

# THE GOVERNANCE OF DEPOSIT INSURANCE\*

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Getting the framework right for deposit insurance is a crucial prerequisite. Without it much of the more detailed discussions about what should be insured and how it should be financed can be decidedly second order, even though they tend to be discussed first and are the focus of the legislation in the EU, for example. The International Association of Deposit Insurers is therefore to be congratulated on recognising this and producing a discussion paper on the topic (IADI, 2006). However, the success of the system depends on both its structure and its operation and these comments reflect on both.

There are accepted governance structures for private companies, public sector agencies - including central banks - and not-for-profit organisations. To a large extent a suitable governance framework for deposit insurers would simply draw on these accepted structures. It is 'merely' necessary to set out the features that situate deposit insurance in the spectrum and that make it unusual.

Inevitably the appropriate governance structure covers a range because deposit insurers vary from being a simple paybox with virtually no staff and a simple mandate that may not even include the collection of premiums and the management of funds through to a large organisation that is responsible not just for managing risks but also for supervising financial institutions to ensure that they are operating in a manner that conforms to minimum standards, and for active intervention and management of the process of distress and insolvency should something go wrong. However, beyond that, not all countries have explicit deposit insurance systems so the mandate and even the organisation implicitly responsible may be unclear. Where the deposit insurer is largely a paybox the issues of governance may relate more to the supervisory agency on which the deposit insurer is dependent. In all cases it would be evading the issue simply to concentrate on the governance of what happens to be the body that is labelled as the deposit insurer or has explicitly been given the primary mandate.

These comments therefore focus on the following two issues that complicate governance for deposit insurance:

- What are deposit insurers in business to achieve?
- How can one tell if they are achieving it effectively and efficiently?

In particular how does the framework of governance cope with the existence of multiple organisations and multiple interest groups in undertaking its task? Since it is not possible to set out a complete contract for the operation of a deposit insurance system it is the governance structure that ensures that the incomplete contract offers the greatest chance of achieving what society wants.

## **An Unusual Product?**

The IADI recommendations start with a simple requirement – set out a clear mandate. It will not be possible to run the business well if it is not clear what it is trying to do and it will not be possible to evaluate progress unless it is possible to establish some sort of measure of what constitutes success. Unfortunately this is not always easy to do. In any case this and many of the other governance requirements lie outside the powers of the authority to achieve on its own. Suggesting that legislation be opened up to make improvements often creates the risk that other less welcome changes will be introduced at the same time. The bounds of possibility may be the improvements

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\* These remarks are made in a personal capacity and are provided to stimulate discussion.

that can be made in the face of unchanged legislation. A well-motivated board can impose much of what is required on itself – for example by spelling out what it sees as its task. Even if this has no power in law it can be very credible as a commitment. What follows, therefore, is primarily concerned with how boards can impose suitable governance structures on themselves, with or without the support of legislation.

Although monetary policy is not often a good analogy, the mandates of central banks for pursuing price stability or anything like it were very vague even as recently as the 1980s. Indeed in many cases they had requirements to pursue a variety of desirable macroeconomic objectives, some of which were somewhat contradictory and others not readily achievable by monetary policy. Many central banks have therefore been keen to spell out what their objectives are and how they will address contradictory requirements. As pressure for accountability has risen, banks only want to be accountable for something that is within their power. The central bank is an easy scapegoat for a government that sets optimistic targets and then is subject to an unfavourable shock. Central banks have traditionally not been very communicative, a state of affairs that worked when they were untouchable or rather passive in the policy process. The bank has thus tended to take the lead – the Bank of Canada and the Reserve Bank of Australia are good examples. Their Governors spelt out in open letters to their ministers of finance what they intended to do and how they would dovetail this with the government's policy making. Naturally such letters are discussed before the event but refusal would be a vote of no confidence in the Governor.

In the case of deposit insurers the task may be more complicated if it is not just the government with whom they have to have an understanding but also other institutions including the central bank that have a role in affecting bank failure and its costs. Indeed one way of handling this is literally to have a Memorandum of Understanding between the parties as to what their roles are and how they will co-operate in the event of difficulty. Such a Memorandum is soft law. Action cannot be taken against the authorities concerned if they do not honour it but it is highly unlikely that the leaders of an authority that breached such a Memorandum without acting in good faith would be continuing in their employment. Such an agreement is perhaps the end of the process. Along the way an authority can make a unilateral commitment. Such commitments can be positive or negative. Thus a deposit insurer could make commitments about how it will treat institutions or depositors in a way that reassures them. On the other hand it can also lay out what it will not do.

