

POWERS

Abstract

As a preliminary matter, a deposit insurer needs only those powers and authorities necessary to fulfil its public-policy objectives effectively. Consequently, one must first determine the specific mandate, roles and responsibilities of the organisation responsible for deposit insurance. Is the deposit insurer's role limited to reimbursing depositors after an insured institution is closed or does it have a broader function? If it has a broader function, does it include intervention and resolution responsibilities, or the liquidation of assets of failed institutions? Finally, is the deposit insurer charged with directly supervising or regulating the institutions that it insures, or does it have some input into the supervisory and regulatory processes? These questions must be answered before it is possible to determine the necessary powers for a deposit insurer to operate effectively. In addition, it is necessary to consider the assigned responsibilities of other safety-net participants so as to avoid overlapping or conflicting responsibilities.

This paper discusses those powers that are necessary for a deposit insurer to fulfil its public-policy objectives. In addition, the paper discusses the fundamental powers related to deposit insurance systems and examines factors and considerations that can influence decisions on the granting of specific powers to deposit insurers. The full panoply of powers that can be provided to deposit insurers will be explored briefly.

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As a preliminary matter, a deposit insurer needs only those powers and authorities necessary to fulfil its public-policy objectives effectively. Consequently, one must first determine the specific mandate, roles and responsibilities of the organisation responsible for deposit insurance.¹ Is the deposit insurer's role limited to reimbursing depositors after an insured institution is closed by the supervisory authorities or does it have a broader function? If it has a broader function, does it include intervention and resolution responsibilities, or the liquidation of assets of failed institutions? Finally, does the deposit insurer directly supervise or regulate the institutions that it insures, or does it have some input into the supervisory and regulatory processes? These questions must be answered before determining the powers necessary for a deposit insurer to operate effectively. It also is necessary to consider the assigned responsibilities of other safety-net participants so as to avoid overlapping or conflicting responsibilities.

This paper, which was prepared by the Subgroup on Powers,² discusses those powers that are necessary for a deposit insurer to fulfil its public-policy objectives effectively. It examines the factors and considerations that can influence decisions on the granting of specific powers to deposit insurers. The full panoply of powers that can be provided to deposit insurers will be explored briefly. Much of the material presented here is covered in greater detail in the other papers prepared by the Working Group on Deposit Insurance; where appropriate, those papers are cross-referenced.

Basic Powers and Legal Authorities

The responsibilities and associated powers of deposit insurers vary greatly and depend, to a large extent, on the public-policy objectives established for them by law or contract. Some deposit insurers serve only to reimburse depositors once an insured institution has been closed ("paybox" systems), while others serve as the receiver and liquidator of the assets of failed institutions. Still others have the role of minimising risk to the deposit insurer ("risk minimisers") and, in a few cases, some directly supervise the institutions they insure. As a result, there is no single set of optimal powers or authorities suitable for all deposit insurers.

At a minimum, however, all deposit insurers need certain basic powers and legal authorities to ensure that they can meet their obligations to depositors in a timely fashion and thus help to maintain public confidence in the financial system. A paybox system requires appropriate authority, including, access to deposit information and access to funding, for efficient reimbursement of depositors when an institution fails. In addition to these authorities, a risk minimiser requires the authority to gather information—either directly from insured institutions or from the supervisory authority—to assess risks, the authority to limit risks through various

¹ See discussion of the varying mandates, roles and responsibilities of deposit insurers in the paper on structure and organisation.

² The Subgroup on Powers is comprised of representatives from the United States (coordinator), Argentina, France, Hungary, Italy, Japan, and the International Monetary Fund. Members of the Subgroup contributed information on their deposit insurance systems for this paper.

means, and the flexibility to access needed funding sources. These authorities may be exercised by the deposit insurer directly, or, alternatively, mechanisms may be instituted to ensure that the supervisor is responsive to the deposit insurer's needs.

