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Governance of Deposit Insurance Systems

Guidance Paper

**Prepared by the Research and Guidance Committee
International Association of Deposit Insurers**

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I. Executive Summary

The mission of the International Association of Deposit Insurers (IADI) is to contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation. Its vision is to share its deposit insurance expertise with the world. As part of its work, the IADI undertakes research and consults widely to provide guidance on deposit insurance matters. IADI guidance is designed for deposit insurance practitioners and other interested parties, and is based on the judgment of IADI members, associates, and observers.

Governance generally refers to the processes, structures, and information used in directing and overseeing the management of an organization. It concerns the relationship between the deposit insurance system and the authority from which it receives its mandate or to which it is accountable. A sound governance framework is a critical component of an effective deposit insurance system. The key elements of such a framework are (1) operational independence, (2) accountability, (3) integrity, and (4) transparency and disclosure. All are equally important, and they reinforce each other in supporting sound governance.

Following extensive research and public consultation the IADI has developed the following guidance should be adopted to enhance the sound governance of deposit insurance systems.¹ The following core principles and supporting guidance points are reflective of and adaptable to a broad range of differing country circumstances and settings. It is intended as a voluntary framework and national authorities are free to put in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions.²

¹ The guidance was developed from the work of the IADI Subcommittee on Developing Guidance for Governance of Deposit Insurance Systems. The Subcommittee was comprised of deposit insurers from Canada (chair), France, Japan, Malaysia, Mexico, Turkey, the United States, and Uruguay. Additional submissions were gratefully received from the Deposit Insurance Agency of Russia (DIAR) and Fondo de Garantía de Depósitos (FOGADE) of Nicaragua. Comments were also received from Stefan Ingves, governor of the Sveriges Riksbank, and from attendees at the IADI Fifth Annual Conference, November 15–17, 2006, in Rio de Janeiro. The subcommittee's discussion paper can be found at: www.iadi.org

² For more information on the development of IADI guidance refer to: Strategic Plan for the Development and Promotion of IADI Research, Guidance and Core Principles, International Association of Deposit Insurers, Basel 2008: www.iadi.org

Core Principle: Governance

The sound governance of agencies comprising the financial system safety net strengthens the financial system's architecture and contributes directly to system stability. 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.

The deposit insurance system should have a governing body and the governing body should be held accountable to the authority from which the deposit insurance system receives its mandate. The deposit insurance system should be structured such that the potential for undue political and industry influence and conflicts of interest respecting members of the governing body and management is minimized.³

Supporting Guidance Points

1. The mandate and responsibilities of a deposit insurance system should be clearly defined, preferably in legislation.
2. Governing body members, senior officers, and employees of a deposit insurance system should be subject to laws or codes regarding conflict of interest and ethical behavior.
3. A deposit insurer should consider maintaining a profile of desired skills for its senior executives and governing body members and for those persons to be appointed on the basis of competence and skill.
4. It is an effective practice for the governing body of a deposit insurance system to conduct meaningful self-assessments.
5. The governing body should set strategic direction of the deposit insurance system and for management to carry it out.
6. The governing body should have a charter or policy in place that lays out its responsibilities.
7. The governing body members, senior officers, and employees of a deposit insurance system should be provided with legal protection for decisions made, omissions, and actions taken in good faith while discharging the mandate of the system.

³ See IADI Core Principles for Effective Deposit Insurance Systems, Principle #5, International Association of Deposit Insurers, Basel 2008: www.iadi.org

8. The deposit insurance system should be subject to regular external audits and examinations and for those audits and examinations to be made public. It is a beneficial practice for a deposit insurer to subject its daily operations to internal audits and for the internal audit function to report to the governing body.

9. A deposit insurer should be as transparent as possible and should disclose appropriate information on its activities, governance practices, structure, and financial results.

II. Introduction and Purpose

The International Association of Deposit Insurers (IADI) was established in 2002 to “contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation.” As part of its work, IADI undertakes research to suggest guidance on deposit insurance issues.

