

Pinner's Hall
105-108 Old Broad Street
London EC2N 1EX
tel: + 44 (0)20 7216 8947
fax: + 44 (0)20 7216 8928
web: www.ibfed.org

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel
Switzerland

To: baselcommittee@bis.org
CC: Service.IADI@bis.org

15 May 2009

Dear Madams and Sirs,

**Response to BCBS and IADI on their
Core Principles for Effective Deposit Insurance Systems**

The International Banking Federation (IBFed) is a confederation of the main trading associations representing banks in the major global economies. Its members are the American Bankers Association, the Australian Bankers Association, the Canadian Bankers Association, the Japanese Bankers Association and the European Banking Federation. The Banking Associations of China, India and South-Africa are associate members of IBFed. We believe that IBFed brings an important perspective to policy issues affecting the banking industry around the world.

The International Banking Federation (IBFed) welcomes the proposed "Core Principles for Effective Deposit Insurance Systems" of the Basel Committee for Banking Supervision (BCBS) and International Association of Deposit Insurers (IADI).

Following the recent market turmoil and resulting bank failures the IBFed recognises and supports the need for enhancements to Deposit Guarantee Schemes (DGS) across the world to help reduce the risk and scope of future reoccurrences. In this context we see DGS as an important feature to financial stability in stressed market conditions in that they underpin consumer confidence and act as a break on potential bank runs. Recent events have shown however that there are limitations to the impact DGS can have on maintaining consumer confidence and financial stability in certain circumstances. We therefore stress that the BCBS and IADI should advance as primary objectives of a DGS the (i) promotion of sound banking practices to protect depositors and support confidence in the banking industry and (ii) the facilitation of the efficient and effective resolution of banks that are in an unsafe and unsound condition.

The recent financial crisis has also given valuable insight and lessons for enhancing depositor protection and maintaining financial stability by addressing consumer awareness, needs and confidence as well as the challenges related to complex cross-border banking groups and their supervision. Given the valuable experiences across the IBFed, we would like to thoroughly emphasise the importance of a holistic and credible approach to deposit insurance from problem prevention right through to resolution.

In particular the IBFed identifies the following key elements for effective depositor protection and promotion of financial stability:

- Effective communication and co-operation for problem prevention and management among key stakeholders as well as effective public communication of the tools available to the DGS in times of stress or upon the failure of an insured bank
- The maintenance of public confidence in the banking system by creating sufficient public awareness of benefits and limits of the DGS
- Credible and sufficient coverage of deposits to meet the purposes of the DGS program
- Credible, adequate and stable funding
- Assurance of continued access of banking services in the first instance and fast payout as a final solution when continuity of banking services fails
- A level playing field for insured banks where there is significant potential for cross border movement of deposits
- Independence of the DGS from chartering authority and authority responsible for macroeconomic issues and overall financial stability

We therefore are happy to see that the Core Principles from the Basel Committee and IADI go far in providing deposit insurers and those that are aspiring to become deposit insurers with the key building blocks and information on how to design mechanisms to do so.

Finally, in terms of cross-border banking groups it is important to first consider the supervisory structures (e.g. Colleges of Supervisors) that provide the framework for coordinated supervisory action. In this respect it is important to address both problem prevention, i.e. in terms of cross border cooperation in managing liquidity, and problem resolution, i.e. through bankruptcy and insolvency agreements.

It would also be useful if the Basel Committee and the IADI could address the practice of protectionist asset localisation or “ring fencing” deposits in a jurisdiction when the home country DGS does not protect host country depositors in a manner consistent with a level playing field.

Please, find below our detailed comments with regard to the 18 Core Principles in the attached appendix.

We would be delighted to discuss our comments with you further if that would be helpful.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Sally J Scutt'. The signature is fluid and cursive, with a large initial 'S' and a distinct 'J' and 'S'.

Sally J Scutt
Managing Director

Appendix - Comments on Core Principles

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. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.

The IBFed supports this principle in part. We do not believe that a deposit guarantee scheme (DGS) can by itself prevent banking failures, we believe that a DGS should (i) promote sound banking practices to protect depositors and support confidence in the banking industry and (ii) facilitate the efficient and effective resolution of banks in an unsafe and unsound condition.

Our main concern is that having multiple policy goals in some cases can lead to conflicts of interests, which in turn can lead to more instability. Therefore we advise that the principle be taken one step further to not only make the goals explicit, but their priority as well.

Furthermore, having the prevention of banking failures as a purpose of a DGS could result in a situation in which unsafe and unsound banks continue to operate, thus eroding confidence in the industry and undermining market discipline.

Principle 2 – Mitigating moral hazard: Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net (see Preconditions paragraph 16).

The IBFed endorses this principle but would like to caution that the features should not give incentives to customers to withdraw deposits in order to avoid potential costs during an imminent bank failure. Recent experience with co-insurance suggests that customers will take out their deposits to avoid even the smallest partial loss of their savings. Adequate coverage limits and a reasonable scope of eligible accounts sufficiently address moral hazard as they provide incentives for depositors to diversify their funds in different accounts.

Principle 3 – Mandate: It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.

The IBFed fully supports this principle.

Principle 4 – Powers: A deposit insurer should have all powers necessary to fulfil 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.

