



CORE PRINCIPLES FOR EFFECTIVE DEPOSIT INSURANCE SYSTEMS

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Presentation Outline

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1. Background

- The Report of the Financial Stability Forum on Enhancing Markets and Institutional Resilience, released on April 7, 2008, pointed out that events during the recent international financial turmoil illustrate the importance of effective depositor compensation arrangements. The FSF Report recommended that:
 - *“Authorities should agree on an international set of principles for effective deposit insurance systems. These principles should recognize that there may be a variety of different designs for deposit insurance arrangements that meet the objectives behind the principles, and therefore should be adaptable to a broad range of country circumstances. The development of the principles should also take close account of the broader characteristics of safety-net arrangements, including those of the regulatory and supervisory framework and of resolution procedures for failing institutions.”*

Background Continued

- The International Association of Deposit Insurers (IADI) developed a set of Core Principles for Effective Deposit Insurance Systems in February 2008.
- In July 2008 a joint working group from the Basel Committee on Bank Supervision (BCBS) and the Guidance Group of IADI was formed to develop a set of joint IADI-BIS Core Principles to be submitted to their respective organizations for review and approval.
- In June 2009 these jointly developed Core Principles were approved and released by the BCBS and IADI.

Background: Objectives and Methodology

The objectives of the Core Principles are to:

- Enhance the effectiveness of deposit insurance systems.
- Be reflective of and adaptable to a broad range of country circumstances, settings and structures.
- Draw heavily on the practical experience of deposit insurers.

The Core Principles are based on:

- IADI research and guidance papers (2002-2009)
- Discussions with Basel Committee (CBRG, ILG)
- APEC Policy Dialogue on Deposit Insurance (2005)
- FSF Working Group on Deposit Insurance (2001)

The Principles are neutral with regard to different approaches to deposit insurance, so long as the overriding goals are achieved.

2. Preconditions

The introduction or the reform of a deposit insurance system can be more successful when a country's banking system is healthy and its institutional environment is sound. Thus, an effective deposit insurance system needs to be based on a number of external elements or preconditions:

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

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

3. The Core Principles

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

Core Principles Continued

- **Principle 2 – Mitigating moral hazard:** Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net (see Preconditions paragraph 16).
- **Principle 3 – Mandate:** It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public-policy objectives and the powers and responsibilities given to the deposit insurer.

Core Principles Continued

- **Principle 4 – Powers:** A deposit insurer should have all powers necessary to fulfill its mandate and these powers should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.

Core Principles Continued

- **Principle 5 – Governance:** The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.
- **Principle 6 – Relationships with other safety-net participants:** A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized.

Core Principles Continued

- **Principle 7 – Cross-border issues:** Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognized in the determination of levies and premiums.

Core Principles Continued

- **Principle 8 – Compulsory membership:** Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (e.g. retail and small business depositors) to avoid adverse selection.
- **Principle 9 – Coverage:** Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public-policy objectives of the system and be internally consistent with other deposit insurance system design features.

Core Principles Continued

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

Core Principles Continued

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

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

Core Principles Continued

- **Principle 12 - Public awareness:** In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.
- **Principle 13 - Legal protection:** The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates...

Core Principles Continued

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

Core Principles Continued

- **Principle 15 – Early detection and timely intervention and resolution:** The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined and transparent criteria by safety-net participants with the operational independence and power to act.

Core Principles Continued

- **Principle 16 – Effective resolution processes:** Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimize resolution costs and disruption of markets; maximize recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings.

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

Core Principles Continued

- **Principle 17 – Reimbursing depositors:** The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance.

Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.

Core Principles Continued

- **Principle 18 – Recoveries**: The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.

4. Conclusions and Next Steps

- Core Principles jointly approved and released in June 2009
- Work initiated on a Core Principles “Methodology” to assist in assessment of compliance

Questions & Comments?