This paper reviews the governance frameworks used by deposit insurers and, where appropriate, suggests guidance in the form of core principles and effective practices to enhance the sound governance of deposit insurance systems.⁴

A. Definitions and Key Elements

Governance generally refers to the processes, structures, and information used in directing and overseeing the management of an organization. It also concerns the relationship between the deposit insurance system and the authority from which it receives its mandate or to which it is accountable. A sound governance framework is a critical component of an effective deposit insurance system. The key elements of such a framework are (1) operational independence, (2) accountability, (3) integrity, and (4) transparency and disclosure. All are equally important, and they reinforce each other in supporting sound governance.

- **Operational independence** is the ability of an organization to use the powers and means assigned to it without undue influence from external parties. However, an organization that is operationally independent does not control its objectives and mandate; these are set by a higher

⁴ The members of the IADI Subcommittee on Developing Guidance for Governance of Deposit Insurance Systems are Canada (chairperson), France, Japan, Malaysia, Mexico, Turkey, the United States, and Uruguay. Additional submissions were gratefully received from the Deposit Insurance Agency of Russia (DIAR) and Fondo de Garantía de Depósitos (FOGADE) of Nicaragua. Comments were also received from Stefan Ingves, governor of the Sveriges Riksbank, and from attendees at the IADI Fifth Annual Conference, November 15–17, 2006, in Rio de Janeiro.

authority.⁵ The greater the degree of operational independence a deposit insurer has, the more effective it can be in fulfilling its mandate in a manner that minimizes potential conflicts.⁶

- **Accountability** means that individuals and organizations should be responsible for their actions and for fulfilling their objectives. A deposit insurer can promote accountability—and help reinforce its operational independence—by demonstrating that it is effective at meeting its mandate or acknowledging areas in which it could improve.
- **Integrity** refers to two concepts. The first is the principle that individuals should pursue the objectives of their organization without compromising them through their own or others' behavior or self-interest. Integrity ensures that individuals working for a deposit insurer follow appropriate standards of behavior and conflict of interest codes, and that the day-to-day operations of the insurer are subject to internal control and audit. Integrity is enhanced when directors, officers, and employees are legally protected in carrying out their duties and responsibilities in good faith. Second, integrity refers to the wholeness and soundness of an organization. The integrity of a deposit insurance system can be affected in many ways; for example, through the appointment of governing body members and management head, and through the terms of office and criteria for removal of those persons.
- **Transparency and disclosure:** Transparency is fostered when the actions and decisions of an organization, such as a deposit insurer, are revealed and clarified to its stakeholders. Disclosure refers to the release to stakeholders of information necessary for them to judge the effectiveness of the organization's conduct. Transparency and disclosure help reinforce accountability and integrity by making these elements of governance more visible to the public.⁷

B. Scope and Purpose

Just as the mandates, roles, and responsibilities of deposit insurers vary from one country to another, so too can governance structures. But whatever structure is chosen, all share certain common characteristics. All deposit insurance systems include some form of higher authority from which they receive their mandates or to which they are accountable; a governing body (e.g., board of directors or supervisory board, or even a department head); and a management team. All deposit insurance systems must uphold certain

⁵ It is crucial to differentiate between operational independence and goal independence. The latter exists when an organization has independent control over its objectives and mandate. Goal independence is, by definition, excluded for deposit insurance systems and other financial system safety net participants.

⁶ Ingves, 2004; Ingves and Quintyn, 2003.

⁷ Ingves and Quintyn, 2003.

responsibilities to depositors, member banks, and other relevant stakeholders.⁸ This paper considers (1) deposit insurance governance structures, (2) relationships, (3) the governing body and management, (4) audit and legal protection, and (5) transparency and disclosure.

The paper is written for deposit insurance practitioners and other interested parties. It is based on the judgment of IADI's members, associates, and observers. The paper draws on relevant academic literature available on the subject, as well as the work of international organizations such as the Organization for Economic Cooperation and Development (OECD).

