



insurance systems with the *Core Principles* and, as noted, several deposit insurance systems have been analyzed in the context of the FSAP. The results of 13 assessments completed as part of IADI workshops or through the FSAP show that a number of areas have emerged that present particular issues for deposit insurance systems. Almost a quarter of these assessments produced ratings of materially noncompliant or noncompliant (figure 1). The most problematic areas involve seven Core Principles (figure 2): Core Principle 4 (Powers), Core Principle 5 (Governance), Core Principle 6 (Relationships with Other Safety-Net Participants), Core Principle 11 (Funding), Core Principles 15 and 16 (Early Detection and Effective Resolution), and Core Principle 17 (Reimbursing Depositors).<sup>2</sup>

Another interesting finding is that all systems assessed were graded as compliant with Core Principle 14 (Dealing with Parties at Fault in a Bank Failure). The reason is that this Core Principle is designed not to focus solely on the role of the deposit insurance system in investigating those contributing to the failure of a bank but to ensure that inappropriate actions are investigated by some government agency, including the public prosecutor's office or a professional or disciplinary body. Also notable is that almost all the deposit insurance systems assessed shared in the proceeds of the recoveries from the estate of the failed bank and were therefore marked as compliant with Core Principle 18 (Recoveries).

### Issues emerging in application

The 13 assessments of deposit insurance systems completed so far point to some common issues in the areas covered by the seven Core Principles proving to be most problematic. Some of these issues may be the result of weaknesses in the overall safety-net framework in the relevant jurisdiction rather than weaknesses attributable to the deposit insurer. Other areas of concern, however, may relate to the institutional framework used in establishing deposit insurers (for example, a governance framework for a deposit insurer's board of directors that provides too little independence and autonomy for the insurer). In addition to describing some of the shortcomings identified in the 13 assessments, the following sections review relevant guidance developed by standard setters on deposit insurance. (For the text of the Core Principles discussed here, see box 1.)

#### Core Principle 4: Powers

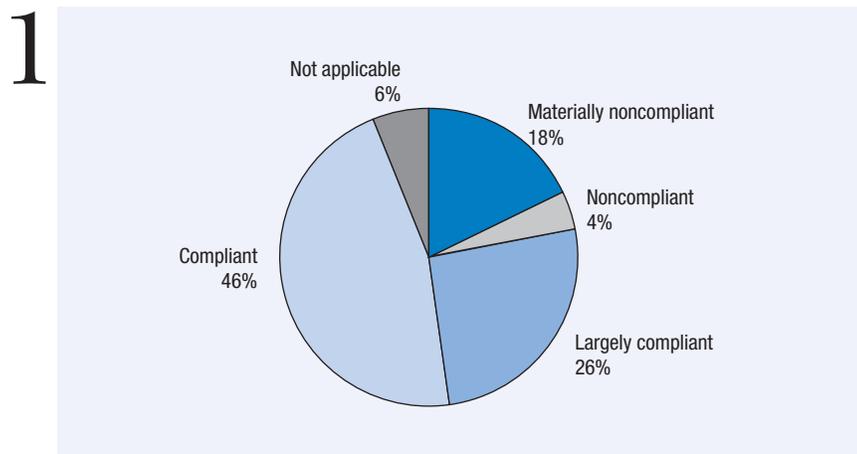
No matter what mandate a deposit insurer has,<sup>3</sup> it must have the power to provide depositors access to their insured funds if a bank fails. In a November 2012 guidance paper, *Enhanced Guidance for Effective Deposit Insurance Systems: Reimbursement Systems and Processes*, IADI found that many deposit insurers faced important constraints in making prompt reimbursement. These included lack of access to depositor records in advance of bank failure, inability to aggregate deposit records of individual depositors because of poor records or lack of unique identifiers associated with the accounts, difficulty in applying netting requirements,<sup>4</sup> and lack of computerized systems for reimbursement.

The main recommendation of the guidance paper is that impediments to prompt reimbursement should be eliminated, including by streamlining procedures for payment and creating an appropriate legal framework for all aspects of the reimbursement process. It is increasingly clear that in order to make prompt payout, a deposit insurer must have ongoing access to depositor data at its member institutions and the ability to test the data for accuracy and completeness.

