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Finance & Markets

Design Features of a Deposit Insurance Scheme

DIS Mandate and Financial Stability Implications

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- ❑ Financial Safety Net design features and DIS mandate and powers
- ❑ IADI CP 2 as a benchmark for the DIS Mandate and Powers modalities
- ❑ Different DIS mandates and their policy implications
- ❑ Preconditions for successful delivery on DIS mandate

Financial Safety Net and DIS Mandate

- DIS mandate design features depend on the mandates of the other financial safety net players
- The final goal is to contribute to and preserve financial stability
- Country specific characteristics determine which institution is the Regulator, Resolution Authority (within the CB, DIS, MoF, or separate)

Mandates within the FSN

Stability of the currency (CB)

Lender of Last Resort (CB)

Depositors' protection (DIS)

Last resort solvency support (MoF)

Stability of the financial system (CB, DIS, other authority: regulator or resolution authority)



Financial Safety Net and DIS Mandate

- Protecting covered depositors and preventing bank runs is the core mandate of the DIS: **to pay out protected deposits in case of a bank closure and insolvency**
- Securing access to protected depositors : **by financing alternative measures to pay out**
- Supplementing DIS mandates depend on the FSN design features and stated public policy objectives of the DIS: **to contribute to the financial stability; to protect depositors; to assure stability of the member institutions among others.**

In such supplementing mandates the deposit insurer:

1. *can be the supervisor of the member institutions*
2. *can be the resolution authority of the member institutions*
3. *can execute the resolution*
4. *can finance resolution*
5. *can provide financial support to member institutions (open bank assistance)*
6. *can finance resolution to secure access to protected deposits*
7. *can supervise the process of bank liquidation*
8. *can be receiver or liquidator of the failed institution*
9. *combination of the options above or others*

Financial Safety Net and DIS Mandate

- DIS Mandate and design features is a **policy choice** and depends on:
 1. *Resolution framework design*
 2. *Availability of other sources to finance resolution*
 3. *Institutional capacity, historical background*
 4. *Liability structure of the financial system (availability of loss absorption capacity)*
 5. *Back-stop arrangements*
 6. *Priority scheme, hierarchy of claims*

Financial Safety Net and DIS Mandate

- ✓ **IADI** has developed its Core Principles
- ✓ **FSB** adopted the Key Attributes for effective resolution regimes
- These **standards** provide guidance and are considered as benchmarks how all these varieties of DIS mandates, and powers can be implemented with the view to contribute effectively to the financial stability, addressing moral hazard.
- They **provide for flexibility** for different financial systems according to size, market development, maturity or business model.
- **IADI CP 2: Mandate and Powers**
- **FSB KA 6: Funding FI in Resolution**

Financial Safety Net and DIS Mandate

- ✓ How to design the modalities of the DIS mandates depends on jurisdiction-specific circumstances

Supervisor	Resolution Authority	Resolution fund
which institution (CB, DIA, other)	Which institution (CB, DIA, other)	Is resolution fund available?
Effective delivery on the mandate so far	Which institution triggers (and/or executes) the resolution, depends on capacity of the institution to be RA	What can RF finance? What are the financing arrangements in resolution?