Guidance is provided on practices that support the sound governance of deposit insurance systems—with particular emphasis on practices that strengthen accountability, integrity, operational independence, and transparency and disclosure. The guidance is intended to reflect and be adaptable to a broad range of circumstances, settings, and structures, taking into account the different types of deposit insurance systems that exist.

III. Governance Structures

Deposit insurance systems can be structured in a number of different ways. Many deposit insurers are structured as separate government agencies or state-owned enterprises, while others are structured as government departments or departments of central banks or supervisory authorities.⁹ Others still are run by the private sector, usually by industry associations of deposit-taking institutions. Whatever the governance structure, they all share a common framework that consists of (1) a higher authority from which the deposit insurer receives its mandate or other authority (e.g., legislature, ministry or treasury department, industry association) and to which it is accountable; (2) the presence of a governing body (e.g., board of directors or supervisory board); and (3) a management team.

Most deposit insurers are set up as separate legal entities that are publicly administered government agencies or state-owned enterprises.¹⁰ These systems (e.g., Canada, Japan, Malaysia, Mexico, and the United States) usually receive their mandate in the form of legislation.¹¹ Publicly

⁸ In this paper, the term “bank” refers to all institutions that accept deposits from the public.

⁹ According to the Canada Deposit Insurance Corporation (CDIC) International Deposit Insurance Survey, 2003; Demirgüç-Kunt, Kane, and Laeven, 2006; and Garcia, 1999, of 79 deposit insurance systems surveyed, 70 were structured as legally separate entities (53 were government agencies or state-owned enterprises, and 17 were privately administered). Nine deposit insurers were structured as departments of a central bank, government department, or other public authority.

¹⁰ Separate legal entities are defined as organizations that exist as legal persons in their respective jurisdictions and are governed by a board of directors, a supervisory board, or another type of governing body. They may exist in either the public or private sector.

¹¹ CDIC, 2003.

administered systems are typically governed by a board of directors, a supervisory board, or another type of governing body. Although this structure may be more resource-intensive than other options, it makes the insurer focused and effective in carrying out its mandate, roles, and responsibilities. This structure may also offer fewer opportunities for conflicts of interest compared with other structures.

Deposit insurers set up as separate legal entities can be structured as private sector not-for-profit organizations (e.g., France, Argentina, Brazil). These deposit insurance systems are usually governed by a board of directors, a supervisory board, or another type of governing body. Although primarily administered by the private sector, they typically receive their mandates from a public authority in the form of legislation. A small number, however, do not. For example, Germany's deposit insurer for commercial banks receives its mandate from the industry association that oversees it.¹²

The least common governance structure is the ministry, supervisory authority, or central bank departmental model (e.g., Isle of Man and Slovenia), which is governed by the head of the department. Although relatively simple to establish and less expensive to administer than a separate entity, this structure usually has limited capabilities and is heavily dependent for resources on the organization in which it operates. Moreover, the ministry, supervisory authority, or central bank may have difficulty separating its other responsibilities from those of the deposit insurer function. This can create challenges in ensuring that the interests of the deposit insurer are given appropriate weight in decision making for the entire organization. Like most other deposit insurance systems, departmental deposit insurers (or the organizations within which they operate) usually receive their mandates in the form of legislation.

Irrespective of the deposit insurer's structure and whether it is administered publicly or privately, the mandate and responsibilities of a deposit insurance system should be clearly defined, preferably through legislation. Legislation has a number of advantages. It clarifies the objectives of the system for all stakeholders (e.g., to compensate depositors in the event of a failure, to contribute to financial stability, to minimize the insurer's exposure to loss); lays out the powers the system may or may not exercise; and usually specifies the terms and conditions of coverage. The legislation should also specify the system's responsibilities to the authority from which it receives its mandate, to depositors, to member banks, and to other stakeholders.

¹² Although Germany's deposit insurer—the Deposit Protection Fund of German Banks—is privately mandated and administered, Germany is still subject to and compliant with the EC Directive on Deposit Insurance (1994/19/EC), which prescribes some aspects of a deposit insurance system's design.