As Robert Eisenbeis (2006) has pointed out, even in some of the most developed systems, such as that in the United States, there are significant actual and potential agency conflicts in the treatment of banking problems. In normal times agencies can get along easily but as soon as pressure emerges each will follow its own perceived objectives. The supervisors anxious to avoid failures may try to keep banks open longer than will minimise the loss to deposit insurers and central banks may alter the hierarchy of claimants through emergency collateralised lending. The different parties need to know where each other stands and act in the light of it. As Eisenbeis has pointed out in the case of Hurricane Katrina in New Orleans, it is no use having sorted out how the helicopters are going to be used for evacuation if they are immediately commandeered by the federal authorities for their own purposes.

In New Zealand for example, where there is no explicit deposit insurance the Reserve Bank, which is responsible for initiating bank closure, has made it clear how depositors will be treated and that action will be extremely swift both to offset any losses of liquidity and to keep losses themselves to a minimum. Prompt corrective action is a means of loss minimisation. Ironically the greater the risk of loss to depositors the more important it is to spell out what depositors can expect and what the mandate of the organisations affecting their losses is going to be. It is unfortunate that IADI is primarily concerned with the explicit deposit insurers. Their remit is just as important where the commitment is implicit, particularly with respect to governance. (Clearly an organisation that is not going to pay out is not going to have a lot of interest in insurance premia but it may have even more interest in concerns over access to deposits in the event of failure. It will be just as concerned as any other country to avoid a run – not just on the problem bank but on others that are (erroneously) thought at risk.)

Despite its name, deposit insurance is often not very similar in concept to the rest of the insurance industry. There people and organisations face risks, some of which are voluntary. Insurance companies seek to price that risk, drawing on their ability to spread across a number of customers and across time. The potential customers can then decide whether to take the insurance. In a competitive market they can choose the insurer that offers them the most attractive package. Deposit insurance on the other hand is typically non-competitive, it is not voluntary and the extent to which it is priced is elementary. Moreover, beyond keeping a 'float' to handle immediate small problems many insurers operate on the basis that they will sort out the funding with either other banks or the government in the event of a nontrivial problem.

In most OECD countries bank failure is unusual and attracts considerable comment. The United States is atypical in this regard. Much of the task of managing the risk of bank failure is done outside the deposit insurance system. Although one of the main justifications for deposit insurance is the removal of the threat of serious loss or lack of liquidity for ordinary people, that protection is actually provided elsewhere in the process of bank regulation and supervision. Indeed, in most European countries the deposit insurance system would not avoid substantial loss of liquidity for depositors according to the rules, as deposit insurers typically have three months or even longer before they have to pay out. (In any case there is a lack of studies suggesting at what point, in terms of length interruption of access to funds or proportion of deposits lost, the probability of a run becomes unacceptably high.)

It is immediately clear, of course, as was reflected in the Nordic crises, that the authorities would rush round and do something different in the event of a severe problem. Everybody believes that, which is why the system works and people have confidence. What does that then imply for governance? It means that the governance system that is in place is a fair weather system and that in the event of a problem other procedures will apply. This does not mean that the IADI proposals are in any sense inappropriate or poorly drawn but that many of the key governance issues may lie outside them.

The nature of the problem is illustrated by a recent case in Sweden where one of the smallest financial institutions has 'failed' but it has taken a year for the authorities to close it because of the ability of those facing losses to petition the courts. The key governance issues for the deposit insurer (and indeed the other authorities involved) lie outside its control. This case in itself is likely to be more effective in achieving legislative change than pressure from the authorities has been in the absence of any actual threat. Reform proposals were made in 2002 but low probability (but high impact) concerns will always tend to come second to problems that exist in a manner that tangibly affect a lot of current voters, such as unemployment or health. Without a financial problem deposit insurance will be a long way down the agenda. And nobody wants a problem. (Although a small test case is 'helpful'.)

Defining such a mandate is difficult the more extensive is the insurer's task. Some insurers, Canada, for example, talk about 'risk minimisation' and such phraseology has been repeated by IADI (Su, 2006). In one sense this is right. Society does not want costly financial problems. However, there needs to be a balance between the costs of avoidance and the costs of occurrence. One could attempt to maximise the present value of these two if it were at all possible to come up with plausible probabilities. There are almost no studies of this, Haldane et al. (2004) being a counter example. Haldane suggests that one can get some sort of measures of the probabilities of financial problems. One can certainly consider the measurement of distance to default for example in the case of individual institutions (Gropp et al., 2002). However, if much of the function of deposit insurance is intended to deter contagion then it becomes necessary to explore correlated risks and indeed the probabilities of macroeconomic problems rather than just those for individual firms. While these may be fairly sweeping and inaccurate they are not impossible.