Operational issues

Organisational structure

Regardless of the scope of a deposit insurer's responsibilities, there are certain fundamental operational issues that must be addressed in any law creating a deposit insurer. First, it must be determined whether the deposit insurer should be established as a separate governmental entity, a department of another government entity, a private entity with government backing, or as a completely private entity. In determining the entity's basic structure, it is important to maintain an appropriate balance between the need for the deposit insurer to be independent and for the insurer to be accountable for its actions. Second, it is important to stipulate the duties and responsibilities of the deposit insurer *vis-a-vis* the central bank and any other financial institution supervisors or regulators. Particularly in times of crisis, it is essential that the roles and responsibilities of all parties be clearly defined to avoid misunderstandings and duplicative efforts on the part of officials responsible for the financial sector.³

Operating procedures

As a basic operating guide, the deposit insurer may consider developing bylaws or some similar document to specify its corporate governance rules clearly. Such a document should specify the manner in which the deposit insurer's general business will be conducted and how the authorities granted to it by law may be exercised.

Operating powers

In order to function efficiently and effectively, a deposit insurer must be vested with certain legal authorities. The deposit insurer should have the ability to employ staff on a permanent and temporary basis so that it can adjust staffing levels quickly to address rapid changes in the level of failures of insured institutions. Another issue is whether the employees of the deposit insurer should be held personally liable for the results of their official actions. Holding employees personally liable for their official actions may cause the employees to be reluctant to perform their official duties. Therefore, some deposit insurance schemes provide indemnification for their employees.

In addition, the ability to enter into contracts to obtain goods and services is an essential power that should be vested in the deposit insurer. Undue restrictions on a deposit insurer's ability to enter into contracts can make it difficult for the deposit insurer to fulfil its responsibilities properly. Finally, the law creating the insurer should specify whether the deposit insurer can sue and be sued on its own behalf. This is a fundamental power that can be used to protect the interests of the deposit insurer.

³ See paper on structure and organisation.

Powers needed to perform the basic deposit insurance function

Control over entry and exit

In setting up a deposit insurance system, it is necessary to determine what types of institutions should be insured.⁴ That determination must be made after taking into account the types of existing institutions and considering the objectives of the deposit insurance system. In addition, the rules for entry and exit should be clear and transparent and should establish eligibility criteria for deposit insurance.

In a paybox system, decisions regarding membership in the deposit insurance scheme usually are made solely by the financial supervisory authority. In a risk-minimising system, the deposit insurer should have a role in determining which institutions are insured since the deposit insurance system bears the risk of loss when a member institution fails. A number of countries require that applications for deposit insurance be filed concurrently with the primary supervisor and the deposit insurer. Thus, institutions cannot gain deposit insurance without the approval of both entities. Alternatively, some countries require that the primary supervisor provide copies of the relevant application materials to the deposit insurer. The deposit insurer is then permitted to add its input to the application process.

In order to maintain a high level of confidence in the deposit insurance system, the rules for closing an insured institution also should be clearly specified to avoid confusion over who has the authority to act. However, consideration should be given to providing the deposit insurer with the opportunity to provide input into the decision-making process. In many countries the primary supervisor has the sole power to close an insured institution.⁵ In some countries, the decision to close an institution is subject to judicial review, either before an institution can be closed or subsequent to the institution being closed.

As an alternative to providing the deposit insurer with the opportunity to provide input into the decision-making process on bank closings, the deposit insurer could be permitted to terminate an institution's deposit insurance. In some countries, where authorities have been slow or reluctant to close insolvent institutions, the ultimate costs to the deposit insurance system have been quite high. Granting the deposit insurer the power to terminate deposit insurance independently may facilitate timely closure and reduce costs to the insurance fund. Termination of insurance does not always cause an institution to lose its license or charter to operate. In countries where an institution can continue to operate without deposit insurance, it is important to specify a process for phasing out deposit insurance and informing depositors about the status of the institution, so as to protect them from potential losses.

