preferential ranking.

If uninsured depositors believe they will not sustain losses because of their priority ranking, they may have less incentive to exercise market discipline. Also, safety-net participants may have reduced incentives to act promptly in dealing with problem banks. The net effects depend on the characteristics of non-deposit creditors, their ability to utilise the available means of limiting their loss exposure and their willingness to exercise market discipline, legal

provisions governing these matters, and the existence of strong governance and accountability regimes at the responsible safety-net participant.

*b) Collateralisation*

Policymakers also should be aware of the effects of collateralisation. In some countries, depositors, the deposit insurer, and other unsecured claimants share only in the unencumbered assets of the failed bank and their recoveries are reduced by the collateralisation of other parties' claims. However, collateralisation may have some offsetting advantages from the standpoint of the payments system and the public-policy objectives. Extensive collateralisation of a bank's liabilities may also increase the deposit insurer's cost and impinge on its ability to provide financial assistance to a troubled bank, because certain assets may not be available. As in the case of depositor priority, collateralisation may give unsecured creditors greater incentives to effect early withdrawals, shorten maturities, or impose additional charges in order to mitigate expected losses.

*(c) Rights of set-off*

The term "set-off" refers to situations where the claim of a creditor (for example, a deposit) in an insolvent bank is deducted from a claim of the bank (for example, a loan) against the creditor. Where set-off is available or imposed, creditors who are also debtors of the failed bank may increase their recoveries, while other creditors' recoveries are diminished.

Set-off can reduce administrative costs by reducing the number of individual creditors and debtors. Netting of the cross-obligations of members of the payments system lessens the credit risk of the remaining participants in the event of the failure of one or more participants, thus reducing the possibility of contagion. Depending on the jurisdiction, banks that operate in the derivatives-market may be able to effect transactions (for example, a swap transaction) that might not be available (or available only on less-favourable terms) if netting were not assured.

Some countries emphasise the importance of set-off while others believe that it can lead to unequal treatment. If set-off is allowed, a number of issues should be considered, including whether set-off should apply to all loans or only those due or in default. Set-off against a performing loan could result in a "call" on a loan to a viable business; as a result, many countries restrict set-off to cases where the loan is in default. Even where set-off is accepted, the extent to which it should apply may be an issue. Set-off of obligations against loans in good standing may reduce the value of a portfolio of loans as a realizable asset. Coordination of the rules of set-off and the reimbursement of insured depositors also raise issues, such as whether deposit insurance is to be paid on the gross amount of the deposit or the net amount after set-off. Finally, set-off also can be influenced by the priority of claims in a bank failure.

## **FINANCIAL STABILITY FORUM**

These issues generally involve trade-offs among public-policy objectives and require country-specific solutions.



## VII. Key Points of Guidance

The Working Group was asked to develop guidance for the benefit of countries considering the adoption or the reform of an explicit, limited-coverage deposit insurance system. The following points of guidance summarize the main conclusions and suggestions by the Working Group to help policymakers design, implement and continually assess a deposit insurance system. These points are reflective of, and adaptable to, a broad set of circumstances, settings and structures.

### 1. Contextual issues

- (a) Policymakers have many choices regarding how they can protect depositors. Explicit, limited-coverage deposit insurance (“a deposit insurance system”) is preferable to implicit protection if it clarifies the authorities’ obligations to depositors and limits the scope for discretionary decisions that may result in arbitrary actions. However, such a system needs to be properly designed, well implemented and understood by the public in order to be credible. It also needs to be supported by strong prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws. (pages 7-8)
- (b) A deposit insurance system can deal with a limited number of simultaneous bank failures, but cannot be expected to deal with a systemic banking crisis by itself. (page 8)

### 2. Moral hazard

- (a) A well-designed financial safety net contributes to the stability of the financial system; however, if poorly designed, it may increase risks, notably, moral hazard. Good corporate governance and sound risk management of individual banks, effective market discipline, and frameworks for strong prudential regulation, supervision and laws, can mitigate moral hazard and these elements are most effective when used in concert. (page 8)
- (b) Good corporate governance and sound risk management of individual banks help to ensure that business strategies are consistent with safe-and-sound operations, and thus can act as the first line of defence against excessive risk taking. Good corporate governance and sound risk management includes standards, processes, and systems for ensuring appropriate direction and oversight by directors and senior managers; adequate internal controls and audits; management of risks and the evaluation of bank performance; the alignment of remuneration with appropriate business objectives; and

## FINANCIAL STABILITY FORUM

management of capital and liquidity positions. Effective market discipline requires sound accounting and disclosure regimes and the ongoing attention to a bank's soundness by rating agencies, market analysts, financial commentators and other professionals. Regulatory discipline can be exercised through effective regulation covering the establishment of new banks, the imposition of minimum capital requirements, the qualifications of directors and managers, sound business activities, a fit-and-proper test for controlling shareholders, standards for risk management, strong internal controls and external audits. Supervisory discipline can be exercised by ensuring that banks are monitored for safety and soundness as well as compliance issues and that corrective actions are taken promptly when problems surface, including the closure of banks when necessary. (pages 8-9)

