THE ROLE OF A DEPOSIT PROTECTION FUND

WORLD BANK GROUP
Finance, Competitiveness & Innovation

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Why a Deposit Insurance?

- Deposit insurance is designed to prevent depositor runs at banks and to protect those most in need of protection if a bank fails (usually small depositors and SMEs).

- Deposit insurance also provides a formal process for repaying depositors when a bank fails thereby shortening the time between a bank failure and the repayment of depositor funds.

- An explicit deposit insurance system gives the supervisory authorities the ability to close troubled institutions with a payout mechanism in place for depositors, thereby lessening the disruption to the financial system from a bank failure.

Why a Deposit Insurance?

- Properly designed formal or explicit deposit insurance systems shift the cost of the insurance to the banking industry and away from the government itself, which is the funding source when implicit or assumed schemes are in place.

- Without explicit deposit insurance, a country may extend such implicit protection to depositors on an ad hoc basis either through forbearance (not closing troubled banks) or by injecting capital or otherwise restructuring a troubled bank so that no depositor loses money through a payout.

- Formal deposit insurance schemes replace such ad hoc systems with rules based systems.

Why a Deposit Insurance?

- Robust bank supervision remains the best line of defense against a banking crisis but a properly designed deposit insurance system is an important component of a properly functioning financial safety net.

- However, a poorly designed deposit insurer can potentially increase the instability of the financial sector especially if it siphons off human resources from the bank supervision authority.

- The most important role of deposit insurance is to shift the cost of protecting depositors to the banking industry and protect the public finances from having to reimburse small depositors.

IADI Core Principles

- The International Association of Deposit Insurers (IADI) was formed in May 2002 to enhance the effectiveness of deposit insurance systems by promoting guidance and international cooperation.

- Currently, IADI has 92 members.

- In 2009, IADI, together with the Basel Committee on Banking Supervision (BCBS), published the Core Principles for Effective Deposit Insurance Systems, which set forth a number of important design issues for establishing an effective explicit deposit insurance system.

- The Core Principles were revised in 2014.

Key Design Features

- Compulsory membership in the system for all licensed financial institutions that accept deposits from the public. This is necessary not only to protect the deposit insurer from adverse selection by only the weaker banks but also to have clarity in the public awareness campaign concerning deposits that are insured.

- The mandate and powers of the deposit insurer must not only be clear and legally defined but aligned so that even a pay box deposit insurer has the powers it needs to meet its responsibility such as the ability to obtain information from banks on the number and type of insured deposits and from the bank supervisor on a bank's troubled condition that may lead to closure.

Key Design Features

- The deposit insurer must have access to adequate funding to accomplish its mandate, which requires the existence of back-up funding that is certain and readily available in times of need, usually through some form of government guarantee.

- Such funding is necessary to allow the deposit insurer to fund a payout as well as hire and train the necessary staff so as to be prepared to make a prompt payout of insured deposits once a triggering event for payout takes place. From a public confidence perspective such funding is necessary to provide assurance to the public that the fund is adequate to pay depositors in times of crisis. Such funding should be sufficient from a technical point of view to allow the deposit insurer to promptly pay out insured deposits within the established statutory period.

Key Design Features

- A deposit insurer may be able to contribute to a resolution rather than be limited to funding only a payout of insured deposits → Good practice.

- Safeguards must exist for such a contribution to be permissible including that no greater contribution to resolution be made than the amount that a payout would cost (net of expenses).

- The deposit insurer and those working for it must be protected against lawsuits for their decisions and actions taken in good faith.

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Key Design Features

- Good governance practices for the deposit insurance system that prevent conflicts of interest and undue external influence, transparency and accountability are essential to foster public confidence.

- Confidence in the deposit insurance system is essential.

- There should be a carefully designed level and scope of coverage that covers fully most of the small and unsophisticated depositors but leaves the vast amount of deposits unprotected so as to avoid moral hazard.

- Public awareness of the existence of deposit protection and confidence in the capacity of the deposit insurer to deliver when called upon is a key element to prevent bank runs and support the stability of the financial system.