#### Core Principle 5: Governance

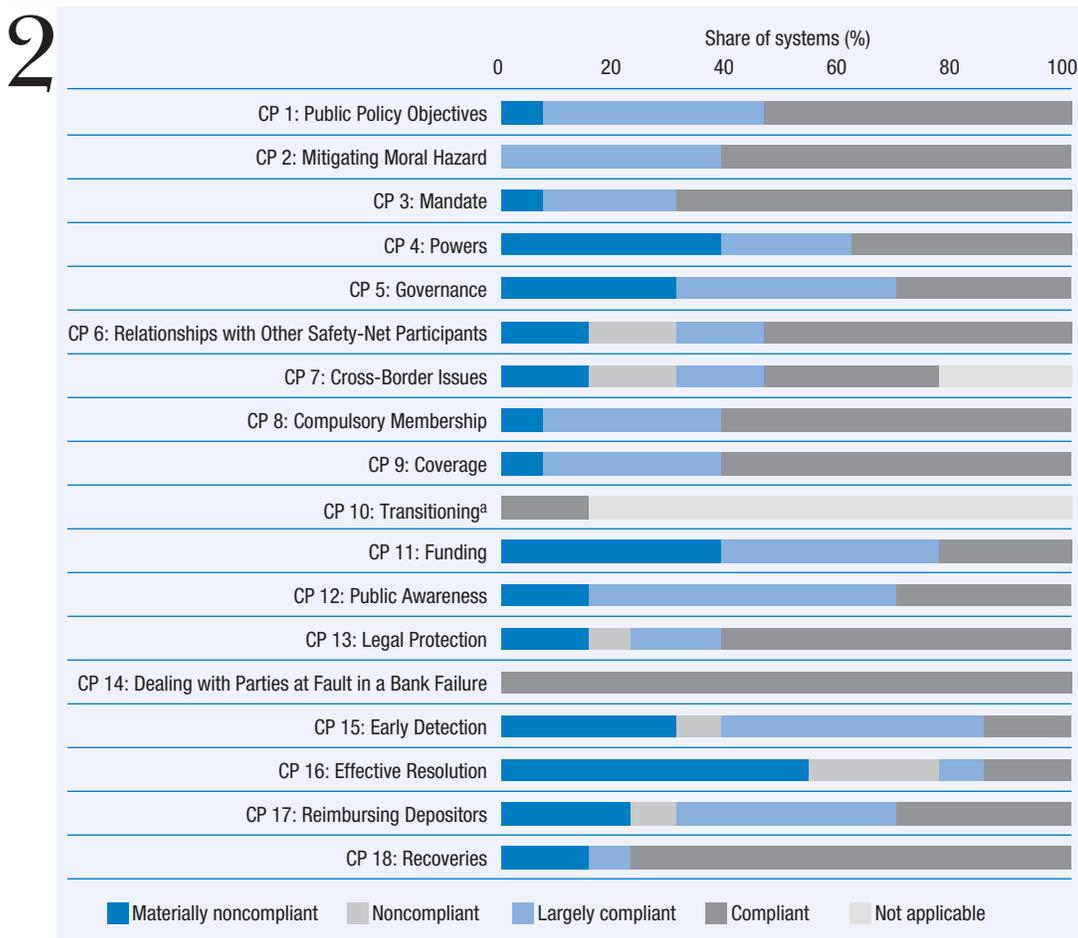
In its *Thematic Review* the FSB defined *operational independence* to mean that "the deposit insurer is able

Figure 1 Distribution of ratings of the 13 deposit insurance systems on all Core Principles



Source: World Bank calculations.

Figure 2 The 13 deposit insurance systems by compliance status with each Core Principle



Note: CP = Core Principle.  
 a. Core Principle 10 addresses transitioning from a blanket guarantee to a limited coverage deposit insurance system.  
 Source: World Bank calculations.

to use the powers and means assigned to it without undue influence from external parties and . . . there is no significant evidence of undue government, supervisory or industry interference” (2012, p. 17, note 36). This has proved to be a difficult area for the deposit insurers that have been assessed. A number have board structures that represent too much influence either by the industry (for example, with too many bankers on the board of directors) or by the government (with a majority of board members being from government agencies or the central bank acting as board chair).

The better practice is to have a board with a majority of independent board members (not active bankers), with the board chair being designated from that group. The ministry of finance and central bank or banking supervisor could also be represented on the board, but without being able to control board decisions

on their own. Some deposit insurers have found that having an advisory committee made up of stakeholders can assist them in getting the benefit of the views of bankers and consumers without creating the confidentiality issues that can arise from having private sector board members.

