

# Core Principles for Effective Deposit Insurance Systems - International Association of Deposit Insurers (29 February 2008)

## Foreword

1. Policymakers have choices regarding how they can protect depositors and contribute to financial system stability. Explicit, limited-coverage deposit insurance (“a deposit insurance system”) has become the preferred choice compared to other alternatives such as reliance on implicit protection. A deposit insurance system clarifies the authority’s obligations to depositors, limits the scope for discretionary decisions, can promote public confidence, helps to contain the costs of resolving failed institutions and can provide countries with an orderly process for dealing with bank failures.<sup>1</sup>

2. The introduction or the reform of a deposit insurance system can be more successful when a country’s banking system is healthy and its institutional environment sound. To be credible, a deposit insurance system needs to be part of a well-constructed financial system safety net, properly designed and well implemented.<sup>2</sup> It needs to be supported by strong prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws. An effective deposit insurance system should also be supported by a high level of public awareness about its existence, its benefits and its limitations. A deposit insurance system can deal with a limited number of simultaneous bank failures, but the resolution of a systemic banking crisis requires that all financial system safety-net participants work together effectively.

## The Core Principles

3. The International Association of Deposit Insurers (IADI) was established in 2002 with a mission to contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation. As part of its work, IADI undertakes research to develop guidance on deposit insurance issues in the form of Core Principles and effective practices.

4. IADI has developed the Core Principles for the benefit of countries considering the adoption or the reform of a deposit insurance system. The Core Principles are designed to enhance the effectiveness of deposit insurance systems and are based on IADI research and guidance papers and the endorsement by IADI of guidance developed by several founding IADI members and other organizations under the leadership of the Financial Stability Forum’s (FSF) Working Group on Deposit Insurance in 2001<sup>3</sup> and the Asia Pacific Economic Cooperation (APEC) Policy Dialogue on Deposit Insurance in 2005.<sup>4</sup> In developing the Core Principles, IADI drew heavily on the practical experience of its members, associates and observers. Thus, the Core Principles are reflective of, and designed to be adaptable to, a broad range of country circumstances, settings and structures. Over time IADI intends to further develop and enhance the Core Principles.

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<sup>1</sup> In this paper the term “bank” is used to denote all financial institutions which accept deposits from the general public.

<sup>2</sup> A financial system safety net usually includes prudential regulation and supervision, a lender of last resort and deposit insurance. In many countries, a department of government (generally a Minister of Finance or Treasury) in the safety net is responsible for financial sector policy.

<sup>3</sup> The FSF Working Group served as the precursor to IADI, which was officially formed in May 2002.

<sup>4</sup> See **References** for source documents.

5. The Core Principles are intended as a voluntary framework for effective deposit insurance practices; national authorities are free to put in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions.

6. The 21 Core Principles are broadly categorized into eleven groups: Setting objectives and the external environment (principles 1 to 2); Mandates and powers (principles 3 to 4); Governance (principle 5); Relationships with other safety-net participants and cross-border issues (principles 6 to 7); Membership and coverage (principles 8 to 10); Funding (principles 11 to 12); Public awareness (principle 13); Selected legal issues (principles 14 to 15); Failure resolution (principles 16 to 18); Reimbursing depositors; claims and recoveries (principles 19 to 20); and, Moral hazard (principle 21). The Core Principles, including source references are:

### **Setting objectives and the external environment**

- **Principle 1 – Public-policy objectives:** The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public-policy objectives that it is expected to achieve and these objectives must be well understood. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and to protect less-financially-sophisticated depositors. A continuous-improvement process should exist for reviewing the extent to which a deposit insurance system is meeting its public-policy objectives and its mandate (**FSF, page 11-12**).
- **Principle 2 – Situational analysis:** When adopting or reforming a deposit insurance system policymakers should conduct a situational analysis to examine conditions and factors such as: the level of economic activity; current monetary and fiscal policies; the state and structure of the banking system; public attitudes and expectations; the legal framework; and prudential regulatory, supervisory, accounting and disclosure regimes. Where existing conditions and factors are not ideal, it is important to identify them. If actions are necessary, they can be taken before, or in concert with, the adoption or reform of a deposit insurance system (**FSF, page 12**).

### **Mandates and powers**

- **Principle 3 – Mandate:** There is no single mandate or set of mandates suitable for all deposit insurers. Existing deposit insurers typically have mandates ranging from narrow, so-called paybox systems to those with broader powers and responsibilities, such as risk or loss minimization with a variety of combinations in between. Whatever the mandate selected, it is critical that there be consistency between the stated objectives and the powers and responsibilities given to the deposit insurer. Formally specifying the mandate of a deposit insurer clarifies the role of deposit insurance within the financial system safety net (**FSF, page 17**).
- **Principle 4 – Powers:** A deposit insurer should have all powers necessary to fulfill its mandate. All deposit insurers require the ability to enter into contracts, set appropriate requirements, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly (**FSF, page 18**).