The IBFed supports this principle. However, we caution against excessively detailed deposit information requirements. The scheme should only require sufficient information for achieving public policy objectives. Excessively detailed information is likely to provide deposit takers with additional unnecessary costs, for little or no value.

Principle 5 – Governance: The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.

The IBFed fully supports this principle. The DGS should be independent from the chartering authority or any authority with a mission to promote financial services, as well as independent from the authority responsible for macroeconomic issues and overall financial stability.

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.

The IBFed supports this principle where applicable and stresses the importance of communication between all stakeholders. However, we again caution against excessively detailed deposit information requirements. The scheme should only require sufficient information for achieving public policy objectives. Excessively detailed information is likely to provide deposit takers with additional unnecessary costs, for little or no value.

Principle 7 – Cross-border issues: 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 more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.

The IBFed fully supports this principle, but would like to add the importance of cross-border communication and cooperation between international supervisors in other areas that focus on the prevention of banking failures such as the provision of emergency liquidity. One issue which should be dealt with in particular is the issue of clarity of information and operational procedures for depositors of foreign firms passporting into a DGS by topping-up arrangements.

It would also be useful here if the Basel Committee and the IADI could address the practice of “ring fencing” deposits in a jurisdiction when the home country DGS does not protect host country depositors in a manner consistent with a level playing field.

Principle 8 – Compulsory membership: Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (e.g. retail and small business depositors) to avoid adverse selection.

The IBFed supports this principle with regard to banks.

Principle 9 – Coverage: Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.

The IBFed supports this principle. We do note that the choice to insure the large majority of depositors is a public policy goal in itself that might feed forward into the definition of what an insurable deposit is. In our view it is most important to note that coverage is in line with the public policy objectives of the system.

Principle 10 – Transitioning from a blanket guarantee to a limited coverage deposit insurance system: When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.

The IBFed fully supports this principle.

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.

The IBFed fully supports this principle but would like to emphasise the importance of credibility for a fund to meet its potential compensation payout obligations. Where there is an apparent shortfall of funding (ex-ante or ex-post) it is important for Government authorities to provide assurance and, if possible, immediate access to national loan facilities, within the limit set by state aid legislations. But it must be stressed that when the DGS needs to borrow funds from government authorities, insured banks should be responsible for timely repayment of the debt. Permanent state guarantee for DGS or directly for secured deposits must be avoided because these would promote moral hazard and serious market distortions. The responsibility for paying the cost of deposit insurance should therefore be in line with the public policy objectives specified.

Principle 12 – Public awareness: In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.

The IBFed fully supports this principle.

Principle 13 – Legal protection: The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.

The IBFed generally supports this principle and understands the principle as not supporting any *ultra vires* actions taken by the DGS.

Principle 14 – Dealing with parties at fault in a bank failure: A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.

It would be helpful if the Basel Committee and IADI could clarify the definition of “parties at fault” as it is currently uncertain how the supervisor would implement this. It further could have a substantial impact on the provision of operational risk and professional indemnity insurance. It certainly should not apply, for example, to cases where bank failure is due to business conditions and not due to violations of banking laws or regulations.

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.

The IBFed fully supports this principle and, as under Principle 7, would like to add the importance of cross-border communication and cooperation between international supervisors in other areas that focus on the prevention of banking failures such as the provision of emergency liquidity.

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).

The IBFed fully supports this principle. Recent experience has highlighted the importance of having an insolvency regime in place that provides the DGS with appropriate tools for providing continuity of access.

Most significantly some countries have established and utilised with great success special tools within their insolvency regimes to maintain the failed bank’s infrastructure in order to

allow for continued access to banking services. For more information please refer to our comments below with regard to *Principle 17 - Reimbursing Depositors*.

Principle 17 – Reimbursing depositors: The deposit insurer 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, whether any advance or interim payments will be made as well as the applicable coverage limits.

The IBFed supports this principle. However, we again caution against excessively detailed deposit information requirements. The scheme should only require sufficient information for achieving public policy objectives. Excessively detailed information is likely to provide deposit takers with additional unnecessary costs, for little or no value.

Also, it must be acknowledged by supervisors and deposit insurers that there are alternative ways to deliver prompt access to insured deposits besides compensation payments via the DGS. As pointed out above under Principle 16 some countries have established and utilised with great success special tools within their insolvency regimes to maintain the failed bank's infrastructure in order to allow for continued access to banking services. This method takes advantage of the remaining liquidity of a failed bank and allows depositors almost immediate (but constrained) access to its insured deposits for critical daily needs and financial obligations. Another upshot of continuity of access is that firms are not required to provide an instantaneous and costly view of eligible accounts while the DGS and remaining industry avoid the administrative burden of compensation payments and new account opening (which really is only feasible for the smallest of banks).

In Europe the EU Deposit Guarantee Schemes Directive has already introduced the concept of continuity of banking services and access to bank liquidity as a viable tool for depositor protection in the context of emergency payouts.

The clear merit of enabling the continuity of banking services is that depositors experience no or little disruption in their access to deposits. We therefore urge the BCBS and IADI to adopt the concept of continuity of banking services as one of their principles as a good practice option for compensation payout.

Principle 18 – Recoveries: The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.

The IBFed fully supports this principle.

Ends