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Respecting the January 2008 Consultation Paper  
"Financial stability and depositor protection: strengthening the framework"  
issued in January 2008 by  
Bank of England, HM Treasury and FSA

## Executive Summary

This Submission is a response to the Consultation Paper issued in January 2008 entitled "Financial stability and depositor protection: strengthening the framework" which contains recommendations to enhance the depositor protection arrangements in the UK. This Submission includes recommendations and suggestions that will help strengthen the financial system, reduce the likelihood that banks may fail in the future, reduce the impact of failing banks, provide effective compensation arrangements in which consumers have confidence, and improve the coordination between the Authorities.

This Submission proposes that the mandate of the Financial Services Compensation Scheme Limited (FSCS) be revamped in two very important areas. It is recommended that the FSCS become an operationally independent agency with a risk-minimiser mandate, backed by the UK Government and with the authority to assess and collect tax-deductible premiums based on the risk profile of its members. The re-structured FSCS would report to Parliament through the Chancellor of the Exchequer and it would have the mandate and the powers to promote the stability of the financial system through the provision of effective depositor protection, have access to all regulatory and supervisory information, have the authority to act independently of the Financial Services Authority (FSA) to effect bank resolutions, and be accountable for its actions. By providing the FSCS with the recommended mandate it will promote an important "check and balance" in the UK financial system safety net. The exposure to taxpayers would be greatly reduced since the FSCS would be mandated to find least-cost resolutions in a manner that contributes and promotes stability of the financial system.

To improve the public's understanding of the benefits and limitations of depositor protection it is proposed that the FSCS be further mandated to develop and implement a public awareness program. The objectives of the program would be clearly set out and consistent with the stated public policy objectives of the UK Authorities. Since considerable guidance in this area has been provided by the International Association of Deposit Insurers (IADI), it is recommended that the UK Authorities also undertake an evaluation of the system of deposit protection in the UK through an assessment against all of the twenty-one IADI Core Principles

This submission draws on work undertaken by many internationally recognized authorities. It is based on the experience of practitioners who have dealt with many bank failures and helped design and improve depositor protection and compensation arrangements for other financial products. However, a full examination and assessment of the FSCS arrangements against all of the IADI Core Principles is very important to ensure that there is effective depositor protection in the UK and that the system can promote financial stability without imposing an undue burden on taxpayers and the banking system.

## Introduction

Deposit-accepting financial institutions are important because of their involvement in the payment system, their role as intermediaries between depositors and borrowers, and their function as agents for the transmission of monetary policy. Banks are in the business of assuming and managing risks and by their nature are vulnerable to liquidity and solvency problems. This is because they transform short-term deposits into longer-term, less liquid loans and investments. They also lend to a wide variety of borrowers whose characteristics are not always readily apparent.

It is now accepted that banks<sup>1</sup> will fail, in one form or another, in all jurisdictions around the world. So many that bank failures have become accepted. Given the potential for bank runs policymakers have a desire to establish effective depositor insurance arrangements<sup>2</sup> to limit the exposure of taxpayers. When a bank does fail, depositors expect that the government will make them whole (i.e. not impose any losses on them) unless there is an effective deposit insurance system in place. Indeed, an effective system will reduce the political pressure on the government to provide blanket guarantees. They do so because the public believes that the failure occurred because the supervisor, deposit insurer, central bank or government (the financial system safety net<sup>3</sup>) failed to do its job. If a bank does fail, depositors should be relieved when they are informed that their deposits are protected and that they will be reimbursed as soon as possible.

Financial markets around the world have faced periods of considerable instability for a variety of reasons for the past several decades. In the aftermath of the Asian financial crisis that spread from there to Brazil, Russia and beyond policymakers revamped banking rules and many countries strengthened their depositor protection arrangements. More recently, the sub-prime mortgage lending crisis has resulted in credit problems in a number of markets not just the USA, UK and Canada.

In earlier times, it might have been expected that a disturbance in one financial system might be largely self-contained. This is no longer the case as transmission mechanisms facilitate crises that extend across borders. Even well-regulated markets are vulnerable to such disturbances. If this leads to stress on financial institutions then early intervention in, and resolution of, institutions facing financial difficulties should occur. At the same time, financial institutions must operate with sufficient supervisory and regulatory incentives to solve their own problems in a timely manner and there must be appropriate accountability and transparency in the supervisory process.

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<sup>1</sup> The term bank or banks in this submission means any deposit-accepting financial institutions.

<sup>2</sup> For a full examination of the components of an effective deposit insurance system see FSF Working Group (2001).

