

## Deposit guarantees and investor compensation

*One way to enhance the resilience of the financial system is to provide depositors and investors with minimum protection against losses that they may incur on account of insolvent deposit institutions or securities undertakings. In Iceland, this question is addressed by legislation passed on the basis of harmonised rules within the European Economic Area. The Act stipulates that the Depositors' and Investors' Guarantee Fund shall be operated with the aim of providing a minimum level of protection in this regard. The following article discusses the protection provided by the Depositors' and Investors' Guarantee Fund. It describes the laws and regulations in this area, the Fund's assets and investment of them, payments from it, the amount of covered claims and minimum levels of protection.*

### Harmonisation of rules in EEA law

The Depositors' and Investors' Guarantee Fund is subject to the provisions of Act No. 98/1999 on Deposit Guarantees and Investor-Compensation Scheme. This Act was passed to implement into Icelandic law Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes<sup>2</sup> and Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes.<sup>3</sup>

These directives formed part of measures to create an internal market for banking and securities services within the EU. Measures involved the establishment of a harmonised regulatory and supervisory framework aimed at enhancing the safety and soundness of financial services, protecting against systemic risk, increasing consumer protection and promoting an efficient and competitive financial market. Minimum harmonisation of regulations, mutual recognition of operating licences and surveillance by home country authorities enabled banks and investment firms to provide direct cross-border services in host countries or through branches or subsidiaries.

One area that was considered necessary to address was protection for depositors and investors. Member states applied different rules in this area which provided varying degrees of coverage. A number of questions arose concerning the legal position of depositors and investors who accept cross-border financial services. To contribute to the integration of markets for banking and financial services it was deemed necessary to harmonise certain fundamentals in the member states' divergent rules, and thus facilitate mutual recognition of companies' cross-border authorities.

Under the Directives, all credit institutions and investment firms are required to belong to an insurance scheme which is approved by the relevant authorities. Their branches in host countries come under

---

1. The author is Deputy Director of the Central Bank of Iceland's Financial Stability Department. He is also Executive Manager of the Depositors' and Investors' Guarantee Fund.

2. OJ L 135, 31.5.1994, p. 5.

3. OJ L 84, 26.3.1997, p. 22.

the same scheme as in the home country. However, host-country schemes shall offer a branch from a member state, where coverage is lower, the option of topping up its coverage to the host-country level.

The Directives stipulate that the aggregate deposits of each depositor and securities held by an investor shall be covered up to a minimum of €20,000. This amount is set sufficiently high to ensure minimum consumer protection and contribute to financial stability, but not so high that management are tempted to take excessive risks in the faith that guarantees can be drawn upon in the event of insolvency (moral hazard). It also takes into account that financing the schemes should not be excessively costly for credit institutions and investment firms.<sup>4</sup>

### Transposition into Icelandic law

Directive 94/19/EC on deposit-guarantee schemes was transposed into Icelandic law with the provisions of Chapter X of Act No. 113/1996, on Commercial Banks and Savings Banks. While this Act was in force two guarantee schemes were operational in Iceland, i.e. the Deposit Guarantee Fund of the Commercial Banks and the Deposit Guarantee Fund of the Savings Banks. The latter dated back to 1941. In 1985 it was converted into a self-owned co-insurance fund. The Deposit Guarantee Fund of the Commercial Banks was established the same year as an independent institution owned by the Icelandic state. Act No. 113/1996 largely harmonised the funds' operating authorisations, but their operational form and ownership remained different. Funds were authorised to operate in two independent departments, a deposit department to cover deposits and a loan department which could grant loans to support a deposit institution's operation. Only the Deposit Guarantee Fund of the Savings Banks made use of this authorisation.

In 1999 these provisions in Act No. 113/1996 were repealed and replaced by new legislation, i.e. Act No 98/1999 on Deposit Guarantees and Investor-Compensation Scheme. The new Act entailed a more accurate transposition of Directive 94/19/EC and furthermore transposed Directive 97/9/EC on investor-compensation schemes. The Deposit Guarantee Fund of the Commercial Banks and the Deposit Guarantee Fund of the Savings Banks were merged and an investor-compensation scheme was introduced. A single Depositors' and Investors' Guarantee Fund was thereby created, which was intended to protect depositors and customers of investment firms against their conceivable insolvency. As pointed out in the explanatory notes accompanying the bill which was passed as Act No. 98/1999, the main justifications for merging the funds were the close inter-linking of banking and investment activities, the actuarial benefits of boosting the fund and spreading its risks, and lower operating costs.