IV. Relationships

The relationship between a deposit insurance system and its key stakeholders (i.e., the authority from which it receives its mandate or to which it is accountable, depositors, member banks, and other safety net organizations) can hold the potential for conflict of interest and for excessive stakeholder influence and interference. A deposit insurance system typically does not have much control over its mandate. However, within its own institutional confines, it is a good governance practice for the deposit insurer to have operational independence with regard to the use of its powers and the means accorded to it to fulfill its mandate.¹³

In reality, however, achieving operational independence can be difficult. To be operationally independent, a deposit insurance system must carry out its mandate in a way that minimizes the potential for conflicts arising from undue political, industry, or other external influence. At the same time, the system must fulfill its responsibilities and be accountable to the organization from which it receives its mandate. The deposit insurer should also communicate and share information with other safety net organizations. Communication can increase the organization's effectiveness and efficiency and help prevent, or at least minimize, gaps or overlap in responsibilities.

Safeguards can minimize the potential for undue political influence. For deposit insurers structured as separate legal entities, one method (used by the Deposit Insurance Agency of Russia) is to legally forbid undue political and bureaucratic influence.¹⁴ A second method is to protect the head of the governing body against removal for political reasons. In Canada, the chair of the board of the Canada Deposit Insurance Corporation (CDIC) can only be removed for cause.

A deposit insurance system's reporting framework can also minimize the potential for undue political influence. For example, a framework might be structured so that the insurer is accountable to a non- or multipartisan authority, such as a legislative body, rather than to a minister or other official, whose allegiance might be with one party or another.

The deposit insurance system should not be manipulated to benefit the interests of a particular member bank. This is especially important for systems whose governing bodies include representatives from member banks or individuals who have a controlling interest in a member bank. Two tradeoffs are involved: (1) operational independence of the deposit insurance

¹³ Invges and Quintyn, 2003.

¹⁴ The Deposit Insurance Agency of Russia advises that according to Article 27 of the Russian Deposit Insurance Law: "Federal executive bodies, as well as regional entities of the Russian Federation, municipal governments and the Bank of Russia, shall not be entitled to interfere in the [Deposit Insurance] Agency activities aimed at implementing its legally set functions and authority."

system from the industry versus accountability to the industry (i.e., the presence of bank-affiliated governing body members could lessen the independence of the deposit insurance system from the industry but, at the same time, strengthen the accountability of the system to its premium-paying members); and (2) banking expertise on the governing body versus potential for conflict of interest (i.e., professionals who are actively involved in the affairs of member banks are likely to be the persons with the most up-to-date knowledge of the financial services sector,¹⁵ but the financial interests of these persons or their private sector employers could create a conflict of interest with regard to the deposit insurance system).

Countries weigh these tradeoffs in different ways. The Financial Stability Forum (FSF) Working Group noted that deposit insurance systems that are predominantly privately administered may include persons from member banks on the governing body but stressed the need to avoid serious conflicts of interest.¹⁶

In a number of countries, such as France, appointments to the deposit insurance system's governing body are allocated according to the types of member banks. On the other hand, some state-owned systems refrain from appointing any governing body members who have active business relationships with member banks. Instead, they appoint persons who have retired from or never been affiliated with member banks. This is the case in Canada, Mexico, and Malaysia. Nicaragua takes a third approach, in which one director of the Fondo de Garantía de Depósitos is selected by the Association of Private Banks, but that person may not be a shareholder, director, officer, or employee of a member bank. Binding governing body appointees to relevant laws, conflict of interest codes, and codes of conduct and ethical behavior can lessen the potential for decisions to be swayed by the interests of individual member banks.

Deposit insurance systems also need to be protected against undue influence from other safety net participants. In some countries, particularly those with systems administered in the public sector, senior officers from other safety net organizations sit on the deposit insurer's governing body. In other countries, particularly those with systems administered in the private sector, this is not the case.

When senior officers from other safety net organizations sit on the governing body, they play a very important role. They bring critical expertise to the functioning of the deposit insurance system, and their presence on the governing body can facilitate the coordination of interventions into troubled

¹⁵ In this paper, "active involvement" in the affairs of a member bank is defined as being an employee, director, officer, significant shareholder, examiner, proxy, or agent of the member bank.