- (c) Ensuring that a deposit insurance system contains certain design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; using certain forms of coinsurance; implementing differential or risk-adjusted premium assessment systems; minimising the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts. (page 9)

### **3. Public-policy objectives**

- (a) The first step in designing a deposit insurance system is to identify the public-policy objectives that it is expected to achieve and these objectives must be well understood. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and to protect less-financially-sophisticated depositors. The choice of how a deposit insurance system is to be operated depends on many factors that are unique to each country and its governmental and financial systems. (page 11)
- (b) A continuous-improvement process should exist for reviewing the extent to which a deposit insurance system is meeting its public-policy objectives and its mandate. (page 12)

### **4. Situational analysis**

- (a) Policymakers should conduct a situational analysis when adopting or reforming a deposit insurance system. This analysis should examine conditions and factors such as: the level of economic activity; current monetary and fiscal policies; the state and structure of the banking system; public attitudes and expectations; the legal

framework; prudential regulatory, supervisory, accounting and disclosure regimes. (page 12)

- (b) Where existing conditions and factors are not ideal, it is important to identify gaps and thoroughly evaluate the options available since the establishment of a deposit insurance system is not a remedy to deal with major deficiencies. If actions are necessary, they can be taken before, or in concert with, the adoption or reform of a deposit insurance system. (page 12)
- (c) Deposit insurance systems cannot be effective if relevant laws do not exist or if the legal regime is characterised by inconsistencies. (page 13)
- (d) The strength of prudential regulation and supervision will have implications for the effectiveness of a deposit insurance system. Strong prudential regulation and supervision should allow only viable banks to operate. Banks should be well capitalised and follow sound-and-prudent risk management, governance and other business practices. (page 13)

## **5. Transitioning from a blanket guarantee to a deposit insurance system**

- (a) When transitioning, 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. (page 14)
- (b) If a country decides to transition from a blanket guarantee to a deposit insurance system, the transition should be as rapid as a country's circumstances permit. A country considering such a transition should undertake the same type of situational analysis as a country moving from implicit protection to a deposit insurance system. In addition, three special issues will need to be considered. First, how to allay fears because protection for depositors and other creditors is being reduced. Second, policymakers should consider the capacity of the banking system to fund a new deposit insurance system. The third issue concerns how fast the transition should proceed. (page 14-15)

**6. Self-assessment methodology (SAM)**

Policymakers should consider the use of an iterative self-assessment methodology to assist them in the design, implementation, modification and continuous assessment of a deposit insurance system. (pages 15-16)

**7. Mandate and powers**

- (a) 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 risk minimisation with a variety of combinations in between. Whatever the mandate selected, it is critical that there be consistency between the stated objectives and the powers and responsibilities given to the deposit insurer. (page 17)
- (b) Formally specifying the mandate of a deposit insurer (either in law, in a formal policy statement, an agreement or by private contract) clarifies the role of deposit insurance within the financial safety net. Clarity of the mandate reinforces the stability of the financial system and contributes to sound governance and greater accountability. (page 17)
- (c) As a general principle, a deposit insurer should have all powers necessary to fulfil its mandate. All deposit insurers require the ability to enter into contracts, set appropriate requirements, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly. (page 18)

**8. Structure**

Policymakers must determine whether the deposit insurance function should be assigned to an existing organisation or whether a separate entity should be established. Regardless of how the deposit insurance system is structured, it is vitally important to set clearly the responsibility and accountability of each safety-net function. (page 18)

**9. Governance**

- (a) The form of governance utilised in a deposit insurance system should reflect the mandate and the degree to which the deposit insurer is legally separated from the other financial safety-net participants. The governing body of the deposit insurance system should include individuals with requisite knowledge to understand the organisation’s activities and the environment in which it operates, and they should have the authority

## FINANCIAL STABILITY FORUM

to make decisions. The deposit insurer should have access to the input and views of the other safety-net participants and relevant interested parties. Members of the governing body and management of the deposit insurer should be subject to a fit-and-proper test, and they should be free from conflicts of interest. (page 18)

- (b) Governance systems and practices should be developed on the basis of sound strategic planning, risk-management processes, and good internal-control and audit systems. The governance structure should be transparent and subject to clear oversight and accountability. Rules specifying corporate governance practices should be developed. (page 18)

### **10. Human resources and statutory indemnification**

- (a) The ability to attract and retain qualified employees is a key challenge for most deposit insurers. Deposit insurers may meet this challenge by: the use of dedicated resources, access to the resources of other financial safety-net participants and/or reliance on outside service providers. (page 19)
- (b) The importance of statutory indemnification should be recognised and employees of the deposit insurance system should receive legal protection against lawsuits for their actions taken in good faith. The lack of legal protection for employees can reduce incentives to be vigilant in carrying out their responsibilities, particularly in cases where mandates emphasise early detection, intervention and closure of troubled banks. (page 19)

### **11. Interrelationships among safety-net participants**

- (a) 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 the different functions is more complex and need to be addressed clearly and explicitly. (page 19)
- (b) A deposit insurer's information needs vary significantly according to its mandate and powers, but the need for close coordination and information sharing among safety-net participants is essential in all cases. Rules regarding confidentiality of information should apply to all safety-net participants. (pages 19-20)