To set against these costs of problems (multiplied by their probabilities) one needs to estimate the costs of prevention/risk reduction. Direct costs to supervisors and insurers are the easy part of the equation. Direct compliance costs to financial institutions can also be estimated. To some extent this is easier ex post than ex ante but in assessing what to do or what has been done this needs to be

a comparative exercise. The FSA in London has gone some way down this road in trying to assess the benefits of marginal regulation although this too has been subject to criticism (NERA, 2004). It is more difficult when trying to decide where to pitch the system as a whole.

However, this omits the most important aspect which is the indirect costs to society at large. This can perhaps be assessed by looking at spreads across markets (Granlund, 2003) or much more contentiously assessments of differences in economic performance (Hoggarth and Saporta, 2001). The advantage of these sorts of measures is that they result in prices that can be externally observable, in subordinated debt markets for example. Their drawback is that it is difficult to strip out what is a function of the activities of one part of the system, namely the deposit insurer, from that of the whole of the rest of it. However, in looking at the success of the deposit insurance system it is also not clear that the supervisory board should focus on the narrow issues that relate to the operations of the insurer that are immediately under its own control.

A simple analogy here might be drawn from the price stability mandate of a central bank. Much of the factors that influence the price level and its rate of change are outside the control of the bank and many of them also under the control of the government: fiscal stance, regulatory framework, institutional arrangements etc. Nevertheless the central bank needs to manage policy in the light of these factors. When other aspects of the framework intrude on the successful operation of monetary policy then the central bank has two ways to go. One is to seek an explicit agreement that certain factors outside its control will be excluded – this is the route of the Reserve Bank of New Zealand with its Policy Targets Agreement. The other is to make public the fact that the problem exists, which for example has been very much the method preferred by the Eurosystem in pointing out the problems with the Stability and Growth Pact.

The public route has its disadvantages in that in drawing attention to problems one may increase the likelihood of their occurrence. However, since deposit insurers are in the main dealing with low probability events or higher probability events with relatively low impact (such as the failure of small institutions in fairly large market) this is unlikely to reveal much mispricing. In countries where there are extensive problems, their existence is not going to be a surprise and hence reference by the deposit insurer is unlikely to change prices although it may well cause political irritation.

Keeping silent about the problems, particularly where mandates are inconsistent among authorities or where a deposit insurer does not have the power to deliver the outcomes set out in its mandate makes the process of governance a sham.

The problem with the assessment of what should be done to avoid banking problems is that it is an asymmetric process. Most definitions of what constitutes satisfactory operation of the system (as illustrated in a good recent discussion by Allen and Wood (2006)) relates to what should not occur. The whole of the distribution of outcomes up to the point of a problem occurring represents the same outcome, namely no problem. It is not possible to know the exact size of the problem tail without incurring it, which is self-defeating. There are, however, three steps that need to be assessed. The first is how the appropriate level of risk should be determined, the second is the extent of the effort that should be expended in achieving that level and not under or over-shooting it and the third the assessment of the deposit insurer's systems whether they relate to prevention or rectification in the event of a problem.

Since the phenomenon being explored is characterised by non-occurrence there is a substantial danger that the processes used to check on risks and compliance will become routine and rather empty. In the same way, because many of the insurer's own systems are fortunately untested in practice the assessment of their efficacy may prove to be rather empty. Simulations of what can be achieved in the event of a problem are clearly needed but it may be difficult to make these realistic as to quite some extent they are dependent on the detail of the banks' systems. Banks are not surprisingly averse to putting in systems that never expect to use, such as sufficient identification of the beneficial depositors that an insurer could in fact make the prompt payments to which it is committed. There is a lack of clear standards – should access be required before the end of the value day (to an agreed portion of the claim) as in New Zealand? There the obligation is on the bank to demonstrate that these performance targets can be achieved. (Since New Zealand is an earthquake

zone it is not surprising that the financial system should be required to demonstrate all sorts of abilities to recover rapidly from a range of failures in excess of what is required in more geologically stable environments. Adding failure of the institution or its parent is thus not an excessive move.) Should access merely be required within a specified number of days? The idea that it should be within three months as in much of the EU is simply a failure to address the problem at hand.

It is tempting to try to benchmark on other countries but this to quite a large extent simply replicates the problem. Taking a wider sample certainly increases the observation of tail events but it is not at all clear that these rather rare events are very comparable. It tends to be the features that distinguish markets that are the best explanators. It is well established that regulatory cycles tend to follow the occurrence of problems. With the widespread experience of problems in the last couple of decades we can expect that the level of crisis avoidance in comparator countries will be high.

