FINANCIAL STABILITY FORUM
Working Group on Deposit Insurance

June 2000

International Guidance on Deposit Insurance
A Consultative Process

Background

In November 1999, the Financial Stability Forum (FSF) - a forum convened by the G7 Finance Ministers and Central Bank Governors to promote international financial stability in the wake of the financial crisis that began in mid-1997 - created the Study Group on Deposit Insurance. The Study Group was asked, among other things, 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. Based on the conclusions of the report, the FSF established the Working Group on Deposit Insurance to develop guidance on deposit insurance arrangements. It is expected that the Working Group will submit a report to the FSF in September 2001.

Objective

The objective of the Working Group is to develop practical guidance on deposit insurance issues for countries considering the adoption of a deposit insurance system. The guidance will be based on the perspective of current practitioners of deposit insurance. The Working Group appreciates that countries have different public-policy objectives that account both for the wide range of existing deposit insurance systems and the many structures within which they function. Accordingly, the guidance will reflect and be adaptive to a variety of circumstances and institutional settings.

Process

A Consultative Approach

To meet its objective, the Working Group will validate its work through a broad consultative approach. The Working Group intends to issue draft papers on different subjects for wide circulation on the Internet through a Web Site. Feedback is welcome, as the Working Group will consider the input provided before it issues its final report.

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Outreach Sessions

As part of its commitment to consult widely, the Working Group will be holding outreach sessions in many locations. Arrangements are being made through the international regional development banks to hold these sessions. Efforts are also being made to provide opportunities for exchange of information and knowledge between deposit insurers through the Financial Stability Institute (the FSI was created by the Bank for International Settlements and the Basle Committee on Banking Supervision to assist supervisors in improving and strengthening their financial systems). The Working Group and the FSI have agreed to co-ordinate their work plans and schedules over the next year in relation to deposit insurance activities. The aim is to organize meetings of the Working Group around outreach sessions and FSI seminars on deposit insurance.

The first outreach session was held at the BIS on May 10 and was attended by 12 newly established deposit insurers. The Basle outreach session was a success as the Working Group validated, through dialogue with many countries, its objectives, process and a preliminary list of subject matters where guidance will be developed.

The outreach session was followed by a two-day conference on deposit insurance arranged by the FSI and the Federal Deposit Insurance Corporation (FDIC). Over 60 countries were represented with approximately 135 people in attendance. The feedback was very positive. Participants stated that there is need for more dialogue and knowledge transfer among deposit insurers and policy makers.

In October, IPAB will host an outreach session in Mexico. There are two more outreach sessions planned, one in Hungary and the other in the Philippines. The Working Group is also considering holding outreach sessions in the Middle East and in Africa.

Research Activities

To support the development of international guidance, the Working Group plans to undertake two additional initiatives:

- **Issue Papers:** the Working Group will produce issue papers and background reports on topics in support of the development of guidance on deposit insurance. The topics will cover issues such as the level and scope of coverage, arrangements for the exchange of supervisory and deposit insurance information, the scope and powers of deposit insurers and other matters relevant to deposit insurance arrangements and operations. These draft papers will be released on the Internet for consultation as they are developed.

- **Feedback:** in order to develop international guidance on deposit insurance, information will be sought on specific subjects from countries interested in this work. The Working Group proposes to engage in a discussion with interested parties on the feedback received to validate the direction of its work.

A background paper is attached which is based on the Study Group report. The report serves as the basis for the list of possible guidance topics. The paper can be found at http://fsforum.org/Reports/Home.html, http://www.cdic.ca/english/library/newsrel.htm, http://www.fdic.gov and http://www1.worldbank.org/finance/. Information on the consultation process and copies of related materials can be obtained on the Internet at **http://www.cdic.ca/international**.

The Working Group welcomes feedback and comments on any of the topics noted above.

Jean Pierre Sabourin
Chairman,
FSF Working Group on Deposit Insurance

Important Dates:

- **Release of Guidance Topics-Late June**
- **Outreach Sessions - Mexico, Hungary and Philippines**
- **Discussion on Draft Guidance-May 2001**
- **Report to FSF – September 2001**

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Working Group on Deposit Insurance
Background Paper

FINANCIAL STABILITY FORUM
Working Group on Deposit Insurance

Table of Contents

FINANCIAL STABILITY FORUM
Working Group on Deposit Insurance

I. Introduction

1. This document contains the findings of the FSF Study Group on Deposit Insurance and indicates the areas where the Working Group will develop international guidance on deposit insurance. The terms of reference of the Study Group are found in Annex 1 and Annex 2 lists the members of the Study Group.