## FINANCIAL STABILITY FORUM

- (c) It is highly desirable to formalise information-sharing arrangements 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. (page 20)

### **12. Membership**

- (a) Banks that are to be included in a deposit insurance system should be subject to strong prudential regulation and supervision. (page 20)
- (b) In general, membership should be compulsory to avoid adverse selection. (page 21)
- (c) 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.(page 21)
- (d) Appropriate mechanisms are necessary to ensure that membership requests are handled expeditiously and effectively, and that eligible banks are required to meet minimum prudential standards and entry requirements. (page 21-22)
- (e) Policymakers take different approaches in deciding which financial institutions should be covered by deposit insurance. Domestic banks are the principal members of most deposit insurance systems; in some countries, foreign banks and branches, non-bank financial institutions, and state-owned banks also are members. Such entities might be included to enhance the stability of the financial system, to ensure competitive equity, to diversify the deposit insurer's risks, and to apply prudential regulatory and supervisory rules to non-bank financial institutions that accept deposits and deposit-like products. (pages 22-23)

### **13. Coverage**

- (a) Policymakers should define clearly in law or by private contract what is an insurable deposit. In doing so, they 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. (page 23)

## FINANCIAL STABILITY FORUM

- (b) The level of coverage can be set through an examination of relevant data, such as statistical information describing the size distribution of deposits held in banks. Whatever coverage level is selected, it must be credible and internally consistent with other design features, and meet the public-policy objectives of the system. (page 23)
- (c) Given the importance of effectively limiting coverage and contributing to financial system stability, as well as keeping the requirement for information reasonable, it is preferable to apply deposit insurance on a per depositor per bank basis. (page 24)
- (d) One approach to foster market discipline and to reduce somewhat the costs of deposit insurance is the use of coinsurance. If coinsurance is adopted, it should be applied above a certain amount. This will provide individuals holding small account balances full protection against the risk of loss, while maintaining the incentive for depositors holding larger account balances to monitor banks. In order for coinsurance to be effective, extensive information needs to be provided to the public regarding the financial condition of banks. (page 24)
- (e) Coverage limits may need to be adjusted periodically because of 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. (page 25)
- (f) The decision whether to cover deposits denominated in foreign currencies depends heavily on a country's usage of foreign currency. When usage is high, it would be of little value to institute a deposit insurance system without covering these deposits. An important decision is whether to reimburse insured deposits in local or in foreign currency when a bank fails. Policymakers should ensure that banks have sound foreign-exchange risk-management systems and controls in place. Furthermore, the deposit insurer should develop sound policies and procedures to manage prudently any foreign-exchange risk it faces. In designing such policies and procedures, the deposit insurer may wish to draw on the expertise residing in banks. (page 25)

### **14. Funding**

- (a) Sound funding arrangements are critical to the effectiveness of a deposit insurance system and the maintenance of public confidence. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims. Inadequate funding can lead to delays in resolving failed banks, to significant increases in costs and to a loss of credibility of a deposit insurance system. (page 26)

## FINANCIAL STABILITY FORUM

- (b) Member banks should pay the cost of deposit insurance since they and their clients directly benefit from having an effective deposit insurance system. However, policymakers should consider the effect of premium levels on the financial health of the banking industry. (page 26)
- (c) Policymakers should choose an assessment base against which a given premium rate will be applied. (page 26)
- (d) The deposit insurer should ensure that funds are well managed and readily available to cover losses as they arise. This can be accomplished by implementing appropriate investment policies and procedures, and by instituting sound internal controls, disclosure and reporting systems. (page 26)
- (e) In practice, deposit insurance systems often are funded on a combined *ex-ante* and *ex-post* basis. The advantages and disadvantages with *ex-ante* and *ex-post* funding are generally applicable to hybrid funding arrangements. (page 27)
- (f) In principle, there are two approaches available to establishing a deposit insurance fund. One approach is to assess a steady premium rate over a long period, while the other involves developing a premium system designed to maintain a target fund ratio or range. If the target fund ratio method is chosen it should be sufficient to reduce the probability of the fund's insolvency to an acceptable minimum, although estimating probabilities of loss is very complicated in practice. (page 27)
- (g) A case can be made either for establishing and maintaining one fund or for establishing and maintaining separate funds for different types of financial institutions that accept deposits from the public. If separate funds are established, policymakers should ensure that distinctions among the institutions and their funds do not contribute to competitive distortions. (page 28)
- (h) Policymakers have a choice between a flat-rate premium system or a premium system that is differentiated on the basis of individual-bank risk profiles. The bases and criteria used in a risk-adjusted differential premium system should be transparent to all participants. As well, policymakers who adopt risk-adjusted differential premium systems should ensure that necessary resources are in place to administer the system appropriately. If policymakers choose to adopt risk-adjusted differential premiums, consideration should be given to the advantages and disadvantages of keeping the risk profiles of individual banks confidential. (pages 28)



**15. Public awareness**

In order for a deposit insurance system to be effective, it is essential that the public be informed about its benefits and limitations. Experience has shown that the characteristics of a deposit insurance system need to be publicised regularly so that its credibility can be maintained and strengthened. (page 29)