<sup>3</sup> A financial system safety net usually includes prudential regulation and supervision, a lender of last resort and deposit insurance. In many countries, a government department (Ministry of Finance or Treasury) in the safety net is responsible for financial sector policy.

There are currently over 100 countries with some form of depositor protection with systems that have a wide variety of mandates, from pay boxes to risk minimisers. Many policymakers have established or reformed their deposit protection systems drawing on the recommendations of the Financial Stability Forum's Study and Working Groups on Deposit Insurance, the conclusions from the APEC Policy Dialogue on Deposit Insurance and the guidance and Core Principles developed by IADI. However, research has shown that the most effective systems are those with risk-minimiser mandates because their objectives are to mitigate the risks inherent in providing deposit insurance and minimize the cost of bank failures.

Deposit insurers are now an integral part of the financial system safety net in many countries. As such, banks obtain the benefit of a stable financial system and, therefore, it is the member banks and not the taxpayers directly that should contribute to the cost of an effective deposit insurance system. This is often undertaken by charging the banks tax-deductible premiums in support of user-pay arrangements.

Care must be taken to address the cost of supervision and of providing effective depositor protection as neither should place an undue burden on financial institutions. Depositor protection systems must be paid for by the industry and the exposure for taxpayers is greatly reduced if the deposit insurer is mandated to find least cost resolutions in a manner that contributes and promotes stability of the financial system. Deposit insurance systems can be designed to meet that objective and, at the same time, ensures that well-capitalized institutions remain competitive domestically and internationally.

Enhancing the safety and soundness of the UK financial system is confirmed in the Consultation Paper as a key goal the HM Treasury, Bank of England and the Financial Services Authority.

The Authorities propose action targeted at achieving five objectives:

- Strengthening the stability and resilience of the UK financial system
- Reducing the likelihood of individual banks facing difficulties
- Reducing the impact if, nevertheless, a bank gets into difficulties;
- Providing effective compensation arrangements in which consumers have confidence; and
- Strengthening the Bank of England, and ensuring effective co-ordinated actions by the Authorities

The Consultation Paper focuses on some key aspects affecting deposit-accepting institutions because of the role that they play in facilitating financial transactions, including payments, and their interaction with so many participants in the financial system.

This Submission focuses on two key policy proposals articulated in the Consultation Paper which will help the Authorities meet the five objectives. The first set of recommendations address the need to establish the Financial Services Compensation Scheme Limited as an operationally independent government agency distinct from the FSA but supported by an effective agreement with the other Authorities. The second group of recommendation concern the public's knowledge, understanding and expectations of the depositor protection arrangements in the UK.

This Submission was also prepared at a time when IADI released Core Principles for Effective Deposit Insurance Systems<sup>4</sup>. The advice contained in this Submission draws extensively from Core Principle 5 – **Governance**, Core Principle 6 – **Interrelationships** and Core Principle 13 – **Public Awareness** developed by the International Association of Deposit Insurers (IADI).

It is recommended that the Authorities, consistent with the advice of the Financial Stability Forum which was endorsed by G7 Finance Ministers and Central Bankers, review their depositor protection arrangements and strengthen them using the IADI Core Principles as benchmarks.

### **Part 1 Enhancing the Effectiveness of the UK Financial System Safety Net – Addressing the Need to Establish a Financial Services Protection Fund**

In Chapter 7, the Authorities wish to know to what extent the proposals in the Consultation Paper enable an improved handling of a financial crisis (see page 92).

*It is recommended that the UK government revamp and broaden the mandate of the Financial Services Compensation Scheme Limited (FSCS) to include the creation of a Financial Services Protection Fund (FSPF). The FSCS would become an operationally independent agency with a risk-minimiser mandate, backed by the Government with the authority to assess and collect tax-deductible ex ante premiums based on the risk profile of its members. The premiums would be used to create financial services protection fund. The re-structured FSCS would report to Parliament through the Chancellor of the Exchequer and it would have the mandate and the powers to promote the stability of the financial system, have access to all regulatory and supervisory information, have the authority to act independently of the Financial Services Authority to effect bank resolutions, be accountable for its action, and undertake its activities with limited exposure to the taxpayer. As a first step, the FSCS would explicitly protect deposits in member institutions. In time, the Authorities could extend similar protection to other financial products (insurance products, investment products and other non-deposit products covered by the Financial Services Markets Act 2000).*

#### **Discussion, Analysis and Advice**

##### *Overview*

There are compelling reasons for establishing the FSCS as an operationally independent agency with an explicit mandate to provide depositor protection. First, and foremost, the public believes that the funds that they entrust to a bank are as safe as money in their wallets<sup>5</sup>. In practice, current accounts and non-term deposits are clear substitutes for cash. As a result, depositors have a clear expectation to be reimbursed within defined limits when a bank fails. But, in the UK, the Authorities have chosen to provide depositors with a system of

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<sup>4</sup> Please see:

<http://www.iadi.org/Lists/Announcements/DispForm.aspx?ID=64&Source=http%3A%2F%2Fwww%2Eiadi%2Eorg%2FLists%2FAnnouncements%2FAllItems%2Easpx>

accessed on 17 April 2008.