Key Design Features

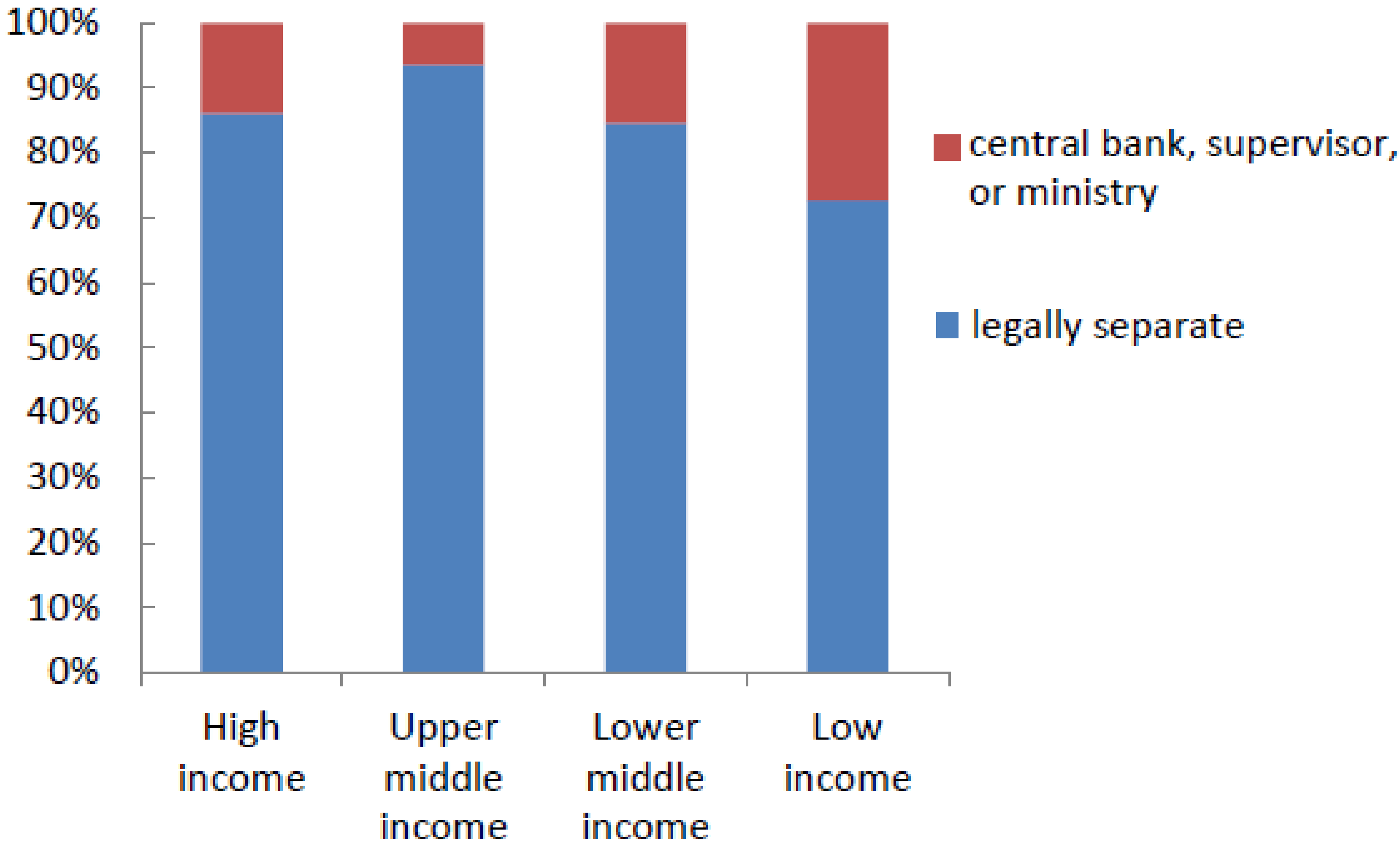
A deposit insurance system has to be designed to work as part of a balanced dynamic system, and should not be considered only as a static pool of funds

Governance and Independence

IADI CP3 on GOVERNANCE:

- The deposit insurer should be operationally independent, well-governed, transparent, accountable, and insulated from external interference
- “Operational independence” includes the authority to set its own budget
- Interference from external parties and conflicts of interest should be minimized: balanced representation on the board; independent board members
- Human resources, operating budget, and salary scales sufficient to attract and retain qualified staff in order to support operational independence and deliver on the mandate successfully