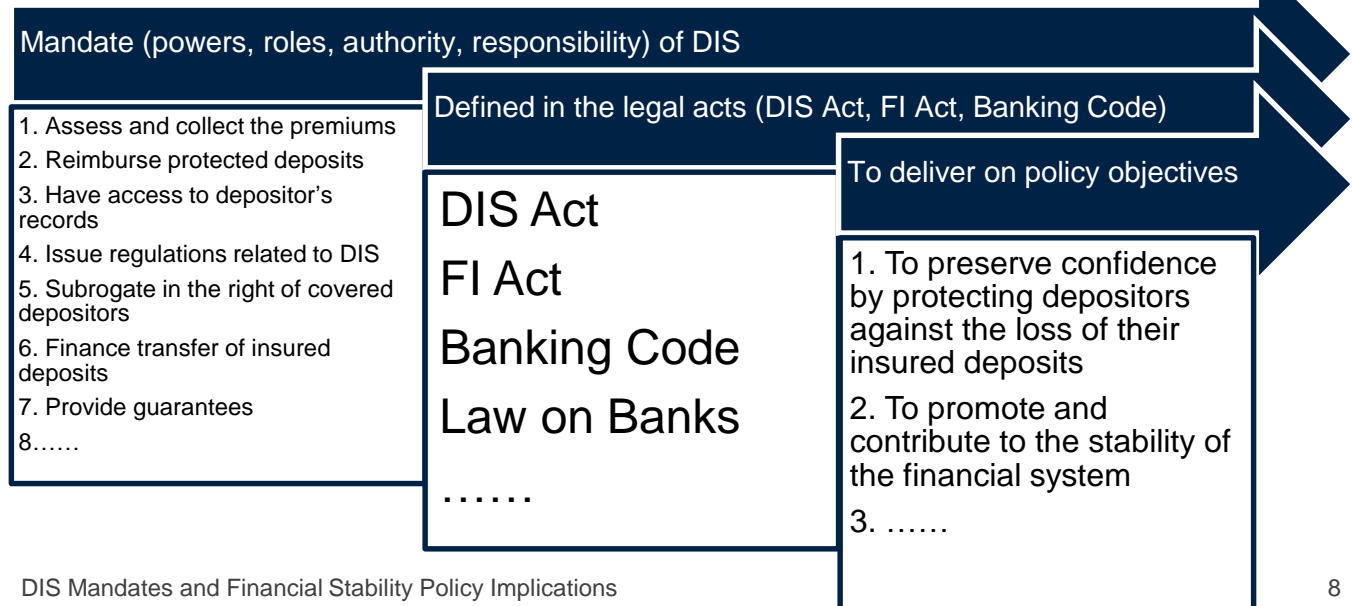
- Deposit Insurer institutional capacity and the stage of development of the DIS is essential in designing the modalities of the DIS mandate and powers

IADI CP 2 as a benchmark

CP 2: *“The mandate and powers of the deposit insurer should support the public policy objectives and be clearly defined and formally specified in legislation.”*

- ✓ CP 2 refers to the **authority, powers, role and responsibilities** of the DIS (**Mandate**)
- ✓ **Requirement to clearly define** DIS role, authority and responsibilities
- ✓ Roles, powers and responsibilities are **defined in the legal framework**
- ✓ The formally defined mandate **enables the deposit insurer to meet the stated public policy objectives**

EC#1



IADI CP 2 as a benchmark

EC#2

- ✓ DIS mandate is **aligned** with the mandate of the other safety net players
- ✓ **Clarity** of the DIS role and responsibility with respect to the roles and responsibilities of the other safety net players

DIS	Other Safety Net
To protect only insured part of deposits	Supervisor: to protect the whole balance sheet
To provide opinion on resolution strategy, to be consulted on use of deposit insurance funds, to finance resolution on behalf on insured deposits or in some circumstances all deposits, to avoid double payment by making sure any resulting institution after resolution is viable	Resolution Authority: To design credible resolution strategy in line with resolution objectives
To access short term liquidity window for prompt pay outs	Central Bank: currency stability, inflation targeting, growth, lender of last resort
To have access to back-stop facility for large pay outs, to obtain government guarantee in raising funds from external sources	MoF: last resort solvency support, back-stop lending, guarantees

IADI CP 2 as a benchmark

EC#3

- ✓ The **powers of the DIS support its mandate** and enable the deposit insurer to fulfil its roles and responsibilities

DIS	Other Safety Net	Comment
To pay out in 7 days after license revocation but has no early access to depositors' records, no access to bank secrecy	Receiver (Appointed by the supervisor) : to provide depositors' records to DIS	Danger on prompt delivery of the DIS responsibilities
To pay out in 7 days when deposits are unavailable	Supervisor: To suspend payments on all liabilities up to 30 days (in temporary administration) before license revocation	Contradiction in responsibilities and powers
To collect premiums, to call for extraordinary premiums	MoF: To provide back-stop funding, which shall be repaid over time by industry	If no possibility to assess the premiums, back-stop might turn out to be a hidden subsidization for the DIS
To contribute to P&A in resolution to secure access to insured depositors, to assess the viability of resolution and cost	Resolution Authority: to design a viable resolution transaction to meet the resolution objectives	Power on providing opinion and least cost test for the DIS is essential to secure sustainability for the DIS, avoid double payment