**16. Cross-border issues**

- (a) If the host-country system provides supplementary coverage, multiple reimbursements of insured depositors should be avoided. The deposit insurance already provided by the home-country system should be recognised in the determination of levies and premiums. (page 30)
- (b) 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 any case, deposit insurers should receive all information necessary to enable a prompt reimbursement of depositors' claims and to enable them to meet their mandate. (page 30)

**17. Failure resolution**

- (a) Cooperation among the various financial safety-net participants, both before and after a failure, is essential if troubled banks are to be handled in a timely and effective manner. (page 31)
- (b) The determination and recognition of when a bank is in serious financial difficulty should be made on the basis of well-defined and transparent criteria by a safety-net participant with authority to act. Prompt and decisive actions are crucial to reduce the cost of a bank failure, but care needs to be taken to address confidentiality issues to protect the exchange of information among financial safety-net participants. (page 31)
- (c) An effective failure-resolution process should: meet the deposit insurer's obligations, ensure that depositors are reimbursed promptly and accurately, minimise resolution costs and disruption of markets, maximise recoveries on assets, settle *bona-fide* claims on a timely and equitable basis, and reinforce discipline through legal actions in cases of negligence or other wrongdoings. (page 31)
- (d) Three basic failure resolution options exist: liquidation and reimbursement of depositors' claims; purchase-and-assumption transactions (sales); and open-bank

## FINANCIAL STABILITY FORUM

financial assistance. 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. (page 32)

### 18. Reimbursing depositors

- (a) Systems and processes should be developed in order to undertake preparatory reviews of deposit liabilities held by troubled banks. This requires development of administrative practices and procedures and the ongoing review of the quality and security of bank deposit records. (page 34)
- (b) The deposit insurer should know, as soon as possible, when a bank will be closed. Access to the necessary deposit data before the bank is closed lessens the risk of manipulation of records, shortens the time for completing the reimbursement process, and helps preserve public confidence. (page 34)
- (c) The reimbursement process should be evaluated *ex-post* to incorporate lessons learned. (page 35)

### 19. Claims and recoveries

- (a) The powers provided to the entity responsible for the claims-and-recoveries function should be guided by applicable laws and should include control of the failed bank's assets; contract rights and privileges; the ability to allow or disallow claims; the capability to enforce or repudiate certain contractual obligations; and the ability to challenge fraudulent transfers and transactions. (page 36)
- (b) Asset-management and disposition strategies should be guided by commercial considerations and their economic merits, given 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. (page 36)
- (c) Transparency and access to information are key factors in marketing failed-bank assets. In principle, a wide range of methods is available for disposition of the assets of failed banks, including: asset-by-asset sales; auctions or sealed bids; asset pools; securitisation; asset-management companies; and equity partnerships. (page 37)

## FINANCIAL STABILITY FORUM

- (d) Claims and litigation advanced by the failed bank or the receiver/liquidator against directors, officers, auditors and other parties related to the bank failure are potentially important assets. These claims may result in significant recoveries and may serve as a tool for fostering discipline in the banking sector. For these reasons, potential claims should be identified and investigated carefully to determine the appropriateness and potential for recovery before being pursued. (page 37-38)

### **20. Depositor ranking, collateralisation and rights of set-off**

- (a) Policymakers should be aware of the potential effects of existing depositor priority laws or statutes on failure-resolution costs and the incentive for depositors or other creditors to exert market discipline. (page 38)
- (b) Policymakers should be aware of the effects of collateralisation. Extensive collateralisation of a bank's liabilities may affect the deposit insurer's cost and impinge on its ability to provide financial assistance to a troubled bank. (pages 39)
- (c) Some countries emphasise the importance of set-off while others believe that it can contribute to unequal treatment. If set-off is allowed, a number of issues should be considered, including whether set-off should apply to all loans or only those due or in default. Set-off also can be influenced by the priority of claims in a bank failure. These issues generally involve trade-offs and require country-specific solutions. (page 39)