Operational structure



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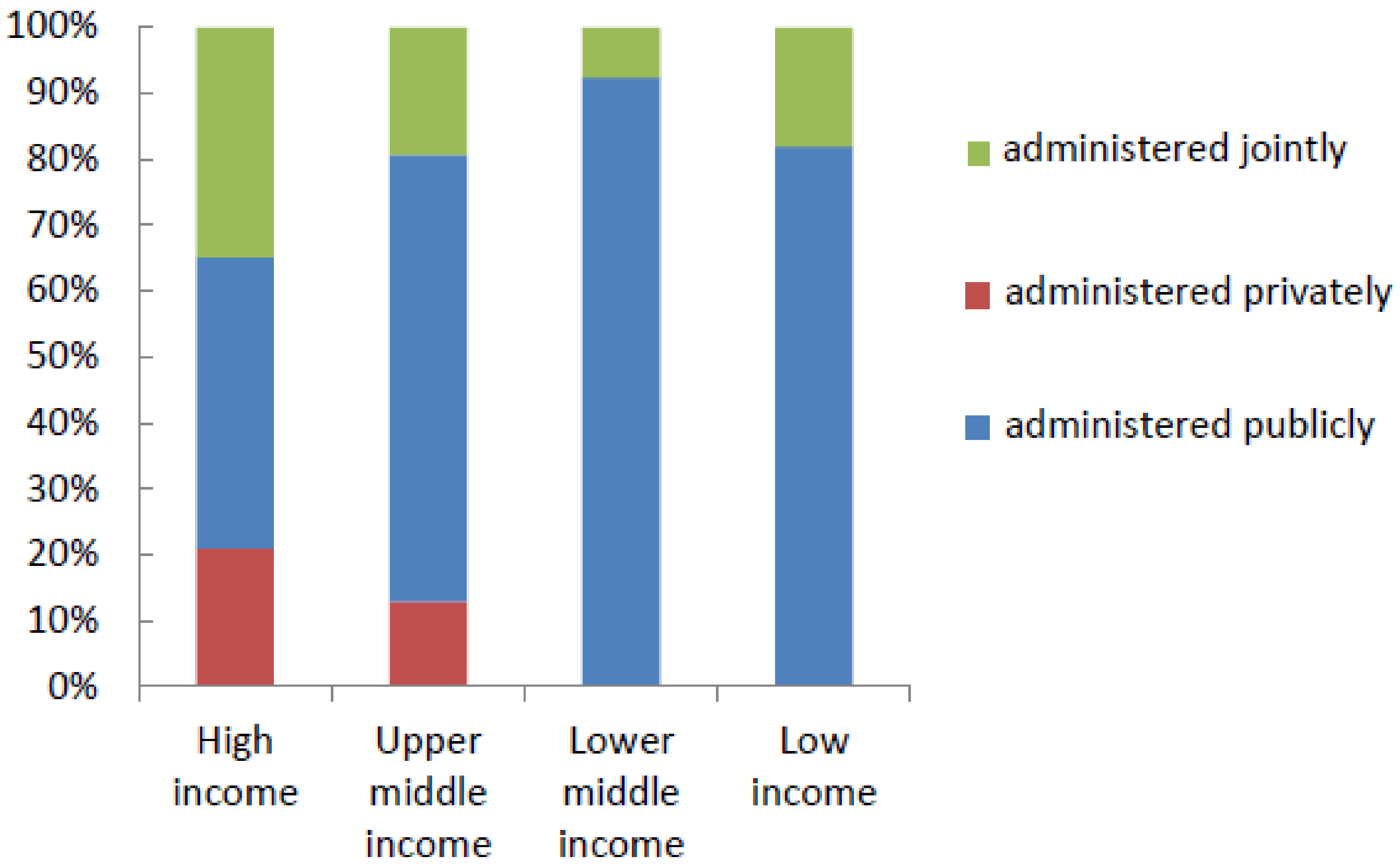
Private x Public Sector



Coverage (IADI CP 8)

- Coverage should be limited, credible and cover the large majority of depositors but leave a substantial amount of deposits exposed to market discipline
- Clear, explicit definition of the level and scope of deposit coverage.
- The level and scope of coverage should be reviewed periodically
- The level of coverage should find a balance between (i) policy objectives, (ii) credibility and (iii) the cost to support it
- Coverage should be limited to avoid moral hazard
- Coverage is normally provided per customer per deposit taking institution

Recovery in Liquidation

- Effective bank liquidation processes are a precondition for effective functioning of the deposit insurance system for replenishment purposes.
- Recovery of funds in liquidation have strong impact over (i) funding needs and (ii) capacity to contribute to resolution.
- Deposit Guarantee Scheme should rank pari-passu with other depositors.
- “Superpreference” creates unwanted distortions and should be avoided.