¹⁶ Financial Stability Forum (FSF), 2001, pp. 5–7.

institutions. The supervisor or central bank governor might also be asked to explain the approach his or her organization takes to an intervention.

The FSF paper cautions, however, against governing bodies being “dominated” by representatives from other safety net participants.¹⁷ For publicly administered systems, an effective way to obtain the expertise and input of other safety net organizations without running the risk of being controlled by those organizations is to ensure that persons from those organizations do not form the majority of the governing body. In Mexico, Malaysia, the United States, and Canada, for example, the deposit insurance system governing body includes directors from both the public and private sectors, but members from the private sector outnumber those appointed from other safety net organizations. Many privately administered systems—such as those in France and Brazil—avoid conflicts by not permitting people from other safety net organizations to serve on the deposit insurer’s governing body at all. In either case, the system’s rules can require all governing body members to act in the best interest of the system. A deposit insurance system that relies on the work of its own staff as well as corporate officers who have a duty to act in the best interest of the system is likely to be further safeguarded against excessive influence from other safety net organizations.

Deposit insurance systems can also develop mechanisms whereby governing body members can excuse themselves from deliberating on matters that affect the interests of their home organizations, whether it is a member bank or another safety net participant.

Senior officers and other employees of a deposit insurance system may find themselves in a conflict of interest arising from asset holdings, work outside the deposit insurance system, or future employment. In a number of systems, senior officers and employees are subject to conflict of interest codes and codes of ethical behavior and conduct. Adherence to these codes can be a condition of employment with a deposit insurer and of appointment to a deposit insurer’s governing body.

V. Governing Body and Management

This section considers the appointment of governing body members; training, remuneration, and performance assessment; and the roles of the governing body and management team.

A. Appointment of Governing Body Members

In many cases, governing body members are selected by the authority from which the deposit insurer receives its mandate or the authority to which it is accountable (a rare exception to this rule is Japan, where the chair of the

¹⁷ FSF, 2001, pp. 5–7.

Policy Board of the Deposit Insurance Corporation of Japan selects nonmanagement members of the board, with the approval of the prime minister and the minister of finance). In privately administered systems, governing body members often are appointed or elected by member banks. However they are made, appointments should be based primarily on skill and competency rather than political or industry considerations. Although governing bodies do not normally control the process by which new members are appointed, it is an effective practice for the deposit insurer to develop a profile of desirable skill sets and provide it to the authority responsible for making appointments.

A second helpful practice, where possible, is to stagger appointments so that a significant number of governing body positions do not become vacant at the same time. This practice can help preserve institutional memory, as current governing body members and senior officers can pass information on to newer ones. It can also make for a healthy turnover of governing body membership and increase the likelihood that members will be appointed by more than one political party.

The FSF (2001) recommended that members of the governing body “be subject to some form of ‘fit-and-proper’ test, be free from serious conflicts of interest, and be as independent as possible from undue political or industry influence” (p. 6). Fit-and-proper tests are helpful to support the integrity of a deposit insurance system. They can take various forms, from matching a candidate to the profile of desired skill sets to vetting a candidate before a legislative committee. In the United States, for example, the chair of the Federal Deposit Insurance Corporation (FDIC) must be approved by bipartisan committees in the Senate and the House of Representatives, and no more than three of the five members of the board of directors may be from the same political party.

In Malaysia, legislation dictates that all directors who do not serve *ex officio* must have relevant experience in the private sector, and at least one must have relevant experience in the banking and financial sector. In Canada, the chair of the board must be a person of “proven financial ability.” In Mexico, all non-*ex-officio* governing body members (i.e., those appointed from the private sector) must have held a top management position in the financial sector for at least 5 years or have at least 10 years of teaching and research experience in economics and finance at an institution of higher learning. In France, members of the supervisory board must be managers of a credit institution.

