12 January 2006

General Guidance to Promote Effective Interrelationships among Financial Safety Net Participants[i]

Prepared by the Research and Guidance Committee
International Association of Deposit Insurers

C/O BANK FOR INTERNATIONAL SETTLEMENTS
CENTRALBAHNPLATZ 2, CH-4002 BASEL, SWITZERLAND
TEL: +41 0 61 280 9933 FAX: + 41 61 280 9554
WWW.IADI.ORG

Table of Contents

I. Executive Summary..2

II. Introduction and Background Information..4

III. Composition, Mandates and Powers of Financial Safety Nets.......5

IV. Co-ordination Among Safety Net Participants.................................7

V. The Importance of Information Sharing..9

VI. Conclusions and Key Points of Guidance.....................................11

Appendix: Countries Responding to the Questionnaire.........................14

I. Executive Summary

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. In designing deposit insurance systems, policymakers should address the deposit insurer's relationships and co-ordination with other safety net participants. A need for close co-ordination exists in any institutional setting and information sharing. However, when more than one organization is responsible for the smooth functioning of the financial safety net, it could be said that "Good Fences Make Good Neighbors" as the functions assigned to different organizations raise issues related to the allocation of powers and responsibilities, information sharing, and the co-ordination of actions. In this regard, there is a need to set out guidance to promote effective interrelationships. The aim of this paper is to provide practical advice to safety net participants on how to promote interrelationships that will contribute to financial stability.

II. Introduction and Background Information

The banking system of any given country has a key role in the performance of the entire economy. A stable banking system underpins a nation's payments system, enhances its savings rate, investment and economic growth, and facilitates financial intermediation. However, there is no guarantee that banks by themselves will assume the level of risk exposure consistent with their deposit liability profile. This briefly explains why the safety and soundness of the financial sector is a critical objective of any government. Hence the importance of strong and viable financial safety nets is being increasingly recognized in the vast majority of countries. An examination of interrelationship issues among financial safety net participants is designed to improve the effectiveness of these back-up mechanisms and therefore the protection of less-sophisticated depositors.

In September 2001, the Financial Stability Forum Working Group introduced for the first time official guidance on, *inter alia*, inter-relationships among safety net participants in a Report entitled "**Guidance for Developing Effective Deposit Insurance Systems**". Although the guidance points contained in the Report represent a significant break through in the provision of information on this subject, it has been recognized that further work is required to provide for detailed and comprehensive guidance. In May 2002, the International Association of Deposit Insurers (IADI) was established with a mission to "contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation". As part of its work, IADI undertakes research to provide guidance on deposit insurance issues. Thus a sub-committee on inter-relationship among safety net participants (SNPs) of IADI's Research and Guidance Committee was formed to specifically extend the research work in this area[ii]. This paper is written from the perspective of the deposit insurer but in doing so, the contribution of the other participants is recognized in achieving an effective safety net. It is designed primarily for deposit insurance practitioners as well as other interested parties.

The paper benefited to a large extent from survey analysis based on a questionnaire to document the experiences of IADI members as well as other financial safety net participants. A total of seventy six (76) questionnaires were circulated to the thirty-four (34) IADI members and forty-two (42) non-IADI members. A total of 34 or 45 percent have responded as shown in the Appendix. In addition, the paper drew on relevant literature available on the subject.

Approximately one-half of the deposit insurers which responded to the questionnaire, indicated that they had pay-box systems, while most of the others described themselves as “risk minimizers” or “risk managers” with some business powers or means to reduce risk exposure, with five (5) also having supervisory powers.

Most deposit insurers operate as government agencies but a few (e.g. Brazil, Finland and France) operate as private companies. The case of Slovenia is interesting where the deposit insurance system consists of the banks themselves. There is no special fund established but only the legal obligation by which banks guarantee payment of deposits. In Japan, besides SNPs (government and central banks), there is private financial sector’s participation in equity, decision making process and staff.

This paper discusses: (1) the composition, mandates and powers of financial safety nets; (2) co-ordination among safety-net participants; and (3) the importance of information sharing. It then concludes by providing guidance with respect to the issues discussed.

III. Composition, Mandates And Powers of Financial Safety Nets

Institutional arrangements may vary from country to country but by and large, looked at from a functional perspective, effective financial safety nets generally have the following components: prudential regulation and supervision, lender of last resort, deposit insurance and a clearly defined resolution mechanism for banks in distress. In many countries, a department of government (generally, the Ministry of Finance or the Treasury), also plays an important role in the financial safety net and is usually responsible for financial sector policy.