⁴ Many different types of companies act as financial intermediaries throughout the world, including banks, savings associations, credit unions, finance companies, industrial loan companies, and postal savings institutions, among others. This issue is covered in the paper on membership.

⁵ In 1991, in the United States, the U.S. Congress granted the deposit insurer independent authority to close any insured institution when certain conditions, as specified in the law, are satisfied. However, this authority is expected to be used rarely and only in very unusual circumstances.

Funding

In order to reimburse depositors and cover its day-to-day operating expenses, every deposit insurer needs the authority to obtain adequate funding, regardless of whether there is an existing insurance fund or an *ex-post* funding scheme.⁶ In addition, ancillary sources of funding must be identified as insurance losses quickly can exceed available funds. In these cases, it is important that the deposit insurer have the authority to obtain additional resources quickly in order to maintain public confidence.

In some countries, the deposit insurer has the authority to determine the appropriate regular and special assessment amounts collected from insured institutions, while in other countries, the primary supervisor either determines those amounts or approves the amounts proposed by the deposit insurer. In collecting assessments, the deposit insurer should be granted broad authority to determine the manner and means of collection, which may include determining the frequency of payments. Although the base upon which the assessment is levied and the rate to be applied may be specified in the law, there are often many practical issues about how the actual amounts are to be collected and the deposit insurer generally would be in the best position to make the necessary determinations. If an insured institution should fail to make a required payment, either by nonpayment or underpaying the amount due, the deposit insurer or the primary supervisory authority should have the legal authority to pursue payment by the institution.

If there is no deposit insurance fund, then the deposit insurer needs a mechanism by which it can obtain funds in order to facilitate the timely reimbursement of depositors at failed institutions. In addition, at some point there is a limit to the amount of money that insured institutions reasonably can be expected to contribute without causing additional insolvencies and burdening the deposit insurance system. Thus, the deposit insurer should have the authority to borrow funds when necessary to cover its expenses and meet its obligations. Possible sources for borrowing funds include the government, the central bank, private banks and the capital markets. It is often deemed prudent to place limits on such borrowings and to specify in the law the terms and conditions under which funds can be borrowed. If there is a government guarantee that stands behind the deposit insurer, then the procedures for invoking that guarantee should be clear to prevent uncertainty.

Managing a fund

If there is an insurance fund, then it is necessary to determine how the fund can be invested. Many countries limit the investment authority of the deposit insurer. Generally, the requirement is to invest in only the safest and most highly liquid instruments to ensure that funds are available to fulfil the deposit insurer's responsibilities.

⁶ For a full discussion of this issue, see the paper on funding.

Reimbursement

The most basic and common function of deposit insurers around the world is to reimburse depositors for losses they would otherwise suffer when an insured institution is closed.⁷ The law creating the deposit insurance system should specify the amount of insurance coverage provided for each depositor, who is eligible for deposit insurance, and the types of bank liabilities that are to be covered by the scheme. The deposit insurer should have broad authority to administer the deposit insurance rules. In order to perform the reimbursement function quickly and efficiently, the deposit insurer should be able to perform the payout function through various means such as cash disbursements, checks, electronic transfers, or other means, as appropriate.

Information requirements

The type and amount of information required by a deposit insurer to fulfil its mandate is directly related to the scope of the insurer's responsibilities. In the simplest case—that of a paybox system—the insurer needs to have access to the names and deposit account balances of all depositors in the insured institution before it can reimburse depositors. This information should be provided as of the date and time of failure and should include information about transactions that occurred before the failure, but which were not included in the account balances. Information may come from the institution itself or from the primary supervisor. It is often easier and more efficient to convey the information in an electronic format. That information should be obtained as quickly as possible from the failed institution to enable the deposit insurer to begin the deposit payout.