FINANCIAL STABILITY FORUM

**Annex I: Members of the Working Group**

|   |  |
|---|--|
| <p><b>Chairman</b><br/> <b>Mr. Jean Pierre Sabourin, President and Chief Executive Officer</b><br/> <b>Canada Deposit Insurance Corporation</b></p>   |  |
| <p><b>Argentina - Seguro de Depósitos Sociedad Anónima</b><br/> <b>Dr. José Carlos Jaime</b>, Chairman<br/> <b>Dr. Adolfo César Diz</b>, Member of the Board<br/> <b>Lic. Martin Lagos</b>, Adviser</p>   | <p><b>Canada - Canada Deposit Insurance Corporation (CDIC)</b><br/> <b>Mr. Ronald N. Robertson</b>, Chairman<br/> <b>Mr. Guy L. Saint-Pierre</b>, Senior Vice-President, Insurance and Risk Assessment<br/> <b>Mr. Wayne Acton</b>, Senior Vice-President, Field Operations<br/> <b>Mr. David Walker</b>, Director, Policy and Economics</p>   |
| <p><b>Chile - Banco Central de Chile</b><br/> <b>Mr. Rodrigo Cifuentes</b>, Senior Economist<br/> <b>Mr. Carlos Budnevich Le-Fort</b>, Manager of Financial Analysis<br/> <i>(until February 2001)</i></p>  | <p><b>France - Secrétariat général de la Commission bancaire</b><br/> <b>Madame Sylvie Mathérat</b>, Chef du service des études bancaires<br/> <b>Monsieur Olivier Jaudoin</b>, Adjoint au chef du service des études bancaire</p>   |
| <p><b>Germany – Federal Ministry of Finance</b><br/> <b>Mr. Udo Franke</b>, Advisor to the Ministry<br/> <b>Mr. Dietrich Jahn</b>, Advisor to the Ministry <i>(until June 2000)</i></p>   | <p><b>Hungary - National Deposit Insurance Fund of Hungary</b><br/> <b>Mr. Dániel Jánossy</b>, Managing Director<br/> <b>Mr. András Fekete-Gyor</b>, Deputy Managing Director</p>  |
| <p><b>Italy - Banca d'Italia</b><br/> <b>Mr. Giovanni Carosio</b>, Head of the Department, Supervision of Credit Institutions<br/> <b>Mr. Alessio De Vincenzo</b>, Economist, Banking and Financial Supervision Department</p>  | <p><b>Jamaica - Jamaica Deposit Insurance Corporation</b><br/> <b>Mr. Winston K. Carr</b>, Chief Executive Officer</p>   |
| <p><b>Japan - Financial Services Agency, Deposit Insurance Corporation of Japan, Ministry of Finance</b><br/> <b>Mr. Masaru Honma</b>, Executive Director of General Affairs Department, DIC<br/> <b>Mr. Masamichi Kono</b>, Director, International Affairs Division, Planning and Coordination Bureau, FSA<br/> <b>Mr. Yasushi Kanzaki</b>, International Bureau, MOF<br/> <i>(until June 2000)</i><br/> <b>Mr. Noriaki Oka</b>, Senior Counsel - General Affairs Department, DIC</p> | <p><b>Mexico - Instituto para la Protección al Ahorro Bancario</b><br/> <b>Mr. Carlos Isoard</b>, Member of the Board of Governors<br/> <b>Mr. Julio César Mendez</b>, Executive Secretary and CEO<br/> <b>Mr. Vicente Corta</b>, Executive Secretary and CEO<br/> <i>(until September 2000)</i><br/> <b>Ms. Ingrid Cerwinka</b>, Assistant General Director<br/> <i>(until November 2000)</i></p> |
| <p><b>Philippines - Philippine Deposit Insurance Corporation</b><br/> <b>Mr. Norberto C. Nazareno</b>, President and CEO<br/> <b>Mr. Ricardo M. Tan</b>, Executive Vice-President<br/> <b>Ms. Rosalinda U. Casiguran</b>, Senior Vice-President for Legal Affairs and Chief Legal Counsel<br/> <b>Ms. Virginia P. Castillo</b>, Senior Vice President<br/> <b>Ms. Rescina S. Bhagwani</b>, Vice-President</p>   | <p><b>United States of America - Federal Deposit Insurance Corporation (FDIC)</b><br/> <b>Ms. Donna A. Tanoue</b>, Chairman <i>(until July 2001)</i><br/> <b>Mr. George Hanc</b>, Associate Director<br/> <b>Mr. Christie Sciacca</b>, Associate Director</p>  |
| <p><b>The World Bank</b><br/> <b>Mr. Gerard Caprio</b>, Director, Financial Policy Department, and Head, Financial Sector Research<br/> <b>Mr. Giovanni Majnoni</b>, Adviser, Financial Sector Strategy and Policy Department</p>   | <p><b>International Monetary Fund</b><br/> <b>Mr. David S. Hoelscher</b>, Division Chief<br/> <b>Mr. Charles A. Enoch</b>, Assistant Director <i>(until April 2000)</i><br/> <b>Mr. Michael Taylor</b>, Senior Economist<br/> Systemic Banking Issues Division</p>   |
| <p><b>Members of the Secretariat</b><br/> <b>Canada Deposit Insurance Corporation</b><br/> <b>Ms. M. Claudia Morrow</b>, Corporate Secretary<br/> Secretary to the Working Group<br/> <b>Mr. John Raymond LaBrosse</b>, Director, International Affairs<br/> Executive Director of the Working Group<br/> <b>Ms. Jacqueline (Jackie) Chartrand</b>, Administrative and Technical Support to the Working Group</p>   |  |
| <p><b>Research Committee:</b></p>   |  |
| <p>Mr. George Hanc, Head (FDIC)<br/> Mr. David Walker (CDIC)<br/> Ms. Detta Voesar (FDIC)</p>   | <p>Ms. Christine Blair (FDIC)<br/> Ms. Rose Kushmeider (FDIC)<br/> Mr. Greg Cowper (CDIC)</p>  |



## **Annex II: Approach to Developing Discussion Papers**

### 1. Research Plan

The Working Group developed a research plan on topics relating to guidance on deposit insurance that was made available at [http://www.cdic.ca/international/guidance\\_topic.cfm](http://www.cdic.ca/international/guidance_topic.cfm). Subgroups were formed for the 16 guidance topics, with a Working Group member acting as the coordinator. A member of the research committee assisted each subgroup.