Article 1 of Act No. 98/1999 states that its objective is to guarantee a minimum level of protection to depositors in commercial banks and savings banks, and to customers of companies engaging in

4. Key, Sydney J.: Deposit-Guarantee Directive. *Banking and EC Law Commentary*. Amsterdam Financial Series. Kluwer, 1994, pp. 7-66.

securities trading pursuant to law, in the event of difficulties of a given company in meeting its obligations to its customers. The Act is divided into seven Chapters. Chapter I specifies the objective of the law and the institution of the Fund, its membership, board of directors and executive manager, and annual general meeting. Chapter II contains provisions on contributions to the Fund's Deposit Department and Securities Department and revocation of licences. Chapter III deals with payments from the Fund, amounts payable, loans between Departments and subordinated loans. Foreign branches are addressed in Chapter IV. Chapter V contains clauses on the Fund's annual account and auditing, supervision, provision of information and exemption from taxation and bankruptcy law. It also authorises a ministerial regulation setting further provisions regarding the Fund's operations. Chapter VI authorises the establishment of a reserve fund in order to safeguard customers' interests and the financial security of commercial or savings banks. Finally, entry into force is stated in Chapter VII.

### **Establishment of the Fund**

Act No. 98/1999 was passed by parliament on December 27, 1999 and entered into force on January 1, 2000. The Depositors' and Investors' Guarantee Fund was established on December 28, 1999. Its Articles of Association are from the same time. By law, its Articles of Association are subject to ministerial approval, following review and comment by the Financial Supervisory Authority. On February 21, 2000 the Minister of Commerce adopted Regulation No. 120/2000, on Deposit Guarantees and Investor-Compensation Scheme, subsequently amended by Regulation No. 864/2002.

The Depositors' and Investors' Guarantee Fund is a private foundation operating in two independent departments, the Deposit Department and the Securities Department, with separate finances and accounting. Neither department is responsible for the liabilities of the other. Besides its Deposit and Securities Departments, the Fund may operate a separate loan department with separate finances and accounting.

The Financial Supervisory Authority supervises that the operations of the Fund are in conformity with Act No. 98/1999, Regulation No. 120/2000 and the Fund's Articles of Association. Supervision is in other respects governed by Act No. 87/1998 on Official Supervision of Financial Operations.

The Fund is exempt from both income tax and wealth tax. It shall not be taken into receivership nor its assets attached for debt.

Commercial banks, savings banks, companies providing investment services, and other parties engaging in securities trading pursuant to law and established in Iceland, shall be members of the Fund. The same shall apply to any of their branches within the EEA and EFTA. Member companies shall not be liable for any commitments entered into by the Fund beyond their statutory contributions to it.

### **Payments to the Deposit Department**

According to Article 6 of Act No. 98/1999 the minimum total assets of the Deposit Department shall be 1% of the average amount of

guaranteed deposits in commercial banks and savings banks during the preceding year. If the Fund's total assets fall short of this minimum, all commercial and savings banks shall, no later than March 1 each year, contribute to it an amount equivalent to 0.15% of their average of guaranteed deposits during the preceding year, cf., however, the 1% minimum limit. The clause on a 1% minimum originated in Act No. 113/1996, but no justification for this specific reference amount is made in the explanatory notes accompanying the bill that became Act No. 98/1999.

By comparison, arrangements for funding of deposit guarantees vary widely within the EU. Fourteen member states finance deposit-protection schemes *ex ante*. Five finance them *ex post*, i.e. payments are made to the fund when a liability towards deposit holders is formed. Six states have hybrid funding arrangements. In the *ex ante* states, highly divergent requirements are made regarding the coverage ratio.