<sup>5</sup> If depositors believe otherwise then experience has shown that they will move their funds to other places.

compensation<sup>6</sup>. As demonstrated in the “Northern Rock” case, the run was caused by the withdrawal of large deposits which caused heightened media coverage which soon led to retail depositors lining up to get at their funds. Most certainly, the power of the media cannot be discounted.

Second, financial system safety nets operate better when there are a number of “checks and balances” in place. There are many excellent examples of effective financial safety net arrangements and the situation that exists in Canada is a good example. Trying to balance different objectives within one organization (as now exists in the UK in the way in which the FSCS effectively reports to the FSA) is difficult and oftentimes counterproductive. The decisions to be made are likely to be better, and more acceptable to the public, and to those directly affected, if they reflect two independent assessments rather than one. How and when to intervene in dealing with a troubled institution is a matter of judgement and such difficult decisions have a substantial impact on the cost of depositor protection (and potentially on taxpayers). The “cost of getting it wrong” will far exceed the routine reporting and administrative costs associated with regulatory or depositor protection services.

Third, by establishing the FSCS as an independent agency there will be important benefits for the Government. With an “arms length” relationship the Chancellor would be insulated from the banks in matters such as premium settings, the timing of interventions, how depositors and other creditors are treated, and issues arising from the disposition of assets.

Fourth, organisations such as the International Monetary Fund view separate, independent depositor protection agencies that are accountable and transparent with more integrity and credibility.

#### *The Need for a Separate Agency to Provide Depositor Protection*

As Norton (2005) observes, in the majority of IADI jurisdictions, the deposit insurer is housed in a separate organisation distinct from that of the supervisor. This trend is even more common among G-8 nations, with the UK now being the only one in which the deposit protection agency, the Financial Services Compensation Scheme, is not an entirely separate entity from the supervisory agency.<sup>7</sup> The separation of deposit insurance and supervisory functions in many countries is based on the premise that the deposit insurer and supervisor is each likely to approach an intervention decision with separate sets of incentives in mind.

The first incentive can be related to mandate in that the supervisor is likely to be more concerned with maintaining financial stability. Whereas the deposit insurer, especially one charged with a risk- or loss-minimisation mandate, is likely to be more concerned with the potential financial price a failure could incur. In these respects, a supervisor might be reluctant to close a troubled bank, after having considered the disruption to the financial system that could come as a

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<sup>6</sup> It might have been possible to forestall a run on Northern Rock but it would have been necessary for the Authorities to have made a concerted effort to inform the public of the benefits and limitations of the existing scheme.

<sup>7</sup> While the Financial Services Compensation Scheme (“FSCS”) is a legally separate organisation from the Financial Services Authority (“FSA”) and relies on the work of its own staff, its board of directors is appointed by the FSA, and the FSCS has few intervention powers independent of its parent organisation.

result. A deposit insurer, on the other hand, would prefer an early closure, and as such would likely minimise the cost to the financial system of a failure.

The second incentive deals with reputation. Viewed a different way, a deposit insurance organization protects against losses for insured deposits but the judgment of the supervisory organisation. Vesting supervisory and insurance functions in the same organisation is less likely to discipline the supervisor than it is to create a moral hazard whereby the supervisor can take intervention decisions with the fallback that mistakes can be covered by the deposit insurance fund, which they administer. Fairly or not, blame for a failed institution is likely to be placed on the supervisor agency or the central bank. Hence, a supervisor might consider the reputation of its own organisation before closing a bank, leading the supervisor to forbear.

A supervisor with the key to a deposit insurance fund might, in turn, be tempted to “wager” the fund against the odds that the troubled institution might turn itself around. If a failure were ultimately to prove more costly than necessary, it would be possible to simply raise premiums or impose levies to account for the difference. On the other hand, reputation incentives are likely to point a deposit insurer in the opposite direction, as a prompt, successfully handled bank closure and payment to insured depositors is likely to enhance the reputation of the deposit insurer, not diminish it. Moreover, with the supervisor and the deposit insurer as separate entities, the supervisor can, in the event of a failure, simply direct angry callers to the other organisation, alleviating some of the hassle of dealing with a failed bank and, hopefully, inducing earlier closure.