B. Training, Remuneration, and Performance Assessment

While deposit insurance systems usually do not control the recruitment and appointment processes for their governing bodies, they are responsible for training the appointee and keeping him or her engaged in the governance process.

Ideally, appointees should possess knowledge about deposit insurance and the financial services industry. But it can be difficult to find governing body members with experience in these fields, so it may be necessary to provide appointees with basic training about the deposit-taking sector and deposit insurance. Moreover, a successful governing body will likely require that some of its members have knowledge related to corporate directorship, accounting, risk management, finance and investment, government relations, legal matters, and human resources, among other things.¹⁸ A deposit insurer might consider establishing a training program for all new governing body members. For example, the Deposit Insurance Corporation of Japan provides training sessions for all new policy board members and more intensive training for the governor (i.e., the head of the governing body) and deputy governors.

Adequate remuneration is necessary to recruit governing body members, but it is usually not the most important factor in a person's decision to serve. In many countries, governing body members are paid significantly less than they would earn in a comparable position in the financial services industry. But directorships of deposit insurance systems are often regarded as a public service, and the lower level of remuneration is not necessarily a hindrance in finding highly qualified persons.

A more likely disincentive to serving on a governing board might be the restrictions a conflict of interest code could impose on the person's personal financial affairs (e.g., restrictions on shares a director can hold in an insured bank or a prohibition against serving as a director of a member bank). It is possible that a balance can be struck between safeguarding the deposit insurance system against conflict of interest and an overly restrictive code. For example, a deposit insurance system might opt to restrict the value and number of shares a governing body member may hold in a member bank but not ban the ownership of shares altogether. Inadequate training and lack of legal protection might also be disincentives to becoming a member of a governing body.

Once it has been populated with appropriately skilled individuals, the governing body needs to fulfill its accountability to stakeholders by demonstrating its effectiveness or acknowledging the areas in which it can improve. The governing body can assess its practices against best practices of the country's private sector, against practices described in this document, and, where deposit insurance systems are state-owned enterprises, against practices set out by the OECD in its 2005 *Guidelines on Corporate Governance of State-Owned Enterprises*.

¹⁸ Training for governing body members can begin with the provision of documents that fully describe the structure and organization of the deposit insurer, as well as the member's duties and fiduciary responsibilities. If it is in the interest of the governing body that a member be trained in an area of technical expertise (e.g., accounting, risk management, finance and investment, government relations, legal matters, human resources, or corporate directorship), that training should be made available at no cost to the member.

Self-assessment involves more than a checklist of compliance with practices that prevail in the private sector or internationally. It involves qualitatively assessing the performance of the body in carrying out its governance responsibilities and assessing the contributions of individual members to the governance process. The overall assessment could be carried out by the governing body as a whole. Individual assessments might be carried out by the chairperson, by peer review, through self-assessment, or using a combination of methods. Individual assessments could include criteria such as attendance, upholding of fiduciary responsibilities and duty of care to the system, preparedness for meetings, and communication and interaction with other governing body members and with management.

A crucial element of any self-assessment process is that it be meaningful. It is one thing for a governing body to tell itself that it is performing well; it is another to be able to demonstrate to outside parties that this is the case. A deposit insurer might consider hiring an independent consultant to help with the assessment and confirm the results.

C. Roles of the Governing Body and Management

The role of the governing body is to direct and oversee management in its administration of the affairs of the deposit insurer. Management, on the other hand, is responsible for translating governing body direction into action and carrying out the deposit insurer's daily operations. In other words, the governing body, with management input, should set the strategic direction of the system and management should carry it out.¹⁹

It is an effective practice to have a governance policy or charter in place to clarify the specific duties of the governing body and management. This document can help the governing body understand its responsibilities and how it will ensure that it is fulfilling those responsibilities, which may include orientation and training of governing body members; delegation of functions to governing body committees and management; responsibilities of the chairperson and the CEO or other management head; standards of business conduct and ethical behavior; appointment of senior officers; and evaluation of the CEO. The governance policy or charter can also describe how management will help the governing body fulfill those responsibilities. In addition to a charter, effective communication between management and the governing body will help clarify their respective roles.