As the scope of the deposit insurer's responsibilities is broadened—for example, if it is responsible for setting assessments—it will need additional powers. In order to determine the appropriate assessment amounts, the deposit insurer must have the information necessary to calculate the assessments. In a number of countries, assessments are calculated on the basis of an institution's total deposits, total insured deposits, or total assets, and may vary with an institution's risk. The deposit insurer must have the ability to obtain that information, on a regular and timely basis, either from the insured institutions directly or from the supervisory authority. In addition, the deposit insurer should have the ability to verify the information. This can be done through either targeted or random audits performed by the deposit insurer, the primary supervisor or an outside audit firm.

If the deposit insurer is involved in resolving failed institutions, then it must have detailed and accurate information not only about the institution's deposit liabilities, but also about its assets. This information could come from either the institution itself or through the primary supervisor. The insurer also needs the best possible information about potential acquirers of the institution so that only those entities that have the requisite financial resources and qualified management can acquire failed institutions. Finally, the deposit insurer needs information about contractual obligations, other agreements, and potential litigation to estimate least-cost solutions.

⁷ See the paper on reimbursing depositors for a full discussion of the conditions necessary to establish an efficient reimbursement process.

Deposit insurers that also act as receivers or liquidators of failed institutions need even more detailed information about the assets and liabilities of the institutions under their control to manage the receiverships properly. In addition, the deposit insurer would have to be aware of all contractual obligations and other agreements of the failed institution as well as any pending litigation. In such cases, the deposit insurer often succeeds to the rights, titles, powers and privileges of the insured institution and therefore must carefully identify every obligation and all of the rights and interests that the insured institution had before it failed.

In addition to the powers discussed above, deposit insurers that have supervisory and/or regulatory responsibilities have expanded information needs, including specific information about each individual institution as well as industry and macroeconomic data. Such information can enable the deposit insurer to spot trends and anticipate problem areas before they develop into substantial losses. All information should be current and specific.

Additional Powers and Authorities

Intervention

Often when the financial condition of an insured institution begins to deteriorate there are steps that can be taken to try to prevent or limit its further deterioration.⁸ Such steps may prevent the failure of the institution or can limit the losses to the insurance system should the institution fail. In most countries, these actions generally are taken by the primary supervisor of the insured institution. However, if the deposit insurer has broad responsibilities, then, as the entity most directly concerned with limiting losses to the insurance system, it should be granted the authority—either indirectly or directly—to participate in an intervention involving a troubled insured institution. For example, if the deposit insurer has no supervisory or regulatory responsibilities, it could be granted the authority to make recommendations to the primary supervisor. By contrast, if the deposit insurer is involved actively in the supervision and regulation of insured institutions, it could be granted independent authority to take appropriate actions against the insured institutions to prevent or limit losses to the insurance system. A middle ground would be to allow the deposit insurer to take such actions with the consent of the primary supervisor.

A number of countries have adopted, or are considering adopting, certain corrective measures that automatically take effect as the condition of an insured institution deteriorates.⁹ Such measures, frequently known as "prompt corrective action," become progressively more severe as the condition of the institution continues to deteriorate. Although the use of automatic corrective measures tends to limit the flexibility to intervene in a troubled institution, they can limit losses to the insurance system.

Another issue that should be considered carefully in establishing any deposit insurance scheme is whether, and under what circumstances, the deposit insurer should intervene or participate in the

⁸ Examples of such steps include setting restrictions on asset growth and payment of dividends, and requiring changes in management or additional capital.

⁹ Such corrective measures can include provisions that prevent institutions from taking certain actions without the express consent of the supervisor or the deposit insurer.

restructuring of a troubled institution. In some circumstances, it may be desirable to restructure a troubled institution with direct financial assistance from the deposit insurer in order to prevent the institution from failing. Such financial assistance might take the form of loans or loan guarantees from the deposit insurer to the troubled institution. Alternatively, the deposit insurer could be granted the authority to make direct equity investments in an insured institution that is in need of financial assistance. If the deposit insurer is a government agency, such assistance could be viewed as the government assisting one private-sector enterprise at the expense of others and spreading protection beyond deposits. Moreover, the deposit insurer may find it difficult subsequently to determine the best possible time and price at which to sell the equity investment, assuming the institution recovers.