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Funding

- Funds should be readily available to ensure prompt reimbursement of protected deposits.
- Investment policy should ensure sound and effective fund management with primary objectives of liquidity and preservation of capital
- The cost of deposit insurance should be borne by banks, which means that any alternative source should be repaid through future premiums
- Deposit insurance funds complement other sources of funding resolution, especially where the deposit insurer is not the resolution authority

Premiums

- DGS should collect funds ex ante.
- Premium mechanism should be explicitly defined in the legal framework.
- Funding scheme should ensure sustainability of the funding model
- Target ratio for the fund should be defined explicitly (legislation or regulation)
- Premiums can be either linear (a percentage of deposit base) or risk-based.

Risk-Based Premiums

- Risk-based premiums are collected based on a bank's risk profile
- Quantitative and qualitative analysis, including supervisory rating.
- Mitigates moral hazard by providing incentives for banks to be more prudent and minimizing cross-subsidization.
    - ➢ But can also provide incentives for misreporting.
- Should only be introduced once the DGS is mature and institutions are strong.

Risk-Based Premiums - Requirements

- Accurate and acceptable methodology for assessing risk profile.
- Transparent criteria.
- Access to reliable and accurate information.
- Scoring criteria and premium rates should be significantly differentiated to allow reaping of benefits.
- Information on the risk ratings and rankings of individual banks must be kept strictly confidential.

Other Sources of Funding

- Right to collect ex post extraordinary premiums
- Loans from private lenders
- Loans from international institutions (World Bank, EBRD, etc.)
- Liquidity lines (Central Bank)
- Funding backstop (Treasury)

Backstop Funding

- The Deposit Insurance System needs to be backstopped with fiscal resources to lend credibility to the system and deal with systemic crisis events
- Dealing with systemic (or banking) crises should be the responsibility of all financial safety net players
- Any backstop should be based on legislation or regulation to support the credibility of the deposit protection system, including proper contingency planning
- Any cost incurred by the Treasury when providing backstop funding should be borne by deposit protection system

Backstop Funding Mechanisms

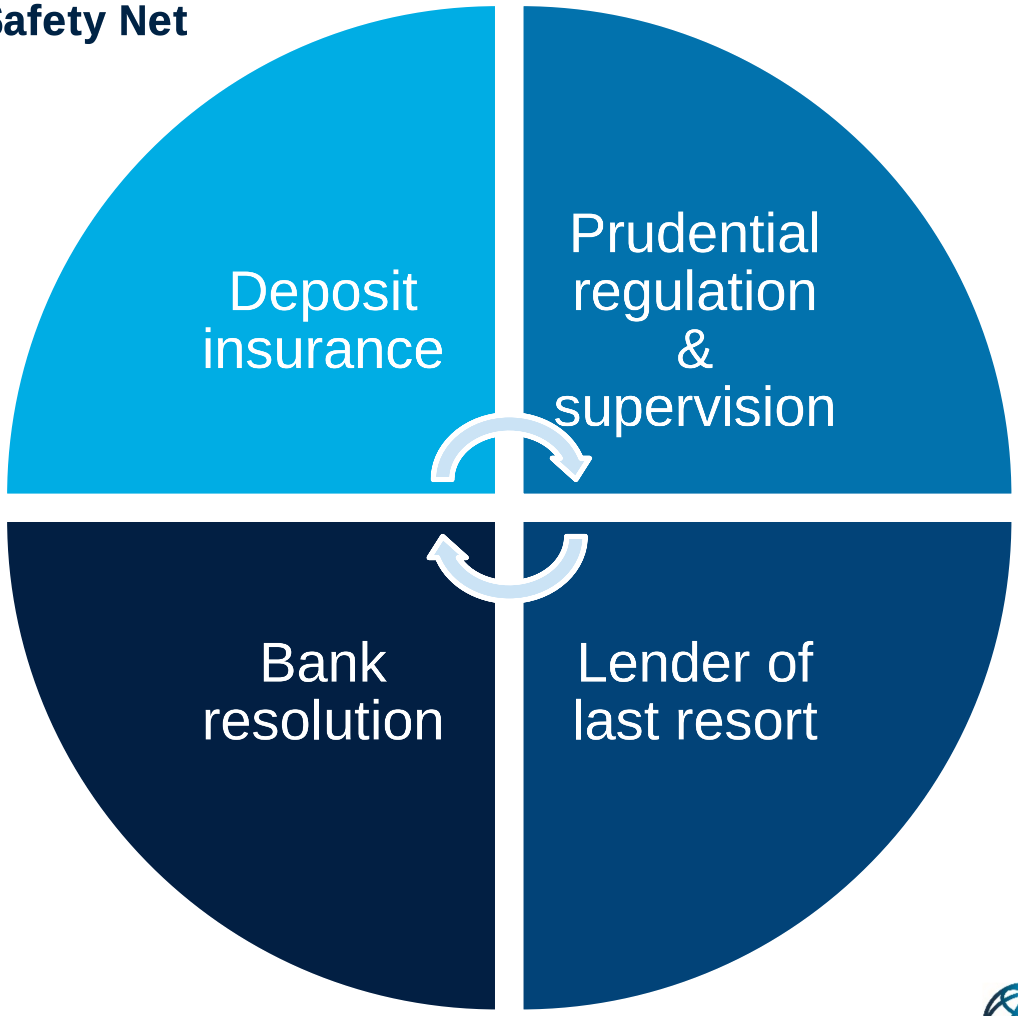
Three common solutions for backstop mechanism:

- Direct lending from the Treasury to the deposit insurance scheme;
- Borrowing from private sector or Central Bank, with government guarantee;
- Bond issuance by deposit insurer, guaranteed by the Treasury.

The important thing is not to put the Central Bank balance at risk.

Mandate

Financial Safety Net



Mandate

The deposit protection system mandate is a **policy choice**:

- Availability of other sources of funding resolution
- Liability structure of the financial system (availability of loss absorption capacity)
- Concentration of the financial system (deposit market)
- Sound and well-designed backstop arrangements for the deposit protection system
- Priority scheme, hierarchy of claims in resolution for the insured and non-insured deposits

Mandate

Different mandates can be grouped in four categories, based on:

(i) what is the role of the deposit insurer in funding resolution,

(ii) its responsibilities in designing and deciding on different resolution methods; and

(iii) its power to supervise and regulate member institutions.

Types of Mandates

Mandate	Description
Pay box	Narrow mandate only to pay out insured deposits in liquidation
Pay box plus: *this is the most common mandate and represents good practice when accompanied by appropriate safeguards*	+ financial support in resolution
Loss minimizer	+ financial support in resolution, least-cost option selection, receiver in liquidation
Risk minimizer	+ prudential oversight, resolution powers, early intervention powers, risk assessment and early intervention functions in going concern

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Safeguards for expanded mandates

Some principles and safeguards are required by the international standards when expanding a deposit insurer's mandate

- ✓ Shareholders bear losses first
- ✓ Least Cost: DIS contribution to resolution should be less than the cost in liquidation (gross amount of covered deposits net of expected recoveries)
- ✓ Independent valuation
- ✓ Cap on financial support = total amount of insured deposits (unless there is a systemic override)
- ✓ Control in decision making (binding or non-binding opinion of the DI) especially in capital and liquidity support in resolution
- ✓ Risk assessment and management capacity
- ✓ Credible, available and pre-committed public backstop

Pre-requisites for expanded mandate

Other preconditions related to governance should be considered when expanding deposit insurer mandate, such as:

- ✓ Capacity (to assess and implement more sophisticated funding arrangements)
- ✓ Expertise to apply safeguards (caps, principles, least cost requirements)
- ✓ Strong and balanced governance
- ✓ Accountability

Examples of countries with different mandates

Paybox:
DIFK (Kosovo), DIA (Georgia), FGDSB (Moldova)

Paybox Plus:
ADIA (Albania), JDIC (Jamaica), IDIF (Tajikistan)

Loss Minimizer:
BFG (Poland), IPAB (Mexico), CDIC (Canada), KDIC (Kenya)

Risk Minimizer:
FDIC (US), NDIC (Nigeria)

Questions?