### 2. Outreach Sessions and Conferences

The Working Group held meetings in Switzerland, the United States of America, Mexico, Hungary, Malaysia, Argentina, Italy and Chile. It also provided a number of *fora* for people interested in deposit insurance issues to exchange ideas and benefit from the experience of others. The Group met with over 400 people from over 100 countries. In addition to the presentations by Working Group members, there were over 90 presentations delivered at the conferences and seminars from individuals who were not directly associated with the Working Group.

The format consisted of a two-day Working Group meeting, followed by an outreach session hosted by one of the members and a two-day conference on specific guidance topics. Outreach sessions and conferences were supported financially and otherwise by the Working Group members, other organisations and, in some cases, the Financial Stability Institute (FSI). As well, the Working Group cooperated with a number of the regional development banks.

The Working Group's Web site includes copies of presentations, the text of the remarks provided by many of the speakers, and videos of each conference. The Web site also includes copies of the Working Group's business plans and discussion papers. Messages *via* e-mail were sent regularly to over 600 individuals and there have been over 40,000 visits to the Web site.

## FINANCIAL STABILITY FORUM

### Outreach Sessions, Conferences and Seminars

| Location                       | Host  | Date                               |
|--------------------------------|---|------------------------------------|
| Basel, Switzerland             | Financial Stability Institute (FSI) and Federal Deposit Insurance Corporation                               | May 2000                           |
| Washington D.C., United States | The World Bank<br>Inter-American Development Bank (IADB)  | June and October 2000<br>July 2000 |
| Cancun, Mexico                 | Instituto para la Protección al Ahorro Bancario (IPAB)  | October 2000                       |
| Budapest, Hungary              | National Deposit Insurance Fund of Hungary (NDIF), European Bank for Reconstruction and Development and FSI | November 2000                      |
| Chicago, IL United States      | Federal Reserve Bank of Chicago   | December 2000                      |
| Kuala Lumpur, Malaysia         | Philippine Deposit Insurance Corporation, FSI and South East Asian Central Banks (SEACEN)                   | January 2001                       |
| Berlin, Germany                | Federal Ministry of Finance, Germany  | March 2001                         |
| Paris, France                  | Organization for Economic Cooperation and Development (OECD)  | March 2001                         |
| Buenos Aires, Argentina        | Seguro de Depósitos Sociedad Anónima (SEDESA)   | March 2001                         |
| Rome, Italy                    | Banca d'Italia  | April 2001                         |
| Lusaka, Zambia                 | Common Market for Eastern and Southern Africa (COMESA)  | April 2001                         |

### 3. Business Plans

The focus for each subgroup was articulated in a business plan (published on the Internet at [www.cdic.ca/international](http://www.cdic.ca/international)), which outlined objectives, methodology, and methods for generating feedback. The Web site, outreach sessions and the conferences were the main vehicles that were used to implement the approach.

### 4. Discussion Papers

The Working Group took a non-prescriptive approach to developing the discussion papers on the guidance topics. The discussion papers drew on existing academic research, examined the pertinent elements of effective deposit insurance systems and explored the trade-offs and implications associated with particular approaches to deposit insurance.

Copies of the discussion papers also were published for consultation and are included as Volume II to this Report. This information can be downloaded from the following Web address [www.cdic.ca/international](http://www.cdic.ca/international).