A further reason for separating the functions of the supervisor and the deposit protection agency, which contrasts with the ones laid out above, is that a supervisor, charged with minimising the deposit insurance fund’s exposure to loss, might use its regulatory powers with too great a zeal, closing down banks prematurely and impairing the industry with excessive regulation and unnecessary restriction. The result would be a regulatory framework to where the balance between financial stability and loss-minimisation tilts too far in the latter direction.

#### *Lessons from the Canadian experience*

A wave of failures in the 1980s led the Government of Canada to expand the mandate and powers of Canada Deposit Insurance Corporation (CDIC) and to reinforce its independence. Canada chose to establish CDIC as an independent (arm’s length) Crown Corporation because by doing so it:

- provides credible protection for the interests of individuals that have small balances in banks because they are not and simply can’t be in a position to assess the risks posed by banks
- provides for balanced and effective decision-making in dealing with bank failures
- removes the risk of there being a perception of government interference; and
- averts the conflicts of interest that can occur when the regulation and deposit insurance functions are lodged in the same agency.

As a result of industry pressure to reduce the cost of regulation of the banking sector a special Task Force<sup>8</sup> considered the matter of amalgamating CDIC with the Office of the Superintendent of Financial Institutions (OSFI). They found that CDIC and OSFI have different purposes that are clear and distinct and should remain so. The Task Force also concluded that the insurer and supervisor have different objectives with respect to failing banks: the supervisor main interest is in rehabilitation and the insurer's interests are in minimizing exposure and losses. They recognized the benefits of having a healthy tension between the objectives of the two organizations and that public policy is best served when they are not combined in a single institution.

### *IADI Core Principles*

In March 2008, IADI released twenty-one Core Principles for effective deposit insurance systems for the benefit of countries considering the reform of a deposit insurance system. They are solidly based on research by IADI Members and work undertaken by other organizations including the International Monetary Fund, the Financial Stability Forum and the APEC Policy Dialogue on Deposit Insurance. The Core Principles are reflective of and adaptable to a wide range of country circumstances.

The Core Principles are broadly categorized into eleven groups. While they are intended as a voluntary framework national authorities are free to put into place supplementary measures that they deem to be necessary to achieve effective depositor protection in their jurisdictions. There are two IADI Core Principles that are relevant to this particular area

- **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>9</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 protection 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**).

- **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

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<sup>8</sup> Task Force on the Future of the Canadian Financial Services Sector (1998) under the Chairmanship of Harold MacKay.

<sup>9</sup> As articulated in work by the IMF and IADI, the major elements comprising sound governance are: independence, accountability, transparency, disclosure, and integrity.

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)**.

### *Creating the "UK Financial Services Protection Fund"*

The Authorities should establish a Financial Services Protection Fund (FSPF) to support the deposit insurance system. In doing so the tripartite arrangement needs to be modified to add the FSCS as an equal member of the financial system safety net similar to what exists in many countries. In Canada, for example, the changes that were brought into effect in 1987 moved CDIC from being a passive or reactive "pay box" to a loss-minimizer with the result being a material decline in losses stemming from failures of member institutions. As Kryzanowski observes, average losses in Canada dropped from 52 cents per dollar over the period 1967-1987 to 17 cents for the period after 1987<sup>10</sup>. The findings of Kryzanowski and Noiseux suggest that government and financially troubled banks prolong explicit bank failure in a world with deposit insurance provided by a pay box insurer.

A loss- or risk-minimiser deposit insurer is highly supportive of early intervention including closure strategies as a means of preserving the safety and soundness of the financial sector. To go along with this thrust there is a reduction in discretion that can be exercised by supervisors and the political authorities can be comforted by the fact that depositors will be assured of receiving their funds within defined limits in a timely way (most often in less than 30 days).

In revamping the mandate of the FSCS, the Authorities will need to address its relationships and co-ordination with the FSA, Bank of England and HM Treasury. When the safety-net functions are assigned to different organisations, it is necessary to put into place the necessary measures to resolve potential tensions related to the allocation of powers and responsibilities and coordinate actions that will need to be taken. In this regard, IADI has provided guidance on how this can be handled. This can be found in the January 2006 paper entitled [General Guidance to Promote Effective Interrelationships among Financial Safety Net Participants](#).

In addition, as the FSPF is put into place the Authorities would need to grant the FSCS additional powers and responsibilities to engage in early intervention strategies (through the delineation of appropriate trigger mechanisms) and allow it to implement a special resolution regime for banks when it is needed.