2. The Study Group identified certain conditions that ideally should exist when establishing an effective and credible limited-coverage deposit insurance system. These include a sound legal regime; a stable macroeconomic environment and policies consistent with maintaining a safe and sound banking system; a financial system characterized by appropriate regulation and effective supervision; compliance with recognized accounting, auditing, and regulatory standards; and an effective disclosure regime.

3. It is acknowledged that each country has different public-policy objectives that account for the wide range of deposit insurance systems and the structures within which they discharge their obligations. Notwithstanding the unique elements that may characterize a country's deposit insurance system, there are common features identified in this paper that are essential to an effective deposit insurance system that promotes public confidence and contributes to stability. These features include an explicit, clear, well-publicized framework; mandatory participation; limited coverage; and the ability of the deposit insurer to access necessary resources. Also critical is a robust information-exchange arrangement among all participants in the financial safety net.

II. Background

4. The financial crisis that began in Asia in mid-1997 resulted in steep declines in currency values, stock markets, and asset prices in a number of countries. In addition to causing severe effects in Asia, the crisis put pressure on emerging markets outside the region and affected many developed countries. The crisis raised questions about the effectiveness of existing regulatory, supervisory, and financial safety-net arrangements to maintain stability of financial systems.

5. During the crisis, and thereafter, many governments provided blanket guarantees to depositors and other creditors to prevent the financial and payments systems from collapsing. To this day, some countries continue to explore ways to limit their exposure to such arrangements and their associated costs, and to move toward sounder financial systems. Measures taken include the establishment of deposit insurance systems. The Study Group noted that more than 70 countries have implemented some form of deposit

insurance, and many more are considering doing so. An effective deposit insurance system can promote public confidence and contribute to the stability of the financial system, but only if the conditions necessary for the system to be credible and sustainable are in place.

6. The remainder of this paper discusses many of the issues pertaining to the establishment and maintenance of an effective deposit insurance system and indicates areas where the Working Group will develop international guidance on deposit insurance. Relevant transition issues in moving from blanket guarantees to limited-coverage deposit insurance systems are set out in Section IV and the approach for developing international guidance is discussed in Section V. Key lessons learned from recent experiences with deposit insurance by members of the Study Group are found in Annex 3.

III. Establishing and Maintaining an Effective Deposit Insurance System

1. Deposit insurance and moral hazard

7. In a competitive market system, banks[1] fail whether the system is in financial crisis or not. The principal objectives of a deposit insurance system are to contribute to the stability of the financial system and to protect small depositors when banks fail. A well-constructed deposit insurance system will achieve these objectives by significantly reducing the risk of bank runs and the disruptive breakdown of essential banking activities that accompanies such runs. It will also contribute to the smooth functioning of the payments system and the credit mechanisms, and it will facilitate the exit of problem banks. The specific role of a deposit insurance system in a country depends, however, on the public-policy objectives it has been mandated to achieve.

8. When considering the establishment of a deposit insurance system, policy-makers must weigh moral-hazard issues. Moral hazard refers to the incentives for banks to engage in riskier behaviour than they would in the absence of insurance. Moral hazard may be particularly acute for institutions that are on the verge of insolvency. Furthermore, because they are insured, depositors are not motivated to exercise discipline in selecting and monitoring the financial health of their bank.

9. Policy-makers have at their disposal a number of measures to limit moral hazard without negating the benefits of deposit insurance. These measures include imposing relatively

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[1] In this report, the word "bank" is defined to include all forms of financial institutions that accept deposits from the public.

low insurance-coverage limits; charging premiums based on the risk profiles of member banks; applying some form of coinsurance[2]; altering the rankings of depositor claims through depositor preference; imposing losses on uninsured depositors, other creditors and shareholders when a bank fails; introducing personal liability incentives on directors and officers of banks to promote good corporate governance; requiring insured banks to follow recognized accounting practices and to hold sufficient capital and uninsured liabilities; promoting transparency and more disclosure of financial information; and establishing a strong regulatory and supervisory system with an effective closure regime that minimises costs to the deposit insurer.

10. When combined with measures to control moral hazard, deposit insurance can contribute to financial stability while maintaining sufficient discipline. Accordingly, policy-makers must consider the appropriate trade-offs between moral hazard and market discipline in the context of their objectives, given their country's history, culture, legal regime, political environment, institutional arrangements, and current financial and economic situation.