### Core Principle 6: Relationships with Other Safety-Net Participants

The strengthening of information sharing and coordination among safety-net participants has been an important reform driven by the financial crisis. But as the sample of assessments indicates, this area can still present difficulties, with deposit insurers in some jurisdictions not being part of the information flow for bank-level data until a bank is in serious financial difficulty.

In a recent guidance paper IADI (2013) noted that deposit insurers with different institutional

mandates (for example, a paybox mandate in contrast with a risk-minimizer mandate) have different needs for information but that in all cases there is a need for close coordination and information sharing. There should be clear guidelines requiring supervisory authorities to share relevant information on a timely basis with the deposit insurer. In addition, the deposit insurer should be part of the country's apex crisis management committee. Only then can the deposit insurer be adequately prepared to meet its obligations to insured depositors with the liquidity and other resources needed to make a payout.

### **Core Principle 11: Funding**

Resolution of a failed financial institution should be done in an orderly manner, without severe systemic disruption and without taxpayer support (FSB 2011). Key to meeting this objective is to identify industry financing in advance of resolution, either deposit insurance funds or some form of industry-funded resolution financing. But even a fully funded deposit insurance scheme may find itself in need of liquidity support during times of stress, and a newly established scheme might certainly lack adequate funds to meet its payout obligation. For that reason Core Principle 11 is designed to assess whether adequate back-up funding is available to the deposit insurer.

This is an area that has presented real difficulties. The absence of formal mechanisms for accessing back-up funding has resulted in systems being marked materially noncompliant with this Core Principle even where the governing statute provides for government back-up funding for the deposit insurer.<sup>5</sup> Another difficult issue relates to how the industry would be made to pay back the government for any funds it might make available.

### **Core Principle 15: Early Detection**

Core Principles 15 and 16 have proved to be difficult to apply in practice because of their overlapping subject matter. As stated in version 5.0 of the *Handbook for the Assessment of Compliance*, Core Principle 15 is designed to assess the early detection of financial distress and the timely decision to intervene, while Core Principle 16 is focused on the process of failure resolution once the decision to intervene is made (IADI 2011, pp. 42–45). In reality, however, it is difficult to separate the two because the failure to have a

robust early detection regimen in place will almost always lead to a suboptimal resolution process.

Assessing compliance with Core Principle 15 requires assessing the intervention process. In some jurisdictions a bank is given a long period (even up to a year) after intervention to attempt to recapitalize or correct shortcomings in its operations. During this time the deposit insurer is not making payments to insured depositors or attempting to find a lesser-cost solution, such as a purchase and assumption or insured deposits transfer. Such long delays in resolving an institution would result in a grade of materially noncompliant or even noncompliant on this Core Principle. In other jurisdictions there might be forbearance, permitting insolvent banks to stay open and continue operations and thereby potentially increasing the cost to the deposit insurer for a future resolution. Such systems would also be rated as materially noncompliant or noncompliant.

### **Core Principle 16: Effective Resolution**

Core Principle 16 has proved to be problematic for some deposit insurers because the responsibility for resolution often resides with another safety-net member. Whatever safety-net member has that responsibility should also have a comprehensive tool kit for bank resolution. Only with such tools can there be a possibility that the deposit insurer will have lesser-cost options for meeting its payout obligations, such as the transfer of deposits to another institution.

### **Core Principle 17: Reimbursing Depositors**

For many of the same reasons that Core Principles 15 and 16 have proved to be difficult for deposit insurers, systems did not often receive a rating of compliant with Core Principle 17. Many issues can adversely affect a deposit insurer's ability to effect prompt reimbursement of insured depositors. These include problematic legal frameworks that require suspending a bank's operations for some period before depositors are entitled to reimbursement, a deposit insurer's inability to access account records in advance of a bank failure so as to check them for completeness and accuracy, and lack of procedures for the efficient payment of depositors (such as the use of paying agent banks or the ability to transfer insured deposits to another bank). For a fuller discussion of obstacles to prompt payout, see IADI (2012).

1

**Core 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 Principle 5: Governance**

The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.

**Core 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 formalised.

**Core 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) utilising 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 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 criteria by safety-net participants with the operational independence and power to act.

**Core 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; minimise resolution costs and disruption of markets; maximise 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 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, [and] whether any advance or interim payments will be made as well as the applicable coverage limits.

Source: Excerpted from BCBS and IADI (2009, pp. 2–5).