Funding of the system of depositor protection should be provided through the collection of tax-deductible *ex ante* premiums that reflect the risk profiles of member institutions. The premiums should be tax-deductible as deposit insurance is an expense just like any other expense for a bank and if they are deductible the banks and taxpayers share the cost of the provision of deposit insurance and both share in the benefits of a more stable financial system.

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<sup>10</sup> Kryzanowski, Lawrence, "Organizational Design and Positioning of Deposit Insurance Function in the Financial System Safety Net", in Campbell, A. et al, [Deposit Insurance](#), pp 98-99.

As noted in the IADI Core Principles<sup>11</sup> that were issued in March 2008, sound funding arrangements are critical to the effectiveness of a depositor protection arrangement. A deposit protection agency should have available all funding mechanisms to ensure prompt reimbursement of depositors. *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. IADI has also provided guidance in terms of the development of differential premium systems<sup>12</sup>.

### *IADI Guidance on Effective Interrelationships*

This section first highlights the main issues articulated in the IADI Guidance Paper on Interrelationships with the aim of providing practical advice to the Authorities on how to promote interrelationships that will contribute to financial stability. A practical example as to how the arrangements actually work in Malaysia is found in Annex A.

The IADI guidance is divided into three parts. The first addresses issues related to composition, mandates and powers of organizations in a financial safety net (SNP); the second section deals with coordination among them and the third underscores the importance of information sharing.

#### ***Composition, Mandates and Powers of Agencies in a Financial System Safety Net***

- The first step in approaching the matter of interrelationships is to have a clear understanding of the institutional arrangements. This will assist with the proper identification of the roles for the components of the financial safety net and provide insights on how to address potential conflicts. Mandates need to be defined in law.
- Having identified the components, the next step is to review their respective functions both in normal times and in a period of a crisis. Since the functions are being assigned to different organizations, issues related to allocation of powers and responsibilities, co-ordination of actions among the different functions, and issues related to information sharing become very complex and need to be addressed clearly and explicitly.

#### ***Coordination Issues***

- In establishing the co-ordination framework, there must be a high degree of transparency and agreement with respect to respective mandates prior to the occurrence of a banking crisis.
- To prevent unproductive overlaps between members of the SNP, the powers of the various agencies must be explicitly defined in law.
- Apart from or in addition to legislation, there needs to be a formalization of the following co-ordination and information sharing activities:

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<sup>11</sup> <http://www.iadi.org/Lists/Announcements/Attachments/64/FSF%20-%20IADI%20Core%20Principles%20final%2029%20Feb2008.pdf>, accessed on 21 April 2008.

<sup>12</sup> See [http://www.iadi.org/Guidance%20Papers/IADI-Diff%20prem%20paper%20final\\_Feb2005.pdf](http://www.iadi.org/Guidance%20Papers/IADI-Diff%20prem%20paper%20final_Feb2005.pdf), accessed on 21 April 2008.

membership on other SNPs board of directors, extensive use of Memoranda of Undertakings (MOUs), and specially designated committees or a combination of these options.

### ***The Importance of Information Sharing***

- The need for relevant information by the FSCS underscores the need for close co-ordination and information sharing among safety net participants. All the required information should be timely, accurate and relevant.
- A risk-minimising FSCS would, however, have greater needs for information given its broader mandate. For example, it must be in a position to assess the financial condition not only of individual member institutions but the entire industry. In addition, it should be able to anticipate troubles of individual banks and deal with them effectively when they arise.
- Since the FSA is the primary and most important source of banking information given its specific powers and responsibilities, there should be clear guidelines for the FSA to share the relevant information with other SNPs. Steps must also be taken to ensure that the FSA is obliged to supply the required information within a specified period of time.
- The FSCS may from time-to-time need to supplement information provided by the FSA with certain specific information obtained directly from the member banks – for example, the level of deposits held for premium assessment and information on specific products and their insurability. Therefore the necessary arrangements must be put in place to facilitate the FSCS gaining access to such supplemental information without difficulty.
- Rules regarding the confidentiality of information exchanged between safety net participants must be set out and enforced under law

The interrelationship between the Malaysia Deposit Insurance Corporation and Bank Negara Malaysia is an excellent model of cooperation that is worthy of consideration by the Authorities. The co-operation between the key safety net players reflects well on the Malaysian financial system and is a good practice of how supervisors and deposit insurers can complement each other in striving to promote financial stability (see Annex A).

### ***What additional functions would be performed by the FSCS?***

The FSCS should be given a broader mandate to contribute to financial system stability. It should be able to assess and address the risks posed by member institutions in an ongoing state of readiness. Assessing risk can minimize exposure to loss by undertaking peer group analysis, working closely with the FSA in monitoring high risk institutions, developing risk profiles on member institutions, and establishing tax-deductible risk-based premiums. In achieving and then maintaining an ongoing state of readiness, the FSCS would capitalise on the lessons learned from the Northern Rock case, undertake contingency planning exercises, and review and incorporate “best practices” deployed in other jurisdictions. Overlap with the FSA would be kept to an absolute minimum through a Strategic Alliance Agreement.