2. Strategic Analysis Model – A tool for policy-makers

11. As a tool for assisting policy-makers in determining how to design, implement, and enhance an effective deposit insurance system, the Study Group developed a strategic analysis model (see figure overleaf). A brief overview of the model follows:

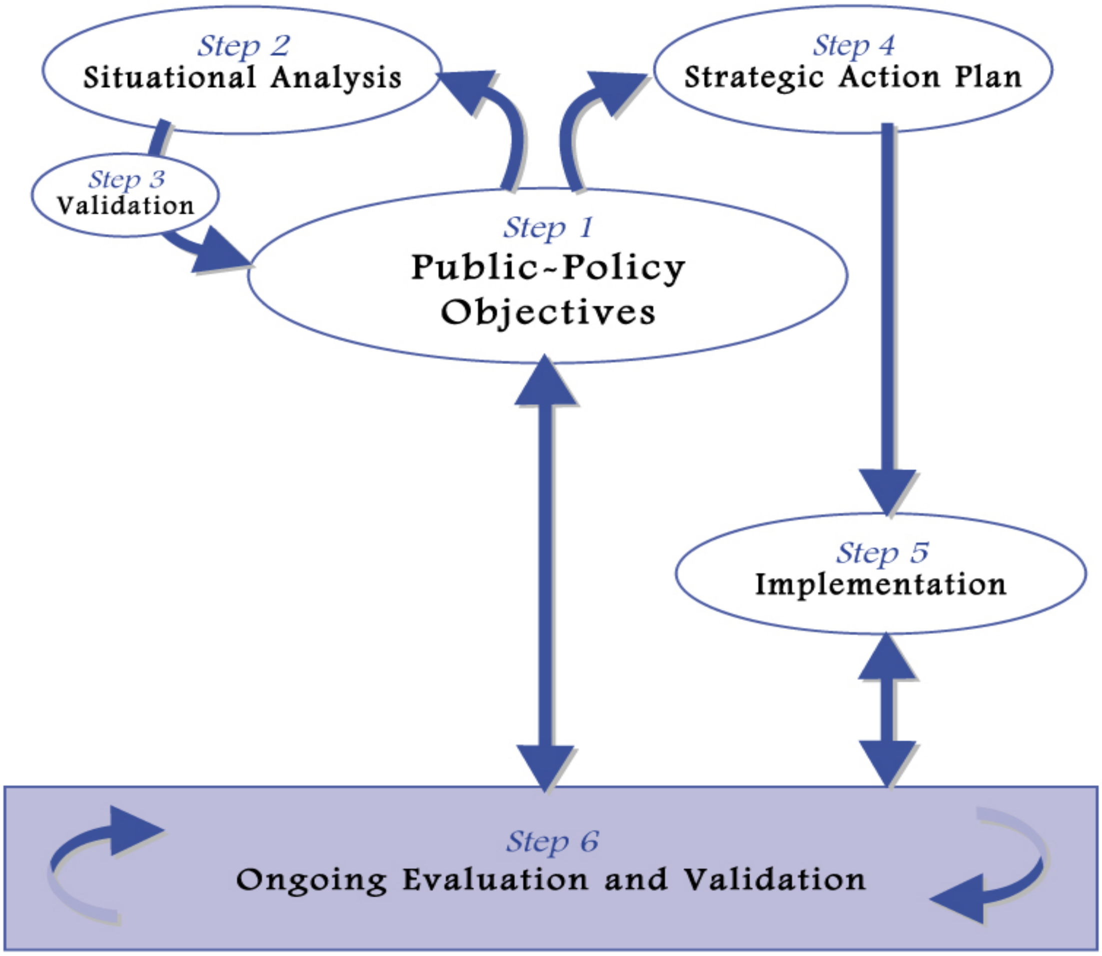
(i) Setting out the public-policy objectives

12. The analysis should begin by listing the relevant public-policy objectives to be attained, preferably in a public-policy paper (Step 1). This analysis should take into account the extent to which the conditions are present in a given country. The policy paper should set out the key attributes and important elements of the system in determining the mandate and the powers to be given to the deposit insurer. As well, the policy paper should outline the role of the deposit insurer within the financial safety net and the deposit insurer's relationship with the other participants in the regulatory and supervisory regime.

2 There is a variety of coinsurance systems in use today. Where coinsurance is applied on deposit balances above a certain threshold, the deposit balances below that amount can be protected in full while at the time limiting the degree of moral hazard.