If the total assets of the Deposit Department do not amount to the required minimum, all commercial and savings banks shall submit a declaration of liability undertaking to make a special contribution to the Department when it is obliged to refund deposits in any commercial or savings bank that is a member of the Fund. Each commercial or savings bank's declaration of liability shall extend to the same proportion of the amount required to make up the minimum as its proportion of the aggregate guaranteed deposits. However, demands for contributions to the Department based on declarations of liability shall not exceed the equivalent of one-tenth of the minimum total assets of the Fund.

When the above circumstances arise, commercial and savings banks are obliged to make payment to the Fund on demand. Payments to the Department are non-refundable.

### **Payments to the Securities Department**

According to Article 7 of Act No. 98/1999 the total assets of the Securities Department of the Fund shall amount to a minimum of 100 m.kr. The explanatory notes to Act No. 98/1999 argue that this amount would be sufficient to ensure a minimum level of investor protection. Customers of investment firms are considered unlikely to incur serious losses from a bankruptcy, given the different nature of deposits and securities. Deposits are the mainstay of credit institutions' funding and appear in their balance sheets.<sup>5</sup> By contrast, investment firms do not procure funding with the securities that must be covered, so they do not appear on their balance sheets. Legislation on securities transactions obliges investment firms to ensure a clear separation of their customers' and their own assets. Investment firms could thus go bankrupt without their customers in securities transactions suffering any losses. Customers would lose their assets only in the event of a gross error or fraud. Finally, it is argued that while the likelihood of bankruptcy among investment firms is

---

5. It should be pointed out that funding of credit institutions has changed substantially since this bill was written.

impossible to assess, strong official supervision and strict legal requirements for capital adequacy and risk management should make it a very rare occurrence.

When the bill was drafted an actuarial estimate was made for the optimum size of the Securities Department based on the amounts held in custodianship by investment firms and the number of custody accounts. It was assumed that guaranteed securities to the value 200-210 b.kr. were under the custodianship or management of investment firms on behalf of their customers at the end of 1998. Of this figure, 70 b.kr. were in mutual funds and equity funds which to a large extent were in safekeeping with investment firms. Just over 100 b.kr. of institutional investors' capital was under investment funds' custodianship. A further 25 b.kr. was owned by almost two thousand private and legal entities other than institutional investors. The average amount under custodianship for private and legal entities other than institutional investors was 12.5 m.kr. The actuarial calculation for the optimum size of the Securities Department was roughly 100 m.kr., which was closely in line with ideas for similar funds in Denmark and Sweden. It was therefore not considered appropriate to tie up more funds in the Securities Department.<sup>6</sup>

Growth in private ownership of securities has clearly caused a substantial increase in the amount of guaranteed securities since the law was passed. This would justify a review of the statutory minimum assets of the Securities Department.

The Act stipulates that, if total assets fall short of the 100 m.kr. minimum, member companies shall contribute a total of 20 m.kr. annually to the Fund until it reaches the required minimum. Each member company shall contribute a minimum of 50,000 kr. The annual contribution, minus the minimum contribution, is divided into two equal parts, according to the member company's share during the preceding year in the aggregate amount of securities trading with customers who are covered, and also according to its share in the aggregate number of securities trading accounts held with member companies. If the total assets of the Department still do not amount to the required minimum, each member company shall submit a declaration of liability undertaking to make a special contribution to the Department when it is obliged to refund deposits or cash in any member company. The declaration of liability shall extend to the same proportion of the amount required to make up the minimum as its proportion of the first aggregate contributions of all member companies after it has become evident that the Department's total assets will not amount to the required minimum. However, claims for contributions to the Department based on declarations of liability shall not exceed the equivalent of one-fifth of the Fund's minimum total assets.

When the above circumstances arise, member companies shall make payment to the Fund upon demand. Contributions to the Department are non-refundable. Furthermore, the Board of Directors

---

6. According to the original bill, the Minister could decide the Securities Department's minimum asset level on the recommendation of the Fund's Board, but this provision was dropped in the course of the parliamentary debate.

of the Fund may purchase insurance from a recognised insurance company within the EEA as a safeguard against losses.