## **Part 2 Enhancing Consumer Confidence – Helping the Public Understand the Benefits and Limitations of the Protection Provided by the FSCS**

This Part addresses the proposals in Chapter 5 aimed at improving consumer confidence in the UK financial system. Specifically, the Authorities wish to increase consumer awareness of the FSCS. The questions set for Consultation are: 5.1 How would a higher compensation limit affect consumer confidence? 5.2 How would a higher compensation limit affect the responsibility consumers have for their financial choices and 5.3 How would a higher compensation limit for deposits affect consumer perception of other financial products?

### ***Discussion, Analysis and Advice***

#### *Overview*

As a principle, an explicit system should protect depositors only within defined limits against the consequences associated with a bank failure. But, it should not be designed to protect banks from failing. Rather, it should limit the government's fiscal exposure since banks pay the cost of the system and it also reduces the political risks of allowing banks to fail. It can also contribute to the maintenance of confidence and reduce the likelihood of bank runs. To be effective, an explicit system needs to be clearly understood by the public, the organization responsible for delivery of the program needs a clear mandate to reinforce the stability of the financial system and to contribute to its own sound governance and greater accountability. An explicit system also requires the powers to fulfil the mandate.

Deposit insurance *per se* is not a route to greater financial stability nor is it the 'mother of all evils'<sup>13</sup>. But carefully designed, tailored to the environment in which it operates and supported by a strong business environment it can offer an important supporting role. "An effective deposit insurance system needs to be properly designed, well implemented and understood by the public in order to be credible. It also needs to be supported by strong prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws' (Financial Stability Forum, 2001a)". A closer look at deposit insurance systems around the world reveals that there is no single approach that has been universally applied. Recent work by the International Association of Deposit Insurers finds that the types of deposit insurers range from simple 'pay boxes' to 'risk minimisers', who have an active duty to manage the system according specific criteria, and everything in between (INSOL INTERNATIONAL, 2005).

The Financial Stability Forum's (2001a) Working Group Report cites four reasons in support of deposit insurance. The first relates to uncertainty regarding the cost of bank failures. The second and third relate to shortcomings in implicit insurance – namely uncertainty and inequities. Alternatively, these can be expressed as positives, namely that *explicit* deposit insurance clarifies the obligations of the insurer and limits the scope for discretionary decisions that may result in arbitrary actions. The fourth reason is that an explicit system provides a basis for a pre-determined contingency plan that more clearly defines the role and extent of Government support in the resolution of bank failures. The achievement of this last objective does not in itself require the creation of a deposit insurance system, but the creation of such a system does render clarity of role and extent of government support an essential prerequisite.

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<sup>13</sup> Sabourin, JP, Chairman of the FSF Working Group on Deposit Insurance, Presentation at the Outreach Session, Kuala Lumpur, January 2001

Mayes and LaBrosse (2007) note that there are at least six functions that should be in place for a system to offer a credible approach to maintaining financial stability:

- Regulation to ensure a set of standards for prudential behaviour and conduct of business
- Supervision and monitoring of individual institutions to ensure compliance with the standards and to help institutions develop their risk management
- Oversight of the financial system as a whole to help in the identification of system wide risks, whether from its structure, regulation or external shocks
- A means of providing emergency support should there be a crisis or sudden lack of liquidity for the system or specific solvent institutions
- A means of handling troubled institutions effectively so that their problems do not spill over into the system as a whole
- A means of protecting small depositors so that they have confidence in the banking system and can have continuing access to their funds.

### *Analysis*

The advice in this part centres on the means to enhance consumer confidence. In order for a deposit insurance system to achieve its public policy objectives effectively, it is essential that the public be regularly informed about the benefits, and limitations, of depositor protection arrangements. IADI has shown that a successful public awareness program can promote and facilitate an understanding of the deposit insurance system and its main features and it can convey accurate messages and build credibility with depositors. Otherwise, a lack of confidence and understanding on these systems can amplify the likelihood that depositors will withdraw their funds when problems develop in a bank.

Financial system stability is a key issue contributing directly to economic growth and development. An effective deposit insurance system is one of the pillars supporting a sound financial system and it reinforces public confidence. Public awareness about deposit insurance – its existence and how it works – plays a significant role in underpinning a sound deposit insurance system.

### *IADI Core Principle*

The Authorities are advised to pay particular attention to another one of the Core Principles advanced by IADI.