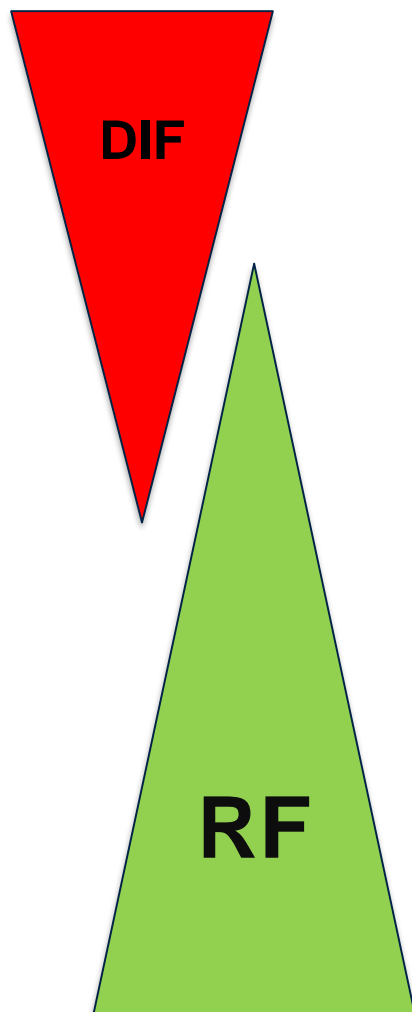
IADI CP 2 as a benchmark

EC#4

- **Minimum set of powers and authority** for the DIS to deliver successfully on its mandate
 - ✓ Assess and collect premiums
 - ✓ Subrogate to the claims of insured depositors
 - ✓ Issue regulations and work with supervisor to force member institutions to comply with DIS requirements
 - ✓ Reimburse insured deposits
 - ✓ Transfer or finance transfer of insured deposits in resolution
 - ✓ Share information with other DIS and other safety net players, entering into contracts
 - ✓ Have access to depositors' records for prompt payout (bank secrecy)
 - ✓ Set its own budget, policies, systems and structure with the view to support its institutional capacity and preparedness
 - ✓ Have legal protection for acts done in good faith in furtherance of its mandate
 - ✓ Others depending on the mandate

DIS mandates and their policy implications

- *DI Fund and Resolution Fund mandates. Use of DIS resources.*



Pay-out of insured deposits

P&A transaction: financial support where insured deposits are transferred

P&A financial support where transferring all deposits

Bridge bank capital

Pay for excluded other creditors from loss absorption for financial stability reasons

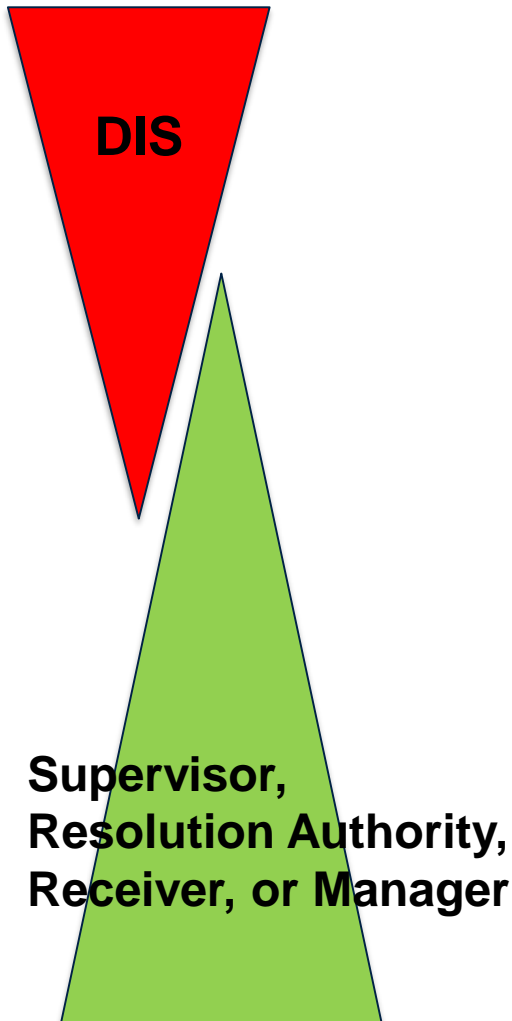
Capital and liquidity to asset management vehicle, asset purchase