**Conclusion**

The *Core Principles* have proved to be a useful tool for deposit insurers in assessing their readiness to compensate insured depositors and complete any other bank resolution functions that are part of their mandate. A review of the assessments completed so far shows that certain

areas are proving to be more problematic than others for deposit insurers, including funding, information sharing, and effective resolution and payout processes. As bank resolution frameworks evolve to take account of ongoing guidance by international standard setters,<sup>6</sup> the *Core Principles* may themselves have to evolve along with the

deposit insurance systems whose operations they are designed to guide.

## Notes

1. These three assessments were completed in Malaysia, Poland, and Uruguay. Malaysia's assessment has been published as IMF and World Bank (2013).
2. In addition, Core Principle 10 (Transitioning from a Blanket Guarantee to a Limited Coverage Deposit Insurance System) has proved to be inapplicable to most deposit insurance systems.
3. As stated in the *Thematic Review* (FSB 2012, p. 4), deposit insurers can broadly be characterized as having one of four mandates: a “paybox” mandate, in which the deposit insurer is responsible only for reimbursement of insured deposits; a “paybox plus” mandate, in which the deposit insurer has additional responsibilities, such as acting as the resolution authority; a “loss minimizer” mandate, in which the insurer actively engages in the choice of the most appropriate least-cost resolution strategy; and a “risk minimizer” mandate, in which the insurer not only has resolution powers but also acts as a prudential supervision authority.
4. The term *netting*, or *set-off*, refers “to the situation where the claim of a creditor against an insolvent entity is to be deducted from a claim of that entity against the creditor” (FDIC, n.d., p. 3). The use of netting can slow the payout process for a deposit insurer because the insurer will need to match up the deposit and loan records for each depositor and then make the necessary adjustments before making payment. For that reason the draft EU directive on deposit insurance recommends ending the practice of setting off depositors' liabilities against their claims (EC 2010; see FSB 2012, p. 4). The use of set-off may also diminish the value of a portfolio of performing loans and thus affect the ability to complete a transfer of performing assets to a new institution in the context of a bank resolution (FDIC, n.d., p. 7).
5. This was the case in Malaysia, for example, where the deposit insurance system was marked as materially noncompliant with Core Principle 11 because no

funding agreement was in place with the minister of finance (see IMF and World Bank 2013).

6. For example, the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (FSB 2011).

## References

- BCBS (Basel Committee on Banking Supervision) and IADI (International Association of Deposit Insurers). 2009. *Core Principles for Effective Deposit Insurance Systems*. <http://www.bis.org/>.
- . 2010. *Core Principles for Effective Deposit Insurance Systems: A Methodology for Compliance Assessment*. <http://www.bis.org/>.
- EC (European Commission). 2010. “Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [Recast].” Brussels.
- FDIC (Federal Deposit Insurance Corporation). n.d. *Depositor Priority and Rights of Set-Off (Netting)*. <http://www.fdic.gov/>.
- FSB (Financial Stability Board). 2011. *Key Attributes of Effective Resolution Regimes for Financial Institutions*. <http://www.financialstabilityboard.org/>.
- . 2012. *Thematic Review on Deposit Insurance Systems: Peer Review Report*. <http://www.financialstabilityboard.org/>.
- IADI (International Association of Deposit Insurers). 2011. *Handbook for the Assessment of Compliance with the Core Principles for Effective Deposit Insurance Systems*. Version 5.0. Available at <http://www.sedesa.com.ar/>.
- . 2012. *Enhanced Guidance for Effective Deposit Insurance Systems: Reimbursement Systems and Processes*. Guidance Paper. <http://www.iadi.org/>.
- . 2013. *General Guidance on Early Detection and Timely Intervention for Deposit Insurance Systems*. <http://www.iadi.org/>.
- IMF (International Monetary Fund) and World Bank. 2013. *Malaysia: Core Principles for Effective Deposit Insurance Systems—Detailed Assessment of Observance*. <http://www.imf.org/external/pubs/ft/scr/2013/CR1360.pdf>.

## viewpoint

is an open forum to encourage dissemination of public policy innovations for private sector-led and market-based solutions for development. The views published are those of the authors and should not be attributed to the World Bank or any other affiliated organizations. Nor do any of the conclusions represent official policy of the World Bank or of its Executive Directors or the countries they represent.

To order additional copies contact Naoki Ogiwara, managing editor, Room F 4P-256B, The World Bank, 1818 H Street, NW, Washington, DC 20433.

Telephone:  
001 202 473 1871  
Email:  
[nogiwara@worldbank.org](mailto:nogiwara@worldbank.org)

Produced by Carol Siegel

Printed on recycled paper