### Assets of the Guarantee Fund

On its establishment in December 1999 the Guarantee Fund took over the assets and liabilities of the Deposit Guarantee Fund of the Commercial Banks and the Deposit Guarantee Fund of the Savings Banks. It began collecting annual contributions in 2000.

Table 1 shows the development of total assets of the Depositors' and Investors' Guarantee Fund until the end of 2004.

**Table 1 Total assets of the Depositors' and Investors' Guarantee Fund at year-end 1999-2004**

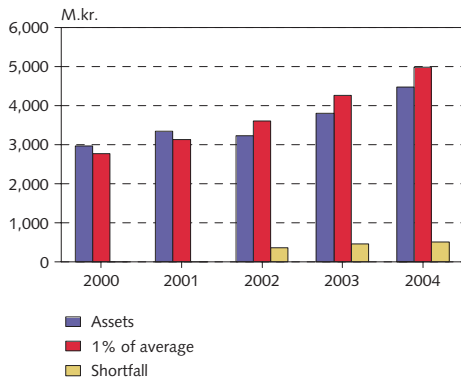
Thous. kr.	1999	2000	2001	2002	2003	2004
Deposit Dept.	2,875,319	2,963,030	3,342,694	3,233,070	3,801,252	4,476,813
Securities Dept.	0	21,340	43,880	65,117	59,982	65,323
<b>Total</b>	<b>2,875,319</b>	<b>2,984,370</b>	<b>3,386,574</b>	<b>3,298,187</b>	<b>3,861,234</b>	<b>4,542,136</b>

Table 2 provides an overview of contributions to the Fund over the period 2000-2005. At the time of writing, collection on account of 2005 has not been completed. In 2000-2004 member companies contributed a total of 925,736 thousand kr. to the Fund, divided between 99,950 thousand kr. to the Securities Department and 825,786 thousand kr. to the Deposit Department.

**Table 2 Contributions to the Guarantee Fund 2000-2005**

Thous. kr.	2000	2001	2002	2003	2004	2005	Total
Deposit Dept.	0	0	0	366,415	459,371	506,498	1,332,284
Securities Dept.	20,000	20,000	20,000	20,000	19,950	20,000	119,950
<b>Total</b>	<b>20,000</b>	<b>20,000</b>	<b>20,000</b>	<b>386,415</b>	<b>479,321</b>	<b>526,498</b>	<b>1,452,234</b>

**Chart 1**  
Assets of the Deposit Department of the Guarantee Fund 2000-2004



**Chart 2**  
Development of covered deposits 2000-2004

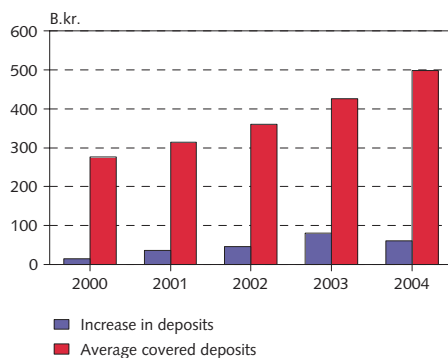


Chart 1 shows the development of net assets of the Deposit Department over the period 2000-2004 relative to the statutory minimum, i.e. 1% of average covered deposits. In 2002-2004, net assets fell well short of the statutory minimum and the outstanding amount had to be collected from member companies.

The main reason for the large amount that member companies have had to pay to the Deposit Department in recent years is year-on-year increases in covered deposits. Returns on investment of the Fund's assets have therefore been nowhere near sufficient to increase assets to the statutory minimum.

Chart 2 shows the development of average covered deposits and their annual rate of increase. In 2000 the average was 276 b.kr. and it has grown steadily since then. In 2004 it was 498 b.kr.