### **No conflict no interest.**

In an ideal world it might seem sensible to have a supervisory board that is in some sense independent of the particular interest groups involved in the success of a deposit insurer. (Clearly the employees need to be independent, professional and impartial.) Where the mandate is narrow this may be possible but in general it is difficult to achieve and indeed it may be the opposite of the sensible way to go. It may make more sense to have the various interests explicitly represented on the board, much in the way that this is the case in some publicly quoted companies. First of all this requires an identification of what the interests are: depositors, taxpayers, banks, creditors, employees etc. but it also can then require an explicit statement of how these interests are to be traded off. In the Finnish case for example the financial supervisor (Rahoitustarkastus), which is in effect responsible for the framework that effects the outcome of deposit insurance even though it is not the insurer, deliberately operates a balanced scorecard approach, setting out the stakeholders and how the interests of each of them are addressed and balanced in the exercise of policy.

In any case there is a danger that there are few really independent board members who could be found who are sufficiently knowledgeable about the business. This is the traditional dilemma over independent directors. If they are to know enough they need to be insiders unless their main value comes from their outside knowledge and experience in other contexts. The important issue from the standpoint of governance is not so much that there should be no conflict of interest but that such interest relationships as do exist should be public and that the rules under which the Board operates given the interest should be transparent and the proceedings adequately open. It is thus more a matter of handling the interests than trying to avoid them. (The problem is exacerbated by the fact that one of the best documented ways of avoiding regulatory capture is to try to ensure that the people involved do not remain in the same post for too long – this relates particularly to the dealings with any particular institution. Thus it is not a matter of finding an independent and currently well qualified and experienced team once but of doing so on a continuing basis.)

The most important distinction that needs to be drawn, however, is between the governance of the deposit insurer and the management of a crisis. In this case it is necessary for the various parties to be represented in the decision making. However it is essential to distinguish crisis from the problems with an individual financial institution. It is all too easy to turn even the smallest case into a political issue and bring into play other factors beyond the technical concerns of how losses or risks should be minimised. Indeed this is exactly how interest groups operate. If they can translate their personal concerns into a wider political issue then they achieve an unfair leverage and negate the ability to treat each case equitably. As soon as influence is used in one or two cases then the ability to treat banks equally under the law disappears.

In the US (where the mandate and powers of the deposit insurer are among the most extensive) the onus is on the deposit insurer to decide if there are systemic or wider threats to stability that over-ride the normal requirement to (Mayes, 2006) and then apply to be allowed to use special treatment. This decision is no easy matter requiring the agreement of the Federal Reserve,

Comptroller of the Currency and the Secretary of the Treasury (effectively the President). It has never been requested let alone granted. Nevertheless it brings the key discussion out into the open. The real problem for a deposit insurer would be if it had the discretion to abrogate the rules on its own judgement. While parliament can ultimately over-ride any previous decisions and alter the rules, it is essential for the effective governance of the deposit insurer that this has to be explicit and require formal procedures.

Hence, where interests are represented on the Board, whether or not formally, the onus is on the deposit insurer to have internal procedures in place to ensure careful balance. The obvious routes to doing this involve the appeal to independent advice or even to make action dependent upon independent assessment. This sometimes achieved in monetary policy by including a substantial number of independent advisors on the decision making body. While the Board may have overall responsibility it knows that in over-riding the independent advice that it has to take a public stand. The employees of the deposit insurer face a greater conflict as their livelihood is affected by disagreeing with the Board. For independents their reputation is likely to be enhanced by disagreement as long as this is reasoned and not capricious.

One of the ironic advantages of European integration has been that it has focused minds on the problems of interactions among different authorities. While ideally one could 'solve' the problem by internalising it in a single institution, this is clearly infeasible. Hence a different arrangement is required. The heterogeneity of arrangements in the European countries (Garcia and Nieto, 2006) means that immediately there is a range of options that could be applied and needs to be discussed.

The interactions are complex. For example, incentives appear to be best matched by putting the central bank in charge of handling marginal problems of liquidity, which can be addressed by collateralised lending and effectively elevating the lender up the hierarchy of creditors (Repullo, 2000); Kahn and Santos, 2006). But as the problem increases it is more effective to place the responsibility on the deposit insurer so that losses are minimised more generally. It is however not quite so clear how this works where there is depositor preference. How this is to be handled needs to be spelt out very carefully as the point at which initial responsibility moves from the one to the other could easily be interpreted differently, leading to overlaps or gaps.