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

Based on the experiences of IADI members, the guidance paper considers the design features of a comprehensive public awareness program. The design features strive to address questions such as:

- What information should be conveyed to target audiences?
- Which communication tools are the most effective and practical?
- What specific scenarios (such as failures of member institution) must be considered while planning public awareness activities?
- How should branding take place?

That paper also examined other matters, including the role that should be played by the deposit insurer with regard to consumer protection and its responsibility to promote public awareness.

The following points summarize the policies that should be adopted by the UK Authorities:

- Public awareness about deposit insurance is crucial. The FSCS should be given a clear mandate to promote public awareness about the deposit protection system on an ongoing basis.
- The major objectives of the program should be to enhance the effectiveness of the UK system through public education and 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 of the FSCS.

There are a number of other important considerations:

The FSCS needs to identify clearly the principal target audience groups and sub-groups

- The FSCS needs to integrate information that may affect depositors' savings in a public awareness program.
- The FSCS needs to employ a wide variety of tools and channels of communication, wherever possible, to ensure that the messages are conveyed to the target audience.<sup>14</sup>
- The FSCS needs to make budget allocations to build/maintain the desired level of public awareness knowledge on deposit insurance among the target audience.
- The FSCS needs to engage an external professional public relations firm and obtain branding expertise to maximize the effectiveness of the public awareness program and to supplement the internal expertise of the deposit insurer.

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<sup>14</sup> Publishing pamphlets or booklets for making the public aware of the terms and conditions of deposit insurance coverage can be useful tools in fulfilling the objectives of public awareness program. See Garcia, Gillian G., 2000, "Deposit Insurance: Actual and Good Practices", IMF Occasional Paper No.197.

- The FSCS needs to conduct a regular, independent evaluation of awareness levels.
- The FSCS needs to develop a public awareness program for crises management in advance to address potential crises.
- The FSCS needs to require member institutions by law to promote information about depositor protection.
- The FSCS needs to develop strategic partnerships of public awareness programs with the FSA and the Bank of England to ensure consistency in the information provided and maximize the synergies.

### **What are the public awareness activities undertaken by leading deposit insurance organizations?**

Canada Deposit Insurance Corporation has developed a highly sophisticated public awareness program. It contains the following elements:

- It is a multi-year program which includes conducting research to determine the expectations and understanding of deposit insurance coverage.
- Delivering information through television advertising campaigns.
- Conducting public relations and media relations.
- Operating a call centre.
- Strengthening partnerships with consumer groups, financial associations and member institutions.
- Participating in trade shows focused on financial products.

Over a four-year period, awareness among Canadians of deposit protection increased from 47 per cent to 64 per cent. Knowledge of the insurance limit over the same period increased from 23 per cent to 32 per cent. In fact, awareness of deposit insurance in 2005/06 reached its highest level since the last member institution failed in 1996<sup>15</sup>.

### **Part 3 Conclusions**

The Authorities have taken a major step forward in addressing financial stability and strengthening depositor protection in the UK. Most certainly, the Consultation Paper has “asked all the right questions” and it is instructive that responses are being sought from domestic as well as international perspectives.

This Submission provides advice in two important policy areas. The first concerns the need to mandate the FSCS with new responsibilities to provide depositor protection. The FSCS should become an operationally independent agency with statutory responsibilities as a risk-minimiser. It would be mandated to undertake early interventions, set tax-deductible differential premiums in advance based on the risk profiles of its members, and implement a special resolution regime for failed banks. The FSCS should be supported by a new arrangement with the FSA through a strategic alliance. In time, the new arrangements related to depositor protection could be extended to other financial products covered by the Financial Services Markets Act 2000.

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<sup>15</sup> Canada Deposit Insurance Corporation, 2004 Annual Report, Contributing to Stability.

The second area of this Submission provides recommendations on ways to improve the public's knowledge, understanding and expectations of the depositor protection arrangements in the UK.

IADI has just released Core Principles for effective deposit insurance systems. This Submission has drawn on three of the twenty-one Core Principles. The Authorities will be better able to meet their objectives of capturing the benefits of a deposit insurance system that contributes to financial stability if the advice contained in this submission is followed. It is also recommended that an evaluation of the proposed UK framework be undertaken through an assessment against all of the twenty-one IADI Core Principles.

## Annex A

### The Malaysian Approach

Promoting the stability of the financial system is a key objective of safety net participants in Malaysia. Explicit depositor protection was put into place in September 2005 following the passage of the Malaysia Deposit Insurance Corporation (MDIC) Act. Bank Negara Malaysia (BNM) continues to play the role of primary financial regulator and supervisor. As such, the Central Bank is an important strategic partner of MDIC since BNM has the authority to access information on member institutions which MDIC mostly relies on when providing an objective risk assessment of member institutions for BNM.