Resolutions

If the deposit insurer has responsibility for arranging resolution transactions, it will need a number of powers in addition to the information requirements discussed above.¹⁰ Specifically, it will need the legal authority to engage in the most appropriate resolution method, including implementing purchase-and-assumption transactions, establishing bridge banks, and facilitating open-bank assistance. Since every financial institution is different, the deposit insurer should be granted considerable flexibility in structuring resolution transactions. Ideally, in such cases, the deposit insurer should be granted on-site access to the records of the failing institution before its closure so that the deposit insurer can become familiar with, and properly estimate the value of, the assets and liabilities involved.

Receivership and liquidation

A deposit insurer that has responsibility for serving as a receiver or liquidator of a failed institution has a fiduciary duty to try to obtain as much value as possible from that institution. In order to maximise recoveries on claims held in a failed institution, a deposit insurer needs broad authority to acquire, manage and dispose of assets. In these cases, the deposit insurer should have the authority to collect all obligations due to the failed institution, sell or otherwise dispose of its assets, administer the claims notification and review and determination process, and deal with all contractual obligations and pending litigation. In order to accomplish this, the law should provide that the deposit insurer succeeds to all of the rights, titles, powers and privileges of the institution. The deposit insurer also should be able to hire outside experts whenever it lacks the expertise or resources to manage or dispose of assets properly or otherwise carry out its responsibilities as a receiver or liquidator.

Supervision and regulation

Few deposit insurers have direct supervisory and regulatory responsibilities over insured institutions, although some have input into the supervisory process. If, however, such responsibility is vested in the deposit insurer, then it will need to have the authority to set and enforce standards through regulations, policy statements, guidelines and other similar pronouncements for the institutions it insures. Examples of such standards include minimum

¹⁰ In some countries, the deposit insurer is required to select the least-costly transaction method for resolving failed or failing institutions so as to minimise the losses to the insurance system.

capital standards, limitations on loans to insiders, internal or external audit requirements, as well as other prudential standards to maintain the safety and soundness of insured institutions. In order to supervise insured institutions properly, the deposit insurer should have the authority to request and obtain detailed and timely information on any aspect of their operations through either regular or special examinations or audits as well as from reports filed by the institutions.

A deposit insurer that serves as a supervisor and regulator of insured institutions must have sufficient authority to enforce any rules setting forth standards for insured institutions. For instance, if an institution does not meet its minimum capital requirements or fails to provide information requested promptly, the deposit insurer must have an adequate mechanism to force compliance. This could be accomplished through an informal administrative proceeding or through a more formal judicial proceeding, although the latter is usually more time-consuming and expensive. Vesting the deposit insurer with the authority to impose monetary penalties, or to remove directors and officers of an insured institution, under certain circumstances, may provide adequate incentives for institutions to comply with any rules or directives issued by the deposit insurer.

Conclusions

A deposit insurer must be vested with adequate powers and sufficient legal authority to fulfil its public-policy objectives. There are certain basic powers and legal authorities that all deposit insurers need to ensure that they can meet their obligations to depositors in a timely fashion and thus help maintain public confidence. Beyond these, a deposit insurer needs all of the powers and legal authorities required to meet its assigned responsibilities efficiently and effectively.

As noted above, deposit insurers have widely varying mandates and responsibilities. Consequently, there is no single set of optimal powers or authorities for all deposit insurers. Deposit insurers that function as paybox systems do not need extensive powers. By contrast, deposit insurers that directly supervise and regulate the institutions they insure need a wide range of powers. Between these extremes are deposit insurers that participate in the resolution process and/or serve as the receiver and liquidator of the assets of failed institutions. To perform these functions effectively, deposit insurers need more powers than those of a paybox system, but fewer than those of a full-fledged bank supervisor or regulator. Providing the optimal legal framework and powers for a new deposit insurer will help to ensure the stability of a country's financial system.