

Advancing robust deposit insurance systems

Deposit insurance has become a main pillar in increasing banking system stability. For the BANKEN-MAGAZIN, Jerzy Pruski, President and Chair of Executive Council of the International Association of Deposit Insurers (IADI) explains the core principles of effective deposit insurance systems.

By Jerzy Pruski

Although the immediate effects of the recent economic crisis are easing, the consequence of the Lehman collapse and the subsequent spill-over effect has led to the recognition of the critical need to better integrate all safety-net players into a coherent framework for maintaining financial stability. Within that framework, the crisis also revealed the central importance of maintaining depositor confidence in the financial system and the critical role that deposit insurance serves in supporting financial stability. While financial supervisors and regulators have strengthened capital and liquidity requirements, with greater supervision aimed at mitigation of risks posed particularly by large banks, the role of deposit insurance has expanded as one of the pillars of the safety-net. The traditional safety-net model, composed of treasurer with regulatory function, central bank with liquidity and lender of last resort mandate and the supervisor with prevention and early intervention tools, was seen as insufficient for effective crisis management. Numerous countries have formally involved the deposit insurer with other safety-net players in common efforts to identifying the financial risks and developing coordinated policies to confront financial distress and respond to financial fragility.

Greater role of deposit insurers in financial stability

The momentum brought about by the crisis identified the need for deposit insurers to broaden their mandate and strengthen the core functions of deposit insurance systems, such as prompt reimbursement. Jurisdictions have found that making a clearer distinction between supervision of on-going institutions and the resolution of

failed institutions enhances the effectiveness of the safety-net. Expanding the role of the deposit insurer to include their functioning as resolution authorities can make that difference clearer. Although the key roles and responsibilities of deposit insurers in resolution vary from jurisdiction to jurisdiction, these recent developments have resulted in the gradual increase in deposit insurers with a broadened mandate. The dynamics in advancing deposit insurance systems has been observed not only among jurisdictions of strategic importance, but also in smaller-scale economies, and may serve as clear evidence of the recognition of the deposit insurance industry in underpinning the safety-net capacities.

IADI Core Principles instrumental in advancing deposit insurance systems

The concept of an enhanced deposit insurance system is gaining increased acceptance. Accordingly, the International Association of Deposit Insurers (IADI) is updating and revising its set of voluntary Core Principles of Effective Deposit Insurance Systems. IADI's Core Principles promote best international standards in deposit insurance and supports the stability and soundness of global financial architecture. Key elements of the Core Principles for all types of deposit insurance systems include a clearly specified mandate of the deposit insurer within the financial safety-net, adequate powers to carry out its responsibilities, appropriate level of coverage in determining the insurable deposits that is limited but credible and cover the large majority of depositors to meet the



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public policy objectives of the deposit insurance system and finally, sound funding mechanisms must be in place that are adequate for the broad role of the deposit insurer, with particular focus on ex-ante funding. A unique feature of the Core Principles is their flexibility in a wide range of country circumstances, settings and structures; as well as the ability of being inclusive, not only to complex deposit insurance and resolution structures, but also to pure pay-box mandates. When designed along the best international standards, even pay-box models may contribute to financial stability by mitigating moral hazard and bolstering confidence of retail depositors in financial systems, as well as avoiding bank-runs driven by panic behaviors. In this context, deposit insurers with ex-ante funding will likely be much more responsive in addressing depositor confidence compared to those with no pre-arranged resources available. Being a part of the FSB Compendium of Key Standards for Sound Financial Systems and used extensively in the IMF and the World Bank Financial Sector Assessment Program, the Core Principles are used by international community in assessing the condition of financial systems. A comprehensive, credible and action-oriented assessment of a deposit insurer against the Core Principles identifies strengths and weaknesses in an existing system and forms a basis for remedial measures by policymakers. Proper application of the IADI Core Principles in local financial structures gives significant advantage in the pursuit of financial stability, pairing the right protection for retail depositors with more multifaceted aspects of crisis management. An important lesson from the recent economic crisis is that

all jurisdictions can benefit from enhancements in their safety-net. Such enhancements include better integration of safety-net players, including deposit insurers, and stronger delineation of their roles and responsibilities. Reforms in the deposit insurance system have strengthened this process. Guided by the Core Principles, which outline critical design features of a deposit insurance system, deposit insurers are playing an increasingly important role in achieving and maintaining depositor confidence and financial stability.

Since July 2010, the Deposit Guarantee and Investor Protection Foundation of the LBA has been a full member of the two international associations of deposit guarantee schemes, the International Association of Deposit Insurers (IADI) and the European Forum of Deposit Insurers (EFDI). Thanks to these memberships, Liechtenstein can participate more actively in the debates on the future development of European and international standards relating to deposit guarantee and investor protection schemes and on relevant stability topics, and it can address the need for new rules in this area to be compatible with the constraints of small states.