Chart 3 shows the development of the Securities Department's net assets over the period 2000-2004. Member companies made annual contributions of 20 m.kr. to the Department to meet the



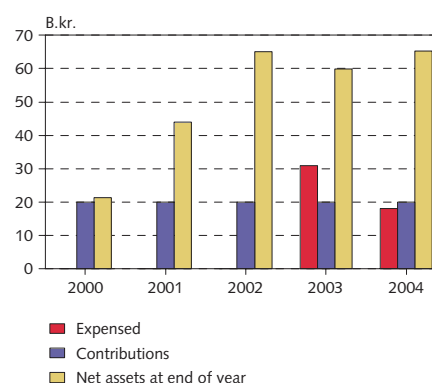
statutory requirement for minimum net assets of 100 m.kr. In 2003-2004, however, a total of 49 m.kr. was expensed due to the bankruptcy of one member company.<sup>7</sup> For this reason, the Securities Department's net assets according to its annual accounts have still not reached the mandatory 100 m.kr. minimum. Further contributions will therefore need to be collected until the minimum is attained.

### Custodianship and investment of assets

In February 2001 the Guarantee Fund made agreements with Landsbréf hf. (now Landsbanki Íslands hf.) and Búnaðarbanki Íslands hf. (now Kaupþing banki hf.) on custody, investment and management of the Fund's resources.

The agreements aim to ensure that the Fund's assets will be well invested and safeguarded by applying systematic measures in line with its investment strategy. The Guarantee Fund may change its investment strategy as it deems necessary. The main principles of the investment strategy are outlined in Box 1.

Chart 3  
Assets of the Securities Department  
of the Guarantee Fund 2000-2004



- Custodians shall invest at least 85% of custodial funds in domestic or foreign Treasury bonds.
- Domestic Treasury bonds shall be in the range 30-75% of custodial funds.
- Foreign Treasury bonds shall be in the range 15-55% of custodial funds.
- Foreign equities may be in the range 0-15% of custodial funds.
- Foreign investment is confined to the EU, excluding Greece, and to the US, Canada, Norway, Japan, Australia and New Zealand.
- The Fund may invest in bond funds that mainly invest in Treasury bonds but contain listed corporate bonds, provided that the bonds' credit rating is no lower than AA.
- Investments in unlisted securities and domestic equities are not allowed.
- Restrictions apply to currency composition of foreign bonds. The use of currency derivatives is allowed, but only to reduce the Fund's risks.
- Speculative day trading with the Fund's assets is not allowed.

### Box 1

#### Main principles of the Guarantee Fund's investment strategy

Custodians are obliged to keep the Fund's assets clearly separated from their own assets and those of other customers, so that the Fund's assets are never used to guarantee their liabilities. The Guarantee Fund pays custodians contractual commissions for services rendered. Commissions are divided into administration fees, transaction fees and performance-related commissions. Administration fees comprise both fixed general fees and fees for handling investment in funds. Table 3 shows total custodianship commissions from March 26, 2001 to December 31, 2004 and as a percentage of the average value of custodial assets.

7. Discussed in more detail below.

Table 3 Custodial commissions 2001-2004

M.kr.	2001	2002	2003	2004	Total
Administration and transaction fees	10.9	26.3	27.3	30.1	94.6
Performance-related commissions	1.5	0	0.7	14.5	16.7
<b>Total</b>	<b>12.4</b>	<b>26.3</b>	<b>28</b>	<b>44.6</b>	<b>111.3</b>
% of average asset value	0.4	0.8	0.8	1.1	0.8

Source: Economic Forecasts and Consulting, 2005.

The Fund's Board has set a long-term target of achieving an average annual nominal return of no less than 7.0%. Furthermore, the Board has set a benchmark for average nominal return on its custody portfolio. The benchmark used is the weighted average of selected securities indices and should reflect market returns in light of the investment strategy. At the end of 2004 the annualised benchmark was 6.6% from the time that custodianship began. However, the average annualised nominal return on the Fund's portfolio from the beginning has been only 5.5% before capital income tax. Table 4 and Chart 4 show the increase in value of total custodial assets due to returns on investments, before and after administration and transaction fees, relative to the Fund's benchmarks.