Strategic Analysis Model – A Tool for Policy-makers

Designing, Implementing and Enhancing an Effective Deposit Insurance System



(ii) Situational analysis against conditions

13. Step 2 should consider the structure (including ownership, extent of competition and size of institutions) and strength of the financial system. The analysis should address the state of the legal regime; the economic environment; the regulatory and supervisory system; the quality of accounting, regulatory and auditing standards; and the disclosure regime.

14. This analysis should expose the strengths, weaknesses, opportunities and threats present in the environment and identify the changes required to construct an effective deposit insurance system.

(iii) Validation

15. Once the situation analysis has been completed, there should be a review and validation process (Step 3) against the proposed public-policy objectives, as well as the key attributes and important elements of the system. Adjustments should be made if necessary.

(iv) Strategic action plan

16. After the validation phase has been completed, a strategic action plan (Step 4) should be developed. This plan should set out the goals (deliverables) and their priorities, time frames, critical paths, communication strategies, and consultation processes. It should also define how the deposit insurance system will be made operational and how it will deal with transitional issues.

17. In transitioning from a blanket guarantee, care must be taken to ensure that the banking system is not disrupted. In this regard, policy-makers should have in place contingency plans to deal with any adverse consequences. It is critical that the public understands the planned changes and the time frame within which they will be completed.

(v) Implementation phase and acceptance

18. Implementation of the deposit insurance system and other necessary changes (Step 5) should be supported by a mechanism to track progress and identify any adjustments required. The purpose of this phase is to render the system operational and deal with transitional issues. For example, appropriate corporate governance of the deposit insurer (the board of directors, 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, need to be addressed promptly.

(vi) Ongoing evaluation and validation

19. Because of the dynamic nature of financial systems, there is a clear need for ongoing evaluation and validation of the effectiveness of the deposit insurance system, which may require changes after it becomes operational. This continuous-improvement process should incorporate new developments in the financial system and the lessons learned at home and abroad and should allow for timely changes to the system. This continuous-improvement process should include benchmarking against core principles, guidelines and best practices.

3. Conditions for establishing an effective limited-coverage deposit insurance system

20. The Study Group identified certain conditions that should exist for an effective and credible limited-coverage deposit insurance system to be established. These include:

- a sound legal regime;
- a stable macroeconomic environment and policies consistent with maintaining a safe and sound banking system;
- a financial system characterized by appropriate regulation and effective supervision;
- compliance with recognized accounting, auditing, and regulatory standards; and
- an effective disclosure regime.

21. In an ideal world all of these conditions would be present before deposit insurance is introduced; however, in many cases this may not be practicable. Thus, careful attention needs to be placed on when and how a deposit insurance system can be introduced successfully.

4. Key attributes of an effective deposit insurance system

22. Key attributes of an effective deposit insurance system identified by the Study Group are:

- the framework upon which a deposit insurance system is established should explicitly define its benefits, including insurance coverage and limits;
- there should be mandatory bank participation in the deposit insurance system;
- there should be clear mandates and defined roles and responsibilities for the deposit insurer, the regulatory and supervisory agencies, and the central bank (the "agencies"). Arrangements should include an accountability regime and close co-ordination and the free flow of timely information among the agencies;
- the deposit insurer should have well-defined funding mechanisms in place to quickly meet its obligations to depositors; and
- the public should be informed of the key elements of the deposit insurance system to instil confidence.

5. Important elements in establishing a deposit insurance system

23. Members of the Study Group represented a spectrum of deposit insurance systems, ranging from narrow systems, such as "paybox" systems, to those with broader powers and responsibilities, such as "risk-minimization" systems. It is clear, therefore, that

deposit insurers can perform a range of functions depending on their mandates. Paybox systems, for example, largely confine themselves to paying claims of depositors after a bank is closed. Deposit insurers in risk-minimization systems, by contrast, have broader mandates, such as the power to control entry into and exit from the deposit insurance system, to assess and monitor risk, and to conduct examinations of banks or request that their affairs be examined. Risk-minimization systems may also have the power to provide financial assistance to problem banks and may have intervention powers. As well, some risk-minimization systems may be charged with resolving bank failures, including finding least-cost solutions.

24. Once the public-policy objectives are established, the deposit insurance system must be properly designed. In its design, policy-makers should take into account the resources available in a particular country. Consideration must be given to such matters as coverage and limits; whether the system should be private or government-backed; the funding mechanisms, including whether to institute insurance premiums; depositor preference; the ability to assess risks and control exposure to loss; information-exchange arrangements; public awareness; and necessary operational considerations.