Capital for bank in resolution, open bank assistance

Resolution of non-deposit taking systemic FI

DIS mandates and their policy implications

- *DIS and other supplementing mandates. Authority of the deposit insurer.*



Pay-out of insured deposits

Non-binding opinion in resolution

Binding opinion in resolution and least cost test

Engages in selection of resolution strategies and resolution planning

Finances early intervention measures

Risk assessment be engaged in financing early intervention measures based on its own risk assessment

Asset management, management functions on banks and assets in distress, bridge bank

Early intervention powers, resolution powers, prudential oversight, supervision

DIS mandates and their policy implications

Mandate	Description
Pay box	Narrow mandate only to pay out insured deposits in liquidation
Pay box plus: <i>this is the most common mandate and represents good practice when accompanied by appropriate safeguards</i>	+ 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

DIS mandates and their policy implications

- Use of DIS resources. Some of the practices are **not recommended by the international standards**
 - ✓ *Pays-out deposits*
 - ✓ *Finances transfer in P&A of insured deposits (net of expected recoveries)*
 - ✓ *Finances transfer in P&A of insured deposits and liquidity support with cap to total amount of insured deposits*
 - ✓ *Finances transfer in P&A of all deposits*
 - ✓ *Provides guarantees or loss-sharing agreement in P&A*
 - ✓ *Provides capital for the bridge bank*
 - ✓ *Provides capital in resolution*
 - ✓ ***Provides capital in open bank cases prior resolution***
 - ✓ *Provides liquidity in resolution (gone concern)*
 - ✓ ***Provides liquidity in open bank cases***
 - ✓ ***Provides financial assistance, guarantees in open bank cases***

DIS mandates and their policy implications

- **Some principles and safeguards (preconditions) should be applied (available) as required by the international standards when expanding DIS mandate**
 - ✓ ***Shareholders bear losses first***
 - ✓ ***No Creditor Worse Off (gross amount of covered deposits net of expected recoveries)***
 - ✓ ***Independent valuation***
 - ✓ ***Cap on financial support measured at most by insured deposits***
 - ✓ ***Least-cost test (might be impractical for small markets with lack of history of failures)***
 - ✓ ***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 back-stop***

DIS mandates and their policy implications

- **Financial stability policy implications**
 - ✓ *Protect depositors with minimum disruption in P&A*
 - ✓ *Protect asset value of the transferred assets with minimum disruption of business activity through continuation of borrower relationships*
 - ✓ *Complements crisis management options of the financial safety net*
 - ✓ *Addresses moral hazard issues if internationally recognized principles applied*

DIS mandates and their policy implications

- **Financial stability policy implications of different DIS mandates**
- ***Pay-box***
 - ✓ **Contributes to financial stability by preventing run on deposits**
 - ✓ **Narrow Mandate**
 - ✓ Gross pay out with recovery on payout from liquidation
 - ✓ Reliable trigger required not to delay pay out, short pay out period
 - ✓ Requires capacity for prompt pay out, active public awareness, careful design of the level and scope of coverage