### **Governance**

- **Principle 5 – Governance:** The sound governance of agencies comprising the financial system safety net strengthens the financial system's architecture and

contributes directly to system stability.<sup>5</sup> Operationally independent and accountable safety net organizations with clear mandates and which are insulated from undue political and industry influence provide greater integrity, credibility and legitimacy than entities lacking such independence (**APEC, page 3**).

The deposit insurance system should have a governing body and the governing body should be held accountable to the authority from which the deposit insurance system receives its mandate. The deposit insurance system should be structured such that the potential for undue political and industry influence and conflicts of interest respecting members of the governing body and management is minimized (**IADI Discussion Paper on Governance of Deposit Insurance Systems, pages 3-4**).

### **Relationships with other safety-net participants and cross-border issues**

- **Principle 6 – Relationships with other safety-net participants:** A deposit insurer's interrelationship management needs vary according to its mandate and powers, but the need for close coordination and information sharing among financial system safety-net participants is essential in all cases. Such information should be timely, accurate, and relevant with due respect given to maintaining confidentiality when required. It is highly desirable to formalize information-sharing arrangements either through legislation, memoranda of understanding, legal agreements or a combination of these techniques. These arrangements also may be helpful in providing a general framework for safety-net participants to coordinate their related activities (**FSF, 19-20**).
- **Principle 7 – Cross-border issues:** The close coordination and information sharing among deposit insurers and other financial system safety-net participants is also significant from a cross-border perspective. Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate.

In circumstances where the host country system provides supplementary coverage for foreign bank branches, multiple reimbursements of insured depositors should be avoided.<sup>6</sup> The deposit insurance already provided by the home country system should be recognized in the determination of levies and premiums (**FSF, page 30**).

### **Membership and coverage**

- **Principle 8 – Compulsory membership:** Membership should be compulsory for banks meeting membership criteria to avoid adverse selection. Banks that are to be included in a deposit insurance system should be subject to strong prudential regulation and supervision (**FSF, pages 20-21**).
- **Principle 9 – Coverage:** Policymakers should define clearly in law or by private contract what is an insurable deposit. The level of coverage can be set through an examination of relevant data. Whatever coverage level is selected, it must be credible and internally consistent with other deposit insurance system design features, and cover adequately the large majority of depositors in order to meet the

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<sup>5</sup> The four major elements comprising sound governance are: independence, accountability, transparency and disclosure, and integrity.

<sup>6</sup> It is advisable for countries introducing supplementary coverage to have in place appropriate bilateral/multilateral agreements.

public-policy objectives of the system. Coverage limits may need to be adjusted periodically because of inflation and other factors (FSF, pages 23-25).

- **Principle 10 – Transitioning from a blanket guarantee to a deposit insurance system:** If a country decides to transition from a blanket guarantee to a deposit insurance system, the transition should be as rapid as a country's circumstances permit.<sup>7</sup> Policymakers should pay particular attention to public attitudes and expectations during the transition period (FSF, pages 14-15).

## Funding

- **Principle 11 – Funding:** Sound funding arrangements are critical to the effectiveness of a deposit insurance system. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims. Ex-ante funding requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a member bank failure. In an ex-post system funds are obtained only once a bank has failed; banks are assessed and contribute at this time. Member banks should pay the cost of deposit insurance since they and their clients directly benefit from having an effective deposit insurance system. Recent IADI research indicates that ex-ante funding has many more advantages than disadvantages particularly with respect to ensuring prompt reimbursement to insured depositors, the maintenance of public confidence and as a means to avoid the pro-cyclical effects of deposit insurance assessments<sup>8</sup> (FSF, page 2, IADI draft paper on Funding of Deposit Insurance Systems, pages 3, 7).
- **Principle 12 – Differential premiums:** For deposit insurance systems utilizing ex-ante funding, policymakers have a choice between a flat-rate premium system or a premium system that is differentiated on the basis of individual bank risk profiles. The bases and criteria used in a risk-adjusted differential premium system should be transparent to all participants. As well, policymakers who adopt risk-adjusted differential premium systems should ensure that necessary resources are in place to administer the system appropriately (FSF, page 28, IADI General Guidance for Developing Differential Premium Systems, pages 3-5).

## Public awareness

- **Principle 13 - Public awareness:** In order for a deposit insurance system to be effective it is essential that the public be informed about the benefits and limitations of the deposit insurance system. The characteristics of a deposit insurance system should be publicized regularly to maintain and strengthen public confidence (FSF, page 29).

All deposit insurers should promote public awareness about the deposit insurance system on an ongoing basis. The major goals of a public awareness program are for the deposit insurer to accomplish its public policy objectives and enhance the effectiveness of a deposit insurance system through public education to promote the stability of the financial system. The objectives of the public awareness program should be clearly set out and consistent with the public policy objectives and mandate

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<sup>7</sup> A blanket guarantee is defined as a declaration by the government that in addition to the protection provided by deposit insurance or other arrangements, all remaining deposits and perhaps other financial instruments will be protected.