Chart 4  
Increase in value of total custodial assets  
2001-2004

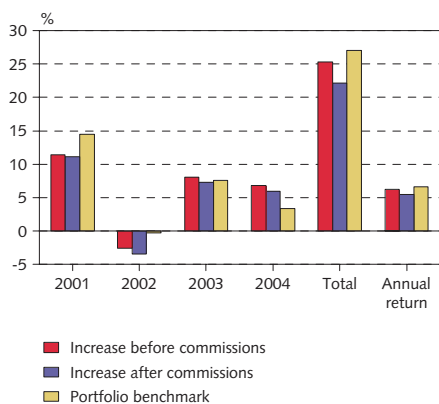


Table 4 Increase in value of total custodial assets before capital income tax 2001-2004

%	2001	2002	2003	2004	Total	Annual return
Increase before commissions	11.4	-2.6	8.1	6.8	25.3	6.2
Increase after commissions	11.1	-3.4	7.3	6.0	22.1	5.5
Portfolio benchmark	14.5	-0.3	7.6	3.4	27.0	6.6

Source: Economic Forecasts and Consulting, 2005.

### Payments from the Fund

If, in the opinion of the Financial Supervisory Authority, a member company is unable to render payment of the amount of deposits, securities or cash that a customer demands it to refund or return in accordance with applicable terms, the Fund is obliged, under Article 9 of the Act, to pay him the amount of his deposit from the Deposit Department and the value of his securities and cash in connection with securities trading from the Securities Department. The obligation of the Fund to render payment also takes effect if the estate of a member company is subjected to insolvency proceedings in accordance with the Act on Commercial Banks and Savings Banks and the Act on Securities Trading. The opinion of the Financial Supervisory Authority shall have been made available no later than three weeks after it first obtains confirmation that the relevant member company has not rendered payment to its customer or accounted for his securities in accordance with its obligations.

The term "deposit" refers to any credit balance resulting from financial deposits or transfers in normal banking transactions which a commercial bank or savings bank is obliged to refund by law or under



contractual terms. However, this guarantee does not extend to bonds, bills of exchange or other claims issued by a commercial bank or savings bank in the form of securities. "Securities" refers to securities that are either in the custody or under the administration or supervision of a member company which is obliged to refund or return them by law or under contractual terms. This refers to asset management, e.g. custodianship or safekeeping of funds, which in particular takes place in investment firms. Securities also embrace book entry securities, cf. Act No. 131/1997 on Electronic Registration of Title to Securities. "Cash" refers to cash deposited by an investor with a member company in connection with securities trading, i.e. when it does not honour its obligations regarding the delivery of securities that have been bought. This means claims that have arisen in connection with securities brokerage by credit institutions and investment firms.

Deposits, securities and cash owned by member companies, their parent and subsidiary companies for their own account, or connected with convictions for money-laundering, are not covered by the guarantee.

Regulation No. 120/2000 contains further provisions on procedures in connection with claims for payment from the Fund. It stipulates, *inter alia*, that before the Fund pays out a claim, it shall ascertain whether the claim was met in part or in full by a member company, and deduct such payments in full from its own payment. If the Fund makes a payment, it will take over the claimant's claims against the member company or bankruptcy estate concerned. If a deposit account or a customer's securities transactions account is a joint account, the share of each claimant shall be applied in calculation of the payment.

No claims have been made on the Deposit Department since the Guarantee Fund was established. In November 2001, however, one of the Fund's members was taken into official receivership. The company is still in receivership and it is not known when this process will be completed. Claims were made against the Securities Department amounting to 226.5 m.kr. Some claims were withdrawn and the majority of others were rejected. It is considered likely that the Securities Department will incur some outlays relating to this matter. A prudential provision of 49 m.kr. has been expensed in connection with this event and is entered in the Department's balance sheet as a liability.

### **Payment amounts**

Act No. 98/1999 does not impose a general ceiling on the amounts to be paid by the Guarantee Fund in connection with deposits, securities or cash that it covers. This means that the Fund must pay guaranteed claims in full to the extent that its assets cover them.

Nonetheless, the law allows for the possibility that the assets of the Department in question are insufficient to pay the total amount of guaranteed deposits, securities or cash in a member company. In such an event the payment from each Department shall be divided between claimants so that the total claim of each one, up to a maximum of 1.7 m.kr., shall be paid in full, and amounts in excess of that

figure shall be paid proportionally to the extent that each Department's assets cover them. This amount is pegged to the exchange rate of the euro (EUR) based on the buying price on January 5, 1999 (i.e. 81.39 kr.). That day, the amount corresponded to €20,887.