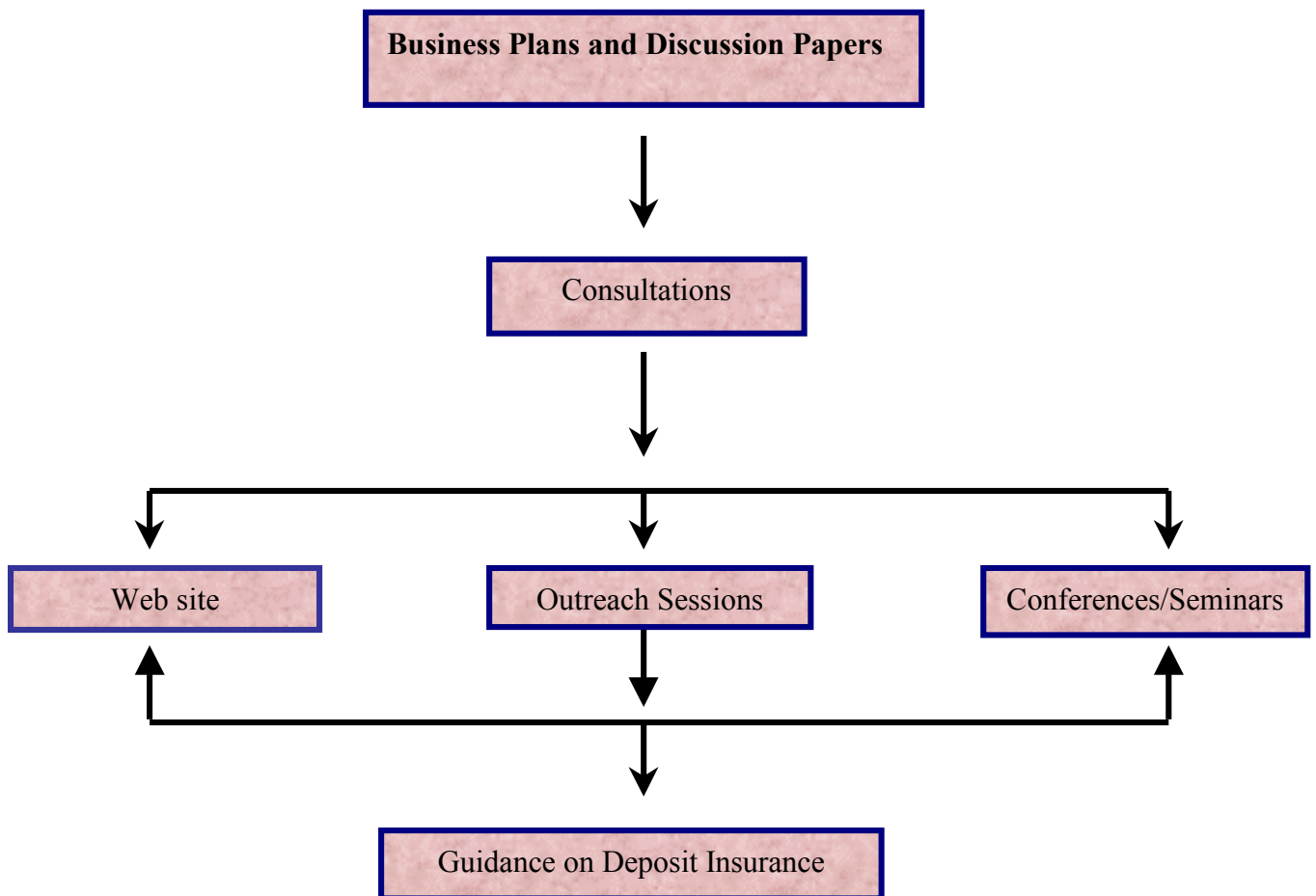


## FINANCIAL STABILITY FORUM

### 5. Final Report – Guidance on Deposit Insurance

The Working Group's activities culminated in this Final Report to the Financial Stability Forum. It draws together the issues presented in the discussion papers, and the views provided during the outreach sessions and *via* the Web site.

The process used is shown below:





## Annex III: Organisations that Assisted the Working Group

### Outreach Sessions, Seminars and Conferences

|  |   |
|--|---|
| Asian Development Bank                           | Federal Reserve Bank of Chicago                         |
| Banca d'Italia                                   | Financial Stability Institute                           |
| Bank for International Settlements               | Instituto para la Proteccion al Ahorro Bancario, Mexico |
| Canada Deposit Insurance Corporation             | Inter-American Development Bank                         |
| Canadian Bureau for International Education      | National Deposit Insurance Fund of Hungary              |
| The Canadian High Commission in Malaysia         | Organization for Economic Cooperation and Development   |
| Common Market for Eastern and Southern Africa    | Philippine Deposit Insurance Corporation                |
| Embassy of Canada in Rome, Italy                 | Seguro de Depósitos Sociedad Anónima, Argentina         |
| European Bank for Reconstruction and Development | South East Asian Central Banks                          |
| Federal Deposit Insurance Corporation            | The World Bank  |
| Federal Ministry of Finance, Germany             |   |

**FINANCIAL STABILITY FORUM**

|                        |                        |                          |
|------------------------|------------------------|--------------------------|
| Albania                | Hong Kong, SAR         | Panama                   |
| Algeria                | Hungary                | Paraguay                 |
| Argentina              | Iceland                | Peru                     |
| Armenia                | India                  | Philippines              |
| Austria                | Indonesia              | Poland                   |
| Azerbaijan             | Iran                   | Portugal                 |
| Bahamas                | Ireland                | Romania                  |
| Bahrain                | Isle of Man            | Russian Federation       |
| Barbados               | Israel                 | Rwanda                   |
| Belgium                | Italy                  | Saudi Arabia             |
| Bolivia                | Jamaica                | Singapore                |
| Bosnia and Herzegovina | Japan                  | Slovak Republic          |
| Botswana               | Jersey                 | Slovenia                 |
| Brazil                 | Jordan                 | South Africa             |
| Bulgaria               | Kazakhstan             | Spain                    |
| Burundi                | Kenya                  | Sri Lanka                |
| Cambodia               | Korea                  | Sudan                    |
| Canada                 | Kuwait                 | Swaziland                |
| Chile                  | Kyrgyz Republic        | Sweden                   |
| China                  | Latvia                 | Switzerland              |
| Colombia               | Lebanon                | Taiwan                   |
| Congo                  | Lithuania              | Tajikistan               |
| Côte d'Ivoire          | Luxembourg             | Tanzania                 |
| Croatia                | Macau, SAR             | Thailand                 |
| Cyprus                 | Macedonia, Republic of | Trinidad & Tobago        |
| Czech Republic         | Madagascar             | Tunisia                  |
| Denmark                | Malawi                 | Turkey                   |
| Egypt                  | Malaysia               | Turkmenistan             |
| El Salvador            | Malta                  | Uganda                   |
| Eritrea                | Mauritius              | Ukraine                  |
| Estonia                | Mexico                 | United Kingdom           |
| Ethiopia               | Moldova, Republic of   | United States of America |
| European Commission    | Mongolia               | Uruguay                  |
| Finland                | Morocco                | Uzbekistan               |
| France                 | Mozambique             | Venezuela                |
| Germany                | Namibia                | Vietnam                  |
| Gibraltar              | Netherlands Antilles   | Yugoslavia               |
| Greece                 | New Zealand            | Zambia                   |
| Guernsey               | Norway                 | Zimbabwe                 |
| Haiti                  | Oman, Sultanate of     |                          |

## Glossary of Terms

**adverse selection** - 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 deposit insurance system is voluntary.

**bank run** - A rapid loss of deposits precipitated by fear on the part of the public that a bank may fail and depositors may suffer losses.