(i) Coverage and limits

25. The scope of deposit insurance coverage and its limits depend on a country's willingness and ability to balance the goal of achieving financial stability with the introduction of incentives for depositors to exercise some discipline. Deciding what to cover and where to set the limits involves a trade-off between depositor discipline and financial stability. Limits that are set too low are unlikely to prevent bank runs in the event of financial troubles. However, limits that are set too high restrict the discipline that depositors can exert on banks to control their risk-taking.

26. A few countries have implemented various forms of coinsurance as a means of instilling more market discipline. Although it was noted that not all coinsurance systems are able to maintain depositor confidence when the financial system is under serious stress, where the coinsurance system is structured to protect depositors up to a certain minimal amount this can be achieved.

27. The Study Group did not discuss who should be insured, which instruments (such as foreign currency deposits) should be covered or the level at which the deposit insurance limits should be set. It is recognized, however, that these are important issues that need to be considered when establishing a deposit insurance system.

(ii) Private or government deposit insurance systems

28. There are many variations of private and public systems in place. Some form of a banking industry group usually runs private protection systems. These systems are usually not established by legislation, have no legal obligation to pay depositors, have no government involvement in their operations, and have no government back-up support. As a result, these systems do not expose, by themselves, the government and taxpayers to loss.

29. Private protection systems can function effectively in normal times if failures are infrequent and minor. In a generalized economic downturn, when the protection system is under stress (for instance, in dealing with a wave of failures or a large failure), the capacity of such a system to absorb losses and its ability to pay depositors may become problematic. These private systems are less likely to maintain depositor confidence in such times. In these circumstances, the government may have to provide a backstop to the protection system, thus exposing the safety net without certain safeguards that would otherwise be in place with a government-backed system.

30. By contrast, there are private deposit insurance systems that have a legislative underpinning. These systems are required to pay depositor claims and usually have access to government assistance, often in the form of interest-bearing loans. Thus, well-structured private deposit insurance systems with these elements can maintain depositor confidence.

31. Certain government-backed public systems provide the full faith and credit of the government and are part of the financial safety net. As a result, they are able to maintain depositor confidence even in times of stress. The credibility of such systems, however, is linked to the government's ability to stand behind the assurance that it provides to depositors.

(iii) Funding mechanisms

32. There is a variety of funding options available to deposit insurers, which range from an *ex-ante* to an *ex-post* basis or some combination thereof. In an *ex-ante* system, the deposit insurer is often able to build a fund so that financial resources are readily available when a failure occurs. A major consideration of an *ex-ante* system is determining the size of the target fund and its investment policies. An important principle of an *ex-ante* system is that banks contribute to the deposit insurance system by paying premiums before their demise. There is a trend toward the adoption of *ex-ante* systems.

33. Deposit insurance systems that are funded on an *ex-post* basis, by contrast, rely on the ability of surviving banks to fund losses after they have been incurred. In many cases, the need to pay assessments or levies to deal with failures occurs at an inopportune time, and the funding requirements may impose a financial burden on the industry.

34. At times both *ex-ante* and *ex-post* mechanisms may need to rely on additional financial resources such as loans or government support. In some countries, deposit insurers also have access to financial markets for their funding needs. It is essential that policy-makers consider how the deposit insurance system can deal with failures in normal times and those that may occur in waves during times of stress. Regardless of the funding mechanism, no deposit insurance system can withstand, on its own, a systemic crisis.

35. When deposit insurance systems are funded through premiums, policy-makers have a choice between a flat-rate premium or some form of differentiated premium based on a bank's risk profile. Many countries are adopting risk-based premiums or some form of a differentiated premium system to help address moral hazard, but there has been limited experience so far.

36. Although a properly designed risk-based premium system can reduce moral hazard, adopting flat-rate premiums in newly emerging or transitional economies may be more appropriate given the potential difficulties involved in the design and implementation of risk-based premiums. These difficulties include finding appropriate and acceptable methods of differentiating institutional risk; obtaining reliable and appropriate data; considering the transparency of the approach; and examining the potential destabilising effects of imposing high premiums on already troubled banks.

(iv) Depositor preference

37. There could be a wide variance in the ranking of depositors among creditors in the event of a bank failure. In some countries, insured depositors have priority over all other claimants while in others depositors rank equally with unsecured creditors.