DIS mandates and their policy implications

- **Financial stability policy implications of different DIS mandates**

- ***Pay-box plus (most common mandate)***
 - ✓ **Contributes to financial stability by preventing run on deposits**
 - ✓ **Secures continuity of bank services, avoids liquidation of good assets thereby preserving asset value, preserves business activity (performing assets)**
 - ✓ **Contributes to financial stability by protecting the interests of all creditors in accordance with the priority scheme in place (optional, when receiver)**
 - ✓ **Finances resolution when transferring the covered deposits**
 - ✓ **May provide liquidity up to the gross amount of covered deposits in resolution**
 - ✓ **DIS bear losses on behalf of covered deposits based on independent valuation**
 - ✓ **Financial loss for DIS is the gross amount of covered deposits net of expected recoveries based on independent valuation with possibility of override in systemic situations in some practices**
 - ✓ **Binding or non-binding opinion in providing resources in resolution**
 - ✓ **Lesser cost test**
 - ✓ **Cap on the amount for financing resolution (viability of resolution, avoid double payment)**

DIS mandates and their policy implications

- **Financial stability policy implications of different DIS mandates**

- ***Loss minimizer***
 - ✓ **Contributes to financial stability by preventing run on deposits**
 - ✓ **Secures continuity of bank services, avoids liquidation of good assets thereby preserving asset value, preserves business activity (performing assets)**
 - ✓ **Finances the resolution in a broader way (going, gone concern)**
 - ✓ **Takes part in designing the resolution strategies**
 - ✓ **DIS may be resolution authority or act as an agent of the resolution authority**
 - ✓ **Responsible for maximization of the asset value in resolution**
 - ✓ **Responsible for selection of range of resolution strategies**
 - ✓ **Least cost test in selecting the resolution strategies**
 - ✓ **Binding opinion when providing financial support in resolution**
 - ✓ **Strong institutional capacity needed**
 - ✓ **Strong and balanced in terms of representativeness governance required**
 - ✓ **Credible and pre-committed back-stop is a must**

DIS mandates and their policy implications

- **Financial stability policy implications of different DIS mandates**

- ***Risk minimizer (most uncommon mandate for a deposit insurer)***
 - ✓ **Contributes to financial stability by preventing run on deposits**
 - ✓ **Secures continuity of the bank services, avoids liquidation of good assets thereby preserving asset value, preserves business activity (performing assets)**
 - ✓ **Contributes to financial stability by protecting the interests of all creditors in accordance with the priority scheme in place (optional, when receiver)**
 - ✓ **Finances the resolution in a broader way (going, gone concern)**
 - ✓ **Responsible along with other FSN members for the stability of the member institutions**
 - ✓ **DIS is Resolution Authority and Supervisor**
 - ✓ **Financing alternative measures (liquidity, capital, guarantees) (IADI CP, FSB KA to be respected!)**
 - ✓ **Strong institutional capacity needed**
 - ✓ **Strong and balanced in terms of representativeness governance required**
 - ✓ **Credible and pre-committed back-stop is a must**

DIS mandates and their policy implications

- **Risks in expanded mandate**
 - ✓ ***Moral hazard risk in capital support and liquidity support in open bank cases***
 - ✓ ***Risk of double payment for the DI if the resolution strategy is not viable***
 - ✓ ***Risk of stressing capacity in the overall financial safety net to provide opinion in resolution and assess resolution strategy (fund depletion)***

- **How to address these risks**
 - ✓ ***Secure strong governance***
 - ✓ ***Apply IADI CP, FSB KA, resolution safeguards***
 - ✓ ***Raise DI capacity with the expanded mandate***
 - ✓ ***Expand DI mandate gradually as the financial system matures***
 - ✓ ***Expanded funding options for the DIS should be balanced with the DI authority and powers***

Preconditions for successful delivery on mandate

- ✓ **Capacity (to assess and implement more sophisticated funding arrangements)**
- ✓ **Sufficient back-stop (to address the risk that measures other than pay out may exhaust the system)**
- ✓ **Safeguards (caps, principles, least cost requirements)**
- ✓ **Alternative measures should not contradict the international principles and require institutional capacity**
- ✓ **Strong and balanced governance of the DIS in practice is essential**
- ✓ **Accountability**
- ✓ **Gradual maturity of the DIS required to expand its mandate**



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