**benchmark** - A standard or guideline to which other items or processes can be compared.

**blanket guarantee** - A declaration by the government that all deposits and perhaps other financial instruments will be protected.

**bridge bank** - A temporary bank established and operated to acquire the assets and assume the liabilities of a failed institution until final resolution can be accomplished.

**coinsurance** - An arrangement whereby depositors are insured for a pre-specified portion, less than 100 percent of their deposits.

**collateralisation** - The taking of a mortgage, pledge, charge or other form of security by a creditor over one or more assets of a debtor.

**contagion** - The spread of an individual bank run to several other financial institutions.

**corporate governance** - The processes, structures, and information used for directing and overseeing the management of an organisation.

**depositor priority** - The granting of preferential treatment to depositors such that their claims must be paid in full before remaining creditors can collect on their claims.

**differential premium/risk-adjusted differential premium** - A levy on a bank assessed on the basis of that bank's risk profile.

**disclosure** - A fact, condition, or description that is revealed clearly and publicly.

**ex-ante funding** - The accumulation of a fund to cover deposit insurance claims in anticipation of the failure of a member bank.

## FINANCIAL STABILITY FORUM

**ex-post funding** - An assessment levied after the failure of a member bank to provide funds to cover deposit insurance claims.

**financial safety net** - Usually comprises the deposit insurance function, prudential regulation and supervision, and the lender-of-last-resort function.

**forbearance** - To grant an extension of time to certain distressed banks from minimum regulatory requirements.

**foreign bank** – A foreign-bank subsidiary is incorporated as a separate entity in the host country. A foreign-bank branch, on the other hand, is an extension of the foreign bank itself into a host country. Foreign-bank branches and subsidiaries may be subject to different rules and supervised differently by a host country.

**least-cost resolution** - A procedure that requires the deposit insurer or other designated entity to implement the resolution alternative that is determined to be less costly to the system than all other resolution alternatives, including the liquidation of the failed bank.

**lender-of-last-resort function** - The provision of liquidity to the financial system by a central bank.

**limited-coverage deposit insurance** - A guarantee that the principal and the interest accrued on protected deposit accounts will be paid up to a specified limit.

**mandate** - A mandate is a set of official instructions or statement of purpose of a firm.

**market discipline** - A situation where depositors or creditors assess the risk characteristics of a bank and act upon such assessments to deposit or withdraw funds from a bank.

**moral hazard** - The incentive for additional risk taking that is often present in insurance contracts and arises from the fact that parties to the contract are protected against loss.

**netting/netting arrangements** – This refers to the reduction of an accountholder's insured deposits by the amount of outstanding loans in a failed institution or the reduction of an accountholder's outstanding loans by the amount of deposits above the coverage limit.

**open-bank assistance** - A resolution method in which an insured bank in danger of failing receives assistance in the form of a direct loan, an assisted merger, or a purchase of assets.

**paybox** - A deposit insurer with powers limited to paying off the claims of depositors.

## FINANCIAL STABILITY FORUM

**purchase-and-assumption transaction (sales)** - A resolution method in which a healthy bank or group of investors assume some or all of the obligations, and purchase some or all of the assets of the failed bank.

**receiver** - The legal entity that undertakes the winding down of the affairs of an insolvent bank.

**recovery** - The amount of net collections of a bank's assets.

**regulatory discipline** - Governs the establishment of new banks; qualifications of directors and managers; business activities; change of control; and standards for risk-management, internal controls, and external audits.

**risk minimiser** – A deposit insurer with the powers to reduce the risks it faces. These powers may include the ability to control entry and exit from the deposit insurance system, assess and manage its own risks and may conduct examinations of banks, or request such examinations.

**set-off** - Refers to situations where the claim of a creditor in an insolvent bank (for example, a deposit) is deducted from a claim of the bank against the creditor (for example, a loan).

**situational analysis** – An examination that policymakers undertake to assess factors such as: the state of the economy; current monetary and fiscal policies; the state and structure of the banking system; public attitudes and expectations; the state of the legal, prudential regulatory and supervisory; accounting and disclosure regimes.

**supervisory discipline** - Requires that banks are monitored for safety and soundness as well as compliance issues and that corrective actions are taken promptly, including the closure of a bank when necessary.

**suspense account** – A suspense account is used when not enough information is available to post a transaction with the right offset. For example, dividends and interest are “paid” to a trust account on their payable date even if all of the money from depositors and paying agents is not received on time.

**systemic risk** – A risk that has implications for the general health of the financial system and can have serious adverse implications for financial stability and overall economic conditions.