38. Depositor preference arrangements can affect market discipline, moral hazard, and the cost to the deposit insurance system. There are trade-offs to be considered in deciding on depositor and creditor ranking. For example, when insured depositors rank in priority to other creditors, it has been observed that the latter will act more definitively in imposing market discipline. Furthermore, lower-ranking creditors will try to protect themselves through various means, such as netting arrangements, collateral demands, and additional charges. It has also been argued that depositor preference may lessen the incentive for the

agencies to act promptly in dealing with a problem bank. On the other hand, depositor preference is beneficial in reducing the cost to the deposit insurer because depositors have priority over other creditors in a bank failure.

39. Therefore, depositor preference is an important consideration when establishing a deposit insurance system because it can significantly affect who absorbs the cost of a failure.

(v) Information-exchange arrangements

40. Because few deposit insurers have supervisory authority, it is critical that they have access to supervisory and banking information. The effectiveness of a deposit insurance system is enhanced if there is a strong information disclosure regime, characterized by transparency, and if the insurer has timely access to requisite banking and supervisory information. Deposit insurers require different types of information depending on their mandates. In a paybox system, for example, information is necessary to ensure that the deposit insurer can discharge its payout function on a timely basis. If not, confidence could erode and render the system ineffective. In a risk-minimising system, the need for information is even greater.

41. Access to information from banks and the adequate flow of timely information among the agencies must be ensured. It may be necessary that this be accomplished either through legislation or by agreements setting out the details of the arrangements. In both cases, the confidentiality of the information has to be assured. Also of importance is that there be goodwill among the heads of the agencies and that they be firmly committed to information exchange. The Study Group noted that information-exchange arrangements could be enhanced in a number of countries.

(vi) Public awareness

42. It is essential that the public be informed about which products are covered by deposit insurance. This is especially true as financial markets are changing rapidly, and new products are introduced. Many countries have widely publicized the terms and conditions of deposit insurance coverage. Public awareness is particularly important for newly established deposit insurance systems. Although the costs of ensuring that the public is informed may be considerable, the need for public awareness should not be underestimated.

(vii) Operational considerations

43. Operational issues must be considered when designing a deposit insurance system. These include a sound corporate governance framework, including internal controls; the availability of skilled human resources, and up-to-date technology; and adequate operational funding. Furthermore, human-resources issues such as compensation, indemnities and incentives should be addressed in order to attract and maintain knowledgeable staff. The issue of personal liability exposure was raised and there was agreement that any disincentives to perform should be eliminated.

IV Transition Issues

44. As noted earlier, a number of countries implemented explicit government blanket guarantees to prevent the collapse of their financial systems and restore or achieve financial stability. As financial stability returns, many of these countries are focusing on ways to make a smooth transition from blanket guarantees to limited-coverage deposit insurance systems.

1. Rationale for adopting explicit blanket guarantees

45. The primary rationale for governments to adopt an explicit blanket guarantee is to restore confidence in the financial sector during a major crisis. Experience shows that depositor and creditor confidence can erode quickly, and this may have a severe effect even on relatively healthy institutions. To maintain confidence, depositors and creditors require immediate and widespread government assurance of the safety and availability of their deposits and claims. Another reason for adopting explicit blanket guarantees is the belief that they will provide the government the time and opportunity to restructure problem banks, thereby avoiding the need to deal with closure decisions.

2. Benefits and costs of blanket guarantees

46. The main benefit of instituting blanket guarantees is to avoid widespread bank runs and thus maintain stability in the financial system, thereby delaying and reducing the government's financial exposure. Nevertheless, the use of blanket guarantees can ultimately prove costly, particularly when banks and others view the blanket guarantee as a licence for excessive risk-taking. This is especially the case when the owners, managers, and large creditors of problem banks do not incur losses during the restructuring of the financial system or during failures.

47. The use of blanket guarantees can obscure problems in government economic policy and in the legal, regulatory and supervisory regimes. For instance, blanket guarantees can provide a false sense of security. Thus, it is important to provide banks and the regulatory and supervisory agencies with incentives to address and correct their problems and weak practices in the context of a comprehensive reform program when introducing or reverting to a limited-coverage deposit insurance system.

3. Moving from blanket guarantees to limited-coverage deposit insurance

48. There are various prescriptions for moving to limited-coverage deposit insurance systems, but the timing will depend on the country's progress toward meeting the conditions for establishing an effective deposit insurance system. Public confidence and stability of the financial system are critical considerations.