In summary, the components that constitute a financial safety net seek to promote an efficient and stable banking system during normal times and to manage the eventuality of a financial crisis. Thus, the regulatory framework and prudential supervision are designed to promote improved stability performance in the banking system as they attempt to offset the negative consequences of the market failure present in the industry. Prudential regulation and supervision include, *inter alia*, the chartering (e.g. licensing) function which imposes capital and character (fit and proper) and disclosure requirements, restrictions on the types of assets that banks may hold and on the activities in which they may engage. Regulation is designed to reduce unwarranted or unmitigated risk taking and supervision to monitor banks to see that they are complying with the regulations in order to ensure the safety and soundness of the banking system.

However, even though there may be restrictions on entry and prudential regulation and supervision, banks by their very nature can and do fail. Financial safety nets therefore normally include measures to deal with those circumstances. In this regard, deposit insurance attends to equity concerns and consumer protection, the lender of last resort function to curb the spread of liquidity crisis and the resolution mechanism to deal with financial institutions in distress – that is, experiencing insolvency. The location of this latter function is important because timing is crucial during a crisis. If, for example, there is more than one institution dealing with different phases of the resolution, co-ordination among them assumes even greater significance.

With respect to mandates and powers, from the survey findings, all deposit insurance entities described themselves as being integral parts of their respective countries' financial safety nets. In some instances, the central bank which operates the lender of last resort function also has the responsibility for supervisory functions (e.g. Jamaica, Bulgaria, Jordan, Lithuania, Portugal and Cyprus) while others have separate supervisory functions (e.g. Canada, U.S.A., Taiwan and Korea). By and large SNPs, are independent statutory bodies with their powers, mandates and responsibilities explicitly defined in legislation and in some instances supported by Memoranda of Understanding (e.g. Jamaica, Bulgaria and Estonia) as well as special agreements for information sharing and co-ordination (e.g. Canada, Hungary, Taiwan and Korea).

The majority of deposit insurers do not have the authority to inspect member banks directly but have the authority to request certain actions or information from the supervisor. Hungary has limited authority while Jordan can do so jointly with the central bank. In the Philippines, the deposit insurer can minimize insurance risks through conduct of examination of banks. However, this requires prior approval of the central bank's Monetary Board, provided that no examination may be conducted within 12 months from the last examination date. In Mexico, the supervisor is required by law to inform the deposit insurer of the condition of an institution where there is a prospect that intervention may be required. Deposit insurers that can or cannot have access to supervisory inspection reports are about equally divided.

A number of countries, including Jordan, Slovenia and Trinidad and Tobago considered that there are areas where the powers and responsibilities of the deposit insurer *vis-à-vis* those of other SNPs should be better defined. Some of the areas suggested for improvement include: provision of clearer mandates bolstered by stronger accountability regimes for ensuring that the participants fulfill their responsibilities; the strengthening of corporate governance provisions and improved information sharing through more specific reference in law as to the type of information to be shared and the timing for the receipt of such information.

IV. Co-ordination Among Safety Net Participants

The necessity for close co-ordination and co-operation among SNPs stems from the possibility of conflicting mandates which could undermine the effectiveness of the financial safety net. Therefore, though the precise mechanisms of co-ordination will obviously depend on each country's institutional set-up, as a first step there should be a clearly articulated division of powers and responsibilities agreed upon by all the participants to prevent unproductive overlapping and duplication of activities as much as possible.

In normal times, agreement as to respective mandates does not have the same level of significance as when there is a banking crisis. Indeed, when failures occur, it could be very difficult for SNPs to fulfill their respective responsibilities without a clear *ex-ante* mandate. In order to reconcile potential conflicting mandates prior discussion and a high degree of transparency must be a requirement when establishing the co-ordination framework to facilitate information sharing and effective communication.

The survey results demonstrated that the co-ordination mechanisms varied from country to country. In those countries where the deposit insurer is a risk minimizer, there are no significant overlaps between the deposit insurer functions and those of the other SNPs because the powers of the various agencies are normally clearly defined in law. Where the central bank, supervisory and deposit Insurance functions are contained within one entity (e.g. the Netherlands), there is little or no scope for conflicts of interests. Co-ordination also becomes easier when a single institution has more than one function - e.g. in Kenya and Cyprus.