<sup>8</sup> For countries utilizing an ex-ante target fund ratio or range the method chosen should be sufficient to reduce the probability of the fund's insolvency to an acceptable minimum (FSF, page 27).

of a deposit insurer (**IADI Discussion Paper on Public Awareness of Deposit Insurance Systems, page 3**).

### **Selected legal issues**

- **Principle 14 - Legal protection:** Individuals working for deposit insurers and other financial system safety-net participants should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates. However, legal protection must coexist in an environment where there is clear accountability. This means that while individuals should be legally protected, they must be required to follow appropriate oaths of office, conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be codified in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified (**APEC, pages 2-3**).
- **Principle 15 – Dealing with parties at fault in a bank failure:** A deposit insurer, or other relevant safety-net participant, should be provided with the power to investigate and if necessary litigate against those parties at fault in a bank failure. The power of investigation into officers, directors, managers, auditors and related parties of the failing/ failed bank can help improve recoveries for an insurer and can mitigate moral hazard problems by providing strong incentives against malfeasance (**IADI Guidance on the Resolution of Failed Banks, page 45**).

### **Failure resolution**

- **Principle 16 – Trigger mechanisms for prompt corrective action:** Financial-system safety-net participants must ensure that a framework exists for the prompt detection 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 and transparent trigger mechanisms by safety net participants with the operational independence and legal authority to act. These arrangements need to be supported by strong regulation and supervision, sound accounting and disclosure regimes, and an effective legal regime (**APEC, page 4**).
- **Principle 17 – Effective failure resolution processes:** Three basic resolution options exist: liquidation and reimbursement of depositors’ claims, purchase-and-assumption transactions (sales) and open-bank financial assistance. Bankruptcy/insolvency and other laws may heavily influence the choice of resolution methods since such laws vary considerably among countries and, in some cases, may make a particular resolution method difficult to implement. Because of the special significance of banks and bank failures, policymakers may wish to review whether bankruptcy/insolvency laws facilitate the orderly exit of troubled banks. In this regard, establishing a special resolution regime for banks should be considered (**FSF, page 31**).

Effective failure-resolution processes should: meet the deposit insurer’s obligations, ensure that depositors are reimbursed promptly and accurately, minimize resolution costs and disruption of markets, maximize recoveries on assets, settle *bona-fide* claims on a timely and equitable basis, and reinforce discipline through legal actions in cases of negligence or other wrongdoings.

- **Principle 18 – Bridge-bank authority:** The deposit insurer or other relevant safety-net participant should have the authority to establish a bridge-bank (or related resolution mechanism) to help preserve critical banking functions by acquiring the assets and assuming the liabilities of a failed bank until a final resolution can be

accomplished (FSF, page 32 and IADI General Guidance for the Resolution of Bank Failures, page 22).

### Reimbursing depositors; claims and recoveries

- **Principle 19 – Reimbursing depositors:** The deposit insurer should be notified or informed sufficiently in advance of bank closure to be able to prepare for timely payment of insured deposits. Systems and processes should be developed in order to undertake preparatory reviews of deposit liabilities held by troubled banks (FSF, page 34).

Determining who should be reimbursed and ensuring that deposit insurance limits are respected are crucial steps in the reimbursement process. Depositors need to know when and under what conditions the deposit insurer will start the reimbursement process, as well as the applicable coverage limits. Depositors should be told the time frame over which reimbursement will take place and whether any advance or interim payments will be made. Access to the necessary deposit data before the bank is closed lessens the risk of record manipulation, shortens the time for completing the reimbursement process and helps preserve public confidence (FSF, page 35).

- **Principle 20 – Claims and recoveries:** Asset-management, claims and disposition strategies should be guided by commercial considerations and their economic merits, the quality of the assets, the depth and condition of markets, the availability of expertise in asset management and disposition, legal requirements relating to the disposition of assets, and public-policy objectives (FSF, pages 34 and 36).

### Moral hazard

- **Principle 21 – Mitigating moral hazard:** A well-designed financial system safety net contributes to the stability of the financial system; however, if poorly designed, it may increase risks, notably, moral hazard. Good corporate governance and sound risk management of individual banks, effective market discipline, and frameworks for strong prudential regulation, supervision and laws, can mitigate moral hazard and these elements are most effective when used in concert.

Ensuring that a deposit insurance system contains certain design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; implementing differential or risk-adjusted premium systems; minimizing the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts (FSF, pages 8-9).

7. The Core Principles are neutral with regard to different approaches to deposit insurance, so long as the overriding goals are achieved. The Core Principles are not designed to cover all the needs and circumstances of every banking system. Instead, specific country circumstances should be more appropriately considered in the context of existing laws and powers to fulfil the public policy objectives and mandate of the deposit insurance system.

8. A high degree of compliance with the Core Principles should contribute to financial system stability and enhance depositor protection.

9. It is recommended that the Financial Stability Forum and other international financial authorities take into consideration the Core Principles in their work to strengthen regulatory frameworks and enhance depositor protection and financial system stability.

## References

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