49. In all circumstances, there should be a well-structured mechanism to reduce the blanket guarantee over time. After a country has suffered a financial crisis, it is best to ensure that most of the major problems relating to the financial crisis have been adequately addressed before transitioning to limited-coverage deposit insurance. However, if governments wait for all deficiencies in an economy or financial system to be addressed or the system to be reformed, blanket guarantees could become entrenched.

50. If necessary, the original time frame for transitioning to a limited-coverage deposit insurance system should be modified to reflect the state of the necessary reforms, the possible effect on public confidence, and the ability to achieve the public-policy objectives. Moving too quickly to limited-coverage could lead to instability and capital flight, which could prolong the crisis.

51. When moving from a blanket guarantee to a limited-coverage deposit insurance system, there are a number of other issues to be considered. These include deciding whether to "grandfather" deposits covered under the blanket guarantee for a period of time and how to phase-out the guarantee for other liabilities. In addition, it may be appropriate to phase in coverage of new deposits by reducing the insurance limit over time.

52. There is a social cost to providing a blanket guarantee, as the guarantee is ultimately borne by taxpayers. In a limited-coverage system, however, there is a specific cost paid by the banks through premiums or levies. Imposing premiums or levies must not undermine the competitiveness of the banks or destabilise them, especially during the transitional period. In addition, there should be appropriate mechanisms in place during the transition

period to provide the deposit insurer with the required funding. To maintain public confidence, the new limited-coverage deposit insurance system must be well understood.

V International Guidance on Deposit Insurance

53. As the business of banking evolves and increasingly cuts across sectoral and national borders, it is essential that governments and the agencies adapt accordingly. The rapid advances in consolidation and technology, coupled with the expansion of banking activities into new areas and related risks, continually challenge the role of deposit insurance and other elements of the financial safety net. Thus, co-operation, communication, and planning for contingencies are increasingly critical to an effective financial safety net.

54. The members of the Study Group agreed that the development of guidance is a necessary step that should be taken and that it is feasible to do so. Although it is difficult to develop a set of detailed principles and practices that would apply to all deposit insurance systems, the Study Group concluded that a set of flexible guidelines could be prepared in a reasonable time frame. The resulting guidance would be helpful to countries adopting or reforming deposit insurance systems.

Annex 1
Terms of Reference of the FSF Study Group on Deposit Insurance

1. Study recent experience with deposit insurance by examining systems that worked well, those that did not work well, and the reasons why and synthesising the key lessons learned.

2. Sketch the policy trade-offs presented by different types of deposit insurance schemes, taking account of different institutional settings.

3. Examine the issues involved in transitions from implicit or explicit blanket guarantees to limited-coverage deposit insurance schemes.

4. Assess the desirability and feasibility of setting out international guidance on deposit insurance, recognising that the different country circumstances may imply different policy prescriptions.

5. Evaluate what form such guidance could take (ranging from formulation of general principles for deposit insurance schemes to setting out pitfalls to be avoided in their design and operation) and who would be best able to take forward this work.

Annex 2
Composition of FSF Study Group on Deposit Insurance

Chairman
Mr. Jean Pierre Sabourin, President and Chief Executive Officer
Canada Deposit Insurance Corporation

Argentina **Dr. José Carlos Jaime,** Chairman Seguro de Depósitos Sociedad Anónima	**Canada** **Mr. Guy L. Saint-Pierre,** Senior Vice-President, Insurance and Risk Assessment Canada Deposit Insurance Corporation
Chile **Mr. Carlos Budnevich Le-Fort,** Manager of Financial Analysis Banco Central de Chile	**France** **Madame Sylvie Mathérat,** Chef du service des études bancaires Secrétariat général de la Commission bancaire
Germany **Mr. Dietrich Jahn,** Adviser to the Ministry Ministry of Finance	**Hungary** **Mr. Dániel Jánossy,** Managing Director National Deposit Insurance Fund of Hungary
Italy **Mr. Giovanni Carosio,** Head of Department, Supervision of Credit Institutions Banca Italia	**Jamaica** **Mr. Winston K. Carr,** Chief Executive Officer Jamaica Deposit Insurance Corporation
Japan **Mr. Yasushi Kanzaki,** Director for International Affairs Financial System Planning Bureau Ministry of Finance	**Mexico** **Mr. Carlos Isoard,** Member of the Board of Governors **Mr. Vicente Corta,** Chief Executive Officer **Ms. Ingrid Cerwinka,** Assistant General Director Instituto para la proteccion al Ahorro Bancario
Philippines **Ms. Rescina Bhagwani,** Vice-President Philippine Deposit Insurance Corporation	**United States of America** **Ms. Donna A. Tanoue,** Chairman Federal Deposit Insurance Corporation
The World Bank **Mr. Gerard Caprio,** Director, Financial Policy Department, and Head, Financial Sector Research	**International Monetary Fund** **Mr. Charles A. Enoch,** Assistant Director Systemic Banking Issues Division
Members of the Secretariat **Canada Deposit Insurance Corporation** **Ms. M. Claudia Morrow,** Corporate Secretary Secretary to the Study Group **Mr. John Raymond LaBrosse,** Adviser to the President and CEO Executive Director of the Study Group	**Financial Stability Forum** **Mr. Pierre Cailleteau**