### **The dilemma of disclosure**

While internal governance will demand full disclosure to the Board there are clear problems of confidentiality. The Board itself may have members drawn from the industry where problems in individual institutions are either not known or more likely inaccurately known. Similarly problems that are successfully treated could have an impact on the value of the firm if disclosed. There thus likely to be concerns over the extent and timeliness of disclosure by a deposit insurer.

However, it is easy to exaggerate the possible problems. New Zealand is largely unique in running a supervisory system that is predominantly driven by disclosure. It is not that the banks are required to disclose more information than under Pillar 3 of Basel 2 but that the information is more frequent, more relevant, more extensively audited and the liability of the directors of the bank for incorrect or incomplete is much more drastic, involving exposure to imprisonment and personal liability for loss. In particular, disclosure is quarterly and involves peak exposures not just quarter averages or end quarter values. In practice therefore the time lag for disclosure of a problem is quite variable, depending on whether it occurred at the beginning or end of the quarter. (The disclosure of any breach of the capital adequacy or other requirements of course has to be made to the supervisor right away.)

Despite this it has been possible to get people to be bank directors and banks have found this disclosure a source of strength rather than weakness. It enables Deutsche Bank for example to advertise that its deposits in New Zealand are insured (in Germany on the same basis as German or any other depositors). When the National Bank disclosed that it had had a major related party exposure as the result of a failed transaction this had no adverse impact on its market price or cost

of capital. The fact that its systems could cope was seen as a plus not a negative (Mayes et al., 2001).

The governance of the system is thus made easier of the disclosure comes from the banks and they know it is inevitable. There is then less of a dilemma on the insurer over what to disclose and the internal governance problem is reduced. The internal governance problem remains for the failures of the deposit insurer itself. If a test of crisis procedures shows very unfavourable results, should it be disclosed? Of course the politics may push for disclosure if what the deposit insurer wants to do is illustrate the need for greater resources or powers. The incentives need to be right. The work needs to be encouraged despite the disclosure, indeed work should be encouraged by disclosure. This is easiest where the path to advancement reflects externally known outputs.

Annual Reports are documents of record. It is rare for them to disclose anything which people do not know already apart from the audited accounts. They are thus a good basis for the exercise of parliamentary or governmental accountability. However, they are not forward-looking and in many respects it is the commitment to future actions that is the most important disclosure for a deposit insurer especially when this entails change. Speed of response and indeed anticipation are important and disclosure only well after the event may not provide the necessary transparency.

### **Concluding Remark**

The present comments are only a scratch on the surface of a substantial and welcome piece of work. The formalised requirements in the IADI guidelines on governance show excellent precepts. However, their success, as revealed in moments of crisis, will depend more on the relationship between agencies and how that interaction has been sorted out, than simply on the formal rules within the single agency. Much of this may be beyond the depositor insurer's direct control but nevertheless it has to be addressed. Handling a problem where there will be losses requires previously agreed rules on burden sharing. Interest groups need their say but the more the decision over how to handle problem banks can be a technical issue rather than a political one the better. Governance rules can be a fair weather system. But if a strong disclosure regime is set up when there are few problems facing the banking system, it will add a strong impetus to prudent risk management by the banks, as there is then less scope for destructive ambiguity and the sorts of discretion that lead to moral hazard.

However, the end note is an item not mentioned in the IADI paper, namely risk management. The most important item in the armoury of the safety net is the prudent risk management by financial firms themselves. The deposit insurer would do well to be exemplary in this regard, especially since many of the risks are difficult to assess. The attention to the financial system will be risk based and the responses proportionate to the threats. Thus the whole focus will be driven by risk management even if the institution is largely passive in its response. These processes need to be very clearly set out with just such a formal regime as is imposed on the banks. Mylrea and Lattimore of the Canadian Deposit Insurance Corporation have set out how this might be achieved on an enterprise basis, but formal governance mechanism, paralleling the structure of internal audit, so that bad news or inadequacies cannot be hidden from the board by those responsible is essential. The risk management committee will play a central role and will give comfort to the insured, to the banking system and to parliament and the wider community, both by its existence and in its reports. One might indeed follow the lead of the UK FSA by publishing an annual risk assessment. This is different from a financial stability review as its name implies, although it is likely to approach many of the same issues from a different angle. The Risk Review is intended to alert all those involved to the balance of potential risks in the coming year and the concerns they will have to address. It may perhaps contribute only a little to the market's knowledge of the risks but it does give it knowledge of how the deposit insurer views the potential problems and how in consequence it is marshalling its resources and orienting its focus. It provides the forward look to balance the Annual Report.

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