The governing body might want to have a formal policy for communicating with stakeholders (e.g., depositors, the authority from which the deposit insurer receives its mandate, member banks, and other safety net organizations). Such a policy could deal with daily communications as well as communications during an intervention or in a crisis. The policy might

¹⁹ The deposit insurance system's objectives or goals should be set out in legislation developed by the authority from which the system receives its mandate. The system's strategic direction includes the action management will take to fulfill the objectives.

delegate a spokesperson (e.g., chair of the governing body or CEO) for specific situations. Management might want to establish its own policy to deal with daily communications with stakeholders.

To provide proper oversight of management activities and thereby enhance accountability and integrity, the governing body may wish to establish committees to oversee human resources, governance, succession, audit, risk management, and other areas. For deposit insurers with sophisticated financial operations (e.g., fund management, payroll, contracting operations), the audit committee is especially important, and its members should be financially literate. The risk management committee is also important; it ensures that significant risks (i.e., insurance and financial risks) are well managed and that adequate controls are in place.

In many systems, the positions of chair of the governing body and head of management functions are separate, but in some systems they are not. Merging the positions can create more efficient command-and-control, so that decisions are made and carried out quickly and efficiently. It can lead to fewer relationship problems between management and the governing body; and more efficiently align operations with strategic direction. On the other hand, separating the positions can create a clearer delineation between management and the governing body. If one person holds both jobs, that person is in the conflicted position of conducting oversight of his or her own actions. This situation could lead to the stifling of criticism of management, thereby eliminating the fundamental oversight function of the governing body. The OECD (2005) recommends separating these positions. In cases where one person holds both titles (chair and CEO), the two functions can be separated by hiring a head of management or delegating management authority to a chief operating officer or other senior officers.

The CEO typically reports to the governing body, so it is logical that he or she be appointed, remunerated, and evaluated directly by the governing body. In some countries, however, the government or other authority to which the deposit insurance system is accountable has a role in selecting the CEO. Whether the CEO is appointed by the governing body or by another authority on recommendation of the governing body, it is helpful to maintain a profile of desired skills for this position.

VI. Audit and Legal Protection

A. Audit

A key component of sound governance is independent validation of the deposit insurer's operations. This is particularly important for insurers structured as separate legal entities. External audits can ensure that operations are being carried out effectively and efficiently, and that controls are in place to safeguard assets. It is an effective practice for external audits and examinations to be provided to the governing body rather than management. A deposit insurance system might also consider making its audits public to increase accountability to stakeholders; however, doing so might need to be weighed against concerns about the confidentiality of some information.

In addition to periodic external audits of financial statements and key operations, deposit insurers should have an internal audit function to oversee processes and controls, such as the keeping of books and records, efficient management of resources, and effective operations. The internal audit department typically reports to the CEO for daily administrative issues, but an emerging practice in the private sector is to have the internal audit function also report directly to the governing body or its audit committee. This is now the case in Canada, Mexico, Malaysia, and Japan.²⁰

B. Legal Protection and Indemnification of Governing Body Members, Officers, and Employees

The governing body, officers, and employees will be judged on the decisions they make and the integrity of those decisions; therefore, they must be able to make decisions in good faith without unnecessary fear of legal reprisal. The APEC (Asia-Pacific Economic Cooperation) *Policy Conclusions Paper* (2004) states:

[I]ndividuals working for deposit insurers and other safety net participants should be protected against civil liability for their decisions, actions or omissions taken in "good faith" while discharging their mandates. Legal protection should be codified in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified. (p. 2)

Without such protection, governing body members, officers, and employees may be reluctant to make decisions about interventions into failed or troubled banks. Lack of legal protection considerably increases the potential for undue external influence on the deposit insurer's decision-making process, limiting operational independence. The APEC paper suggests four elements for a legal protection regime: (1) granting statutory immunity

²⁰ The internal auditor of the Deposit Insurance Corporation of Japan (DICJ) may submit opinions to the governor of the DICJ, the minister of finance, and the prime minister.