Annex 3

Key Lessons Learned from Recent Experiences with Deposit Insurance

The Study Group discussed recent experiences that affected deposit insurance systems and identified key lessons learned. The observations of the Study Group primarily addressed the overall effect on deposit insurers. These key lessons are summarized below.

- Deposit insurance systems are not intended to cope with systemic financial crises by themselves. The resolution of systemic crises requires broad, co-ordinated government action.

- Financial-sector liberalisation needs to be accompanied by appropriate changes to the regulatory, supervisory and deposit insurance systems. If not, stress in the financial system may cause governments to introduce blanket guarantees, thus exacerbating the problem of moral hazard.

- Appropriate incentives need to be in place in supervisory and, where appropriate, in deposit insurance systems to ensure early detection of problems in the banking system and to ensure prompt remedial action. The Study Group noted examples where early detection and intervention reduced costs to the deposit insurance system and maintained stability of the financial system.

- Weaknesses in bank supervision, a lack of qualified people to deal with complex issues, and forbearance contributed to delays in dealing with bank problems and, at times, increased costs to governments and deposit insurers.

- Deficiencies in the flow of information from the banking sector and poor information exchange among the agencies undermined the ability of some deposit insurance systems to carry out their mandates.

- Roles and responsibilities among the agencies were often not properly defined or were not always compatible with the public-policy objectives. In some cases, clear accountability regimes were also absent, and this hindered the ability to resolve problems and assess the performance of each agency. Although the range of powers and independence accorded to the agencies varied widely among the Study Group members, there was agreement that the respective agency mandates should be clearly set out in legislation. Furthermore, the performance of each agency should be assessed and reported accordingly.

- In a number of countries, accounting and auditing standards were either not applied consistently or were non-existent, transparency and disclosure regimes were lacking, bank risk-management and corporate-governance practices were deficient, and asset-valuation methodologies were inadequate. As a result, early detection and timely intervention became difficult. These factors resulted in higher overall costs to taxpayers and deposit insurers. The Study Group noted the critical importance of sound accounting and auditing standards to a stable financial system.

- In times of stress, inadequate awareness of deposit insurance systems eroded public confidence. Accordingly, the public should be kept informed of the benefits and limitations of deposit insurance. This could also serve to ensure that the public is not led to believe that it has more protection than is the case, as such a misunderstanding reduces market discipline and increases moral hazard.

- The inability of agencies to adapt quickly to changing banking conditions hindered their ability to address problems quickly. This inability was based, in part, on poor information systems and the lack of skilled human resources. In this regard the Study Group highlighted the need to attract and retain qualified human resources and saw establishing and maintaining competitive compensation as a major challenge.

- The Study Group also noted that in a number of countries, employees of deposit insurers and other agencies were held personally liable for actions taken on behalf of their organisations. This was seen as a serious impediment to performance and to fulfilling mandates. The Study Group recognized the advantages of statutory indemnification against legal liability that has been provided in some countries.

- Legal regimes were inadequate for supervisors and deposit insurers to fulfil their mandates. This was particularly evident when dealing with bank closures, liquidating assets, and resolving creditors' claims.

- Not enough measures to limit moral hazard and increase market discipline were in place to support deposit insurance systems. For example, policy-makers should consider introducing personal liability incentives against directors and officers of banks to promote good corporate governance. Furthermore, effective and early closure regimes accompanied by least-cost approaches to bank failures should also be considered.

- The protracted use of lender-of-last-resort facilities by a bank was seen in many instances as an early warning of solvency problems and therefore should be monitored closely and communicated to the other agencies.