Where the possibility of conflicts of interest between SNPs exists, the following co-ordination methods are usually adopted: membership of other SNPs on the deposit insurance systems' board of directors, use of Memoranda of Undertakings (MOU's), specially designated committees, and legal agreements. In the Philippines, for example, the functions and responsibilities of the deposit insurer and the central bank in the areas of examination, monitoring, prompt corrective action, and failure resolution, are defined in their respective charters and/or circulars, rules and regulations and Memorandum of Agreement. The boards of both entities prescribe guidelines that may be necessary to ensure that there are no duplication of functions. In Jamaica, a statutory committee composed of representatives of the central bank, deposit insurance system, ministry of finance and supervisory authority has been established to facilitate information sharing and to coordinate regulatory policy.

As far as the size of boards of deposit insurance agencies is concerned, the number varies from three (3) in Portugal to fourteen (14) in Korea. It is interesting to note that in a country as large as the U.S.A., the FDIC has a five (5) member board. In the case of some deposit insurers (e.g. in Canada and Jamaica) board members cannot be directors, officers or employees of member institutions. Representation on Board of Directors of the Canada Deposit Insurance Corporation (CDIC) coupled with specially designated committees to consider matters of mutual interest and an "Guide to Intervention" for federal institutions developed jointly between CDIC and the Office of the Superintendent of Financial Institutions (OSFI) have worked well in that country.

V. The Importance of Information Sharing

Information sharing is one of the vital areas in the relationship of the deposit insurer and other safety net players. The types of information to be shared may be specified by law, formal agreement or informally.

Depending on its institutional mandate and powers, the need for relevant information by the deposit insurer can vary significantly. In the case of a simple pay-box system, the deposit insurer should have the basic information to calculate insurance premiums and to reimburse depositors in a timely and efficient manner when required to do so. Such information would relate to data on the banks' deposit base, including information on the amount of insured deposits held by individual depositors. The nature of the information required by the deposit insurer will vary from normal times to that in a crisis.

A risk-minimizing deposit insurer would however, have greater needs for information given its broader mandate. It must be in a position to assess the financial condition not only of individual member institutions, through access to, for example, their financial statements and other reports, but also the entire industry. In addition, the risk minimizer should be able to anticipate the financial troubles of individual banks and deal with them effectively when they arise. This requires well-defined roles, responsibilities, information sharing and co-ordination of activities with the other safety participants. When this is accomplished, it can result in a high level of effectiveness and minimization of losses for the deposit insurer and the financial system as a whole.

An important issue concerns access to the results of on-site examinations that produce information on the institution's condition not otherwise available. The empirical evidence suggests that in the majority of cases the supervisory authority is the primary and most important source of such banking information. Due to its specific powers and responsibilities, the supervisory authority is usually the only safety-net agency able to assess accurately and ensure the quality of information provided by financial institutions. Therefore close co-ordination of the collection and sharing of information between supervisory authority and the other SNPs becomes an imperative. The available evidence suggests, however, that access of the deposit insurer to examination reports or critical data from such reports differs among the countries surveyed.

In general, depending on the scope of their specific mandates, deposit insurers may need to supplement information provided by supervisors with certain specific information obtained directly from the insured banks. For example, this could include, for purposes of verification, the level of deposits held for premium assessment and information on specific products and their insurability. However, it is important to balance the need of the deposit insurer to obtain supplemental information against the need not to place an undue burden on the banking industry.

For information to be useful to the deposit insurer, it should be timely, accurate and relevant to facilitate an effective system of ongoing evaluation of individual insured institutions as well as the banking industry as a whole. In many instances, the supervisor is not obliged to respond to the requests of the deposit insurer for information within a specified period of time. Examples of exceptions to this are to be found in Canada, Bulgaria, Colombia, Korea, and Albania. There are some deposit insurers which cannot obtain information from the supervisor or other SNPs, (e.g. Trinidad and Tobago).

Certain types of information about individual banks, such as supervisory ratings of individual institutions and customers' accounts are usually held in confidence. Therefore, rules regarding the confidentiality of information exchanged between safety net participants should be respected at all times.

VI. Conclusions And Key Points of Guidance

The following points of guidance summarize the main conclusions and suggestions flowing from the paper to help policymakers and other interested parties deal with the critical issues regarding inter-relationships among the various participants in a financial safety net. These points are reflective of, and adaptable to, a broad range of circumstances, settings and structures.