to individuals in the deposit insurance system; (2) holding deposit insurance systems, rather than individuals, liable for actions or omissions; (3) including indemnification provisions in employees' contractual arrangements; or (4) combining these mechanisms.²¹

Legal protection should only extend to actions or decisions made in good faith while discharging the mandate of the deposit insurance system; thus, individuals who benefit from legal protection should also be subject to conflict of interest codes and codes of conduct and ethical behavior. They should not be protected for actions taken in bad faith, actions not related to the insurer's mandate, or fraudulent or criminal actions. Member banks, depositors, and other concerned parties should have the right to challenge the decisions of the deposit insurer by suing the insurer as an entity, as opposed to suing individuals.

VII. Transparency and Disclosure

Deposit insurance systems have to balance the competing aims of disclosure and protection of sensitive third-party information. Perhaps the strongest incentive to ensure that governance and operational practices are carried out in an ethical, prudent, and effective manner is to expose them to public scrutiny. Transparency and disclosure also reinforce other elements of sound governance, such as accountability and integrity. At the same time, many deposit insurance systems receive confidential business information from member banks and other safety net participants, and may create confidential information themselves, such as lists of troubled institutions. The release of this kind of information could seriously affect the stability and competitiveness of a member bank and, potentially, the stability of the entire financial system.

A deposit insurance system structured as a separate legal entity—such as a government agency, state-owned enterprise, or private enterprise—is expected to publish certain pertinent financial and nonfinancial details about its operations, usually in an annual report or other document. The amount and types of information published depend on the system's mandate, the size of its operations, whether it is publicly or privately administered, and whether it operates as a stand-alone entity or a subsidiary or division of another safety net organization. Pertinent information may include financial statements, organization structure, governance practices, staffing details, fund investment policies and performance levels, and an overview of the health of the country's deposit-taking sector. To enhance transparency, it is also helpful for the annual report to include an assessment of key business objectives and strategies against performance targets. The report might also disclose mechanisms for coordination and information sharing among safety net players, as well as relevant approaches for assessing member bank premiums.

²¹ APEC, 2004.

Some deposit insurance systems—especially those run as government or quasi-government entities—may be subject to freedom of information statutes.²² These statutes typically give citizens the right to request any government document, subject to certain exemptions. With regard to deposit insurance systems and government in general, these statutes support a culture of transparency and accountability. The FDIC also conducts its board of directors meetings in public, with some exceptional sessions held *in camera*. However, in many cases confidential third-party information is exempted from freedom of information statutes and from the requirement for public disclosure.

Deposit insurance systems should be as liberal as possible in their disclosure of information that does not adversely affect the stability of the financial system or the competitiveness of a member. Appropriate disclosure of information that is not commercially sensitive can foster confidence in the operations of the deposit insurance system and reinforce the stability of the financial system.

²² A distinction should be made between freedom of information statutes and deposit insurance system openness generally. The latter, which may include annual reports, public board meetings, and outreach, is carried out proactively and at the initiative of the deposit insurance system. Freedom of information processes, on the other hand, allow citizens to gain access to information on a post facto basis, and the requests are initiated by citizens.

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Annex

Definitions of Key IADI Guidance Terms

IADI's objects state that the Association will: "...set out guidance to enhance the effectiveness of deposit insurance systems [and] such guidance shall take into account different circumstances, settings and structures." * For the purposes of this paper, we have set out the following definitions for the guidance IADI provides:

- **Core Principles** which are defined to be: *fundamental statements applied to a broad policy area*. Although principles focus on what is fundamental, they can also be applied broadly and provide a high degree of flexibility in implementation to suit individual country circumstances.
- **Supporting Guidance Points:** which help to clarify the principle(s) and can add additional information to help practitioners apply the core principles.

When developing guidance it is important to ensure that it assists countries in developing and enhancing their deposit insurance systems and, as much as possible, that this guidance should be adaptable to the overall culture, history, political, economic, legal and institutional environment.

* See *Statutes of the International Association of Deposit Insurers*, Article 2(b), Basel, October 2004.