The conduct of the relationship between MDIC and BNM is set out in the legislation.<sup>16</sup> The MDIC Act underscores the need for close relationship between the two agencies and specifically enables MDIC to enter into a **Strategic Alliance Agreement (SAA)** with BNM to promote financial system stability. In this regard, MDIC and BNM entered into a SAA on 19 June 2006 as a means to formalise the coordination of actions and information sharing between the two organizations.

### Philosophy and Guiding Principles

The SAA recognises that although MDIC and BNM have distinct and separate mandates and responsibilities, both of them are integral regulatory agencies that have a common primary objective i.e. promoting financial system stability in Malaysia. Both agencies are confident that this objective is best achieved if they work closely in a spirit of co-operation and goodwill.

To reflect their commitment, the agencies have adopted the philosophy to “cooperate and exchange information in furtherance of the Act”. This philosophy is highly important from a governance perspective as it sets the tone for the management and conduct of the SAA.<sup>17</sup>

Under the SAA, both agencies agree to support, complement and work together, having mutual respect for their roles, responsibilities and accountabilities since a collaborative working relationship promotes and enhances the stability of financial system. The agencies have adopted four guiding principles aimed at supporting long-term and sustainable co-operation:

- Transparency and openness in dealing with issues;
- Respect for the independence and accountability of each agency’s scope of work within their mandates;
- Timely and up-to-date communication and exchange of information; and
- Mutual respect and acceptance of the diversity of experience and skills of each agency when addressing issues raised by either agency.

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<sup>16</sup> The conduct of relationship means the manner in which both agencies interact and manage their relationship including information sharing and their coordination of actions.

<sup>17</sup> In particular, from a governance perspective, this philosophy from the top management of BNM and PIDM guides the spirit of information sharing and coordination of actions between the employees of the two agencies.

## Salient Features of the Malaysian SAA

The SAA formalises a co-operation arrangement between MDIC and BNM in order for them to carry out their mandates effectively and efficiently. It is composed of two parts i.e. the main agreement and separate appendices. The main agreement sets out the purpose, common objective, underlying philosophy, guiding principles governing interrelationship and nine areas of cooperation. The areas of cooperation include: the exchange of up-to-date information on the financial system and member institutions, including emerging threats to the banking system; cooperation and consultation on new regulations and other policy initiatives relating to member institutions; the development of an early warning system; development and implementation of prompt corrective measures, intervention framework and incentives to promote sound risk management; resource sharing whereby certain services are outsourced to BNM so as to enable MDIC to concentrate on its core functions in an effective and efficient manner.

The appendices of the SAA set out the framework and elements of areas of cooperation specified in the main agreement. The SAA is designed to flexibly meet the needs of both agencies with no amendment in the main agreement. Hence, appendices can be added on or amended from time-to-time in accordance with the evolving needs of both agencies.

Currently, the SAA has two appendices which cover: (1) exchange of supervisory information; and (2) outsourcing of selected services by MDIC to BNM.<sup>18</sup> The appendix on information sharing sets out the framework as well as a detailed list of information to be provided by BNM to enable MDIC to perform the ongoing risk assessment of its member institutions. The information to be shared between the agencies includes:

- Information on new licenses and mergers and acquisitions;
- On-line access to information regarding member institutions as contained in BNM's databases and systems;
- Information on significant large borrowers which pose a threat to the financial system or member institutions;
- Watch-list member institutions and specific information on the areas of concern of such member institutions;
- Consultation and collaboration on prompt corrective measures or supervisory actions prior to imposition on member institutions; and
- Examination reports, including onsite and offsite information.

On failure resolution, the appendices note that MDIC can require relevant information to BNM, specifically BNM's assessment basis on which a non-viability determination has been established in order for MDIC to determine the least cost resolution option. It is important to note that MDIC and BNM are still working out the non-viability criteria.

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<sup>18</sup> On the matter of outsourcing, this constitutes one of the areas of cooperation between the two agencies whereby resources are shared, based on the strategic and long-term benefits and values for each agency. For this purpose, the SAA sets out for BNM to provide selected services to MDIC to enable it to concentrate on its core functions in an effective and efficient manner. Other areas of mutual interest include opportunities for inter-placement of employees between the two agencies.

The SAA also provides the agencies with novel ways to minimise conflicts through regular meetings and assessment reviews of employees responsible for implementing the SAA. When conflicts do occur, a Liaison Committee under the SAA is mandated to find a solution.

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