1. Composition, Mandates and Powers of Financial Safety Nets

- The first step in approaching the matter of inter-relationships among SNPs is to have a clear understanding of the particular country's institutional arrangements. This will assist with the proper identification of the composition and scope of the financial safety net and provide insights into the potential for conflicts.
- Having identified the various components of the safety net, the next step is to review their respective functions both in normal times and in a financial crisis. In cases where a single organization performs all of the safety net functions, the smooth resolution of potential tensions will depend on the clarity of mandates and an adequate accountability regime among the relevant departments. However, when the functions are assigned to different organizations, issues related to allocation of powers and responsibilities, co-ordination of actions among the different functions, and issues related to information sharing becomes more complex and need to be addressed clearly and explicitly.

2. Coordination among Safety-Net Participants

- The necessity for close co-ordination and co-operation among SNPs stems from the possibility of conflicting mandates. Therefore, though the precise mechanism of co-ordination will obviously depend on each country's institutional set-up, as a first step, there should be a clearly articulated division of powers and responsibilities agreed upon by all the participants to prevent unproductive overlapping and duplication of activities as much as possible.
- In establishing the co-ordination framework, there must be a high degree of transparency and agreement as to respective mandates prior to the occurrence of a banking crisis.
- To prevent unproductive significant overlaps between the deposit insurer functions and those of the other SNPs, it is strongly recommended that the powers of the various agencies are explicitly defined in law.
- Apart from or in addition to legislation, consideration should also be given to the formalization of the following co-ordination and information sharing techniques: membership on other SNPs board of directors, use of Memoranda of Undertakings (MOUs), and specially designated committees or a combination of these techniques.

3. The Importance of Information Sharing

- The need for relevant information by the deposit insurer can vary significantly depending on its institutional mandate and powers but this does not obviate the need for close co-ordination and information sharing among safety net participants in all cases. All the required information should be timely, accurate and relevant. In the case of a simple pay-box system, the deposit insurance agency should have the basic information to pay off depositors in a timely and efficient manner when required to do so.

- A risk-minimizing deposit insurer would however, have greater needs for information given its broader mandate. For example, it must be in a position to assess the financial condition not only of individual insured institutions but the entire industry. In addition, the risk minimizer should be able to anticipate the financial troubles of individual banks and deal with them effectively when they arise.
- Since the supervisory authority is usually the primary and most important source of banking information given its specific powers and responsibilities, there should be clear guidelines for this entity to share the relevant information with other SNPs. Steps must also be taken to ensure that the supervisory authority is obliged to supply the required information within a specified period of time.
- Deposit insurers may from time to time need to supplement information provided by the supervisory authority with certain specific information obtained directly from the insured banks – for example, the level of deposits held for premium assessment and information on specific products and their insurability. Therefore the necessary arrangements must be put in place to facilitate the deposit insurer gaining access to such supplemental information without difficulty.
- Rules regarding the confidentiality of information exchanged between safety net participants must also be respected at all times.

Appendix

Countries Responding to the Questionnaire

IADI Members

1. Albania
2. Brazil
3. Bulgaria
4. Canada: CDIC
5. l'Autorité des marchés financiers, Quebec
6. Colombia
7. Czech Republic
8. El Salvador
9. France
10. Hungary
11. Jamaica
12. Japan
13. Jordan
14. Kazakhstan
15. Kenya
16. Korea
17. Mexico
18. Russia
19. Sweden
20. Taiwan
21. Trinidad & Tobago
22. U.S.A.
23. Venezuela
24. Vietnam

Non-Members

1. Chile
2. Cyprus
3. Estonia
4. Finland
5. Lithuania
6. Netherlands
7. Portugal
8. Slovenia
9. Spain
10. U.K.

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[i] This paper was prepared by a sub-group of the Research and Guidance Committee Chaired by Winston Carr (Jamaica Deposit Insurance Corporation). The sub-group was also composed of Andrei Pekhterev (Deposit Insurance Agency – Russian Federation), Bakhyt Mazhenova (Kazakhstan Deposit Insurance Fund), Carlos Isoard (Instituto para la Proteccion al Ahorro Bancario – Mexico), Charles Cornut (Fonds de Garantie des Dépôts – France), Daniel Jánossy (National Deposit Insurance Fund of Hungary, David Walker (Canada Deposit Insurance Corporation), Dong-Il Kim (Korea Deposit Insurance Corporation), Hajime Shinohara (Deposit Insurance Corporation of Japan), Ricardo Tan (Philippines Deposit Insurance Corporation), and Roumyana Markova (Bulgarian Deposit Insurance Fund).

[ii] The initial approach was outlined in a presentation made by Winston Carr on 23 October 2003 at the Second Annual IADI Conference held in Seoul, Korea. Mr. Carr delivered a presentation based on this paper at the Fourth Annual IADI Conference on 29 September 2005 in Taipei.