Should the total assets of the Fund prove insufficient to cover the amount of guaranteed claims, the Board of Directors is entitled by law to take a loan to pay claimants, if it sees compelling reasons to do so. The Board may furthermore authorise loans of up to 50 m.kr. between the Deposit Department and Securities Department, to be repaid within 36 months. No further payment can then be claimed from the Fund even if a claimant's loss has not been paid in full.

A comparison can be made between minimum coverage in Iceland and the protection provided in the other Nordic countries and in the EU. The minimum amounts stipulated in Act No. 98/1999 are based on the provisions of Directive 94/19/EC on deposit-guarantee schemes and Directive 97/9/EC on investor-compensation schemes, which specify a minimum of €20,000. Iceland's statutory coverage is somewhat higher than required under the Directives, i.e. it corresponds to €20,887. Table 5 presents a comparison of minimum coverage in the Nordic countries, which shows that it is somewhat lower in Iceland than elsewhere.

The minimum coverage in Iceland is, however, well in line with that in the EU countries, apart from Denmark, the UK, France and Italy, which have a considerably higher coverage. A common insurance amount is €20,000.

As mentioned above, Act No. 98/1999 makes a minimum requirement that the Department's net assets shall be 1% of average covered deposits. In 2004, average covered deposits amounted to 498 b.kr. By law, the Guarantee Fund is obliged only to have disposable funds corresponding to 1% of this amount, i.e. 4.98 b.kr.

Table 5 Minimum coverage in the Nordic countries<sup>1</sup>

	Kr.	EUR	Domestic currency
Norway	18,725,000	228,912	NOK 2,000,000
Denmark	3,294,000	40,268	DKK 300,000
Sweden	2,289,000	27,986	SEK 250,000
Finland	2,045,000	25,000	EUR 25,000
Iceland	1,708,000	20,887	ISK 1,708,000

1. Amounts in Icelandic krónur (kr.) are based on the euro exchange rate on January 17, 2005, rounded to the nearest thousand.

Source: Norges Bank: *Innskuddsikring i Norden og virkninger av å filialisere Nordea*, March 26, 2004, p. 3.

No analysis has been made of the proportion of the Deposit Department's net assets to the amount of deposits below the minimum coverage level. However, the number of accounts with deposits below and beyond the minimum coverage on December 31, 2004 has been examined.<sup>8</sup> At that time a total of 1,117,208 savings

8. Parliamentary reply by the Minister of Commerce to a question by Jóhanna Sigurðardóttir, MP, on deposit protection, parliamentary session 2004-2005, parliamentary record 780-421, February 10, 2005, pp. 2-3.

accounts and cheque accounts, which were registered against private individuals' ID numbers and processed by the Banks' Data Centre (RB), had deposits in them. The average deposit amount in these accounts was 249,837 kr. A total of 1,009,784 accounts in commercial banks and savings banks with a deposit below the minimum coverage (then 1,740,000 kr.) were registered against 580,669 ID numbers (each ID number could have up to four accounts).<sup>9</sup>

However, these figures have limited informational value, since the total amount of deposits below the minimum coverage level was not examined. Taking the average deposit (249,837 kr.) and multiplying it by the number of ID numbers against which accounts below the minimum coverage were registered (580,669) gives a total guaranteed deposit amount of 145 b.kr. This figure is clearly an overestimate, since the average used in these calculations is too high, i.e. it includes accounts with a deposit above the minimum coverage. Nonetheless, it does indicate that the Guarantee Fund's net assets would not be anywhere near sufficient to provide minimum protection for all deposit holders and investors if they had to be tapped at one and the same time.

This finding should not be surprising. It is in line with the underlying assumption in the current law that it is unlikely that such a serious situation would develop in the financial system that 1% of the average of insured deposits would not suffice to provide minimum coverage.

However, a more likely scenario might be that the insolvency of one credit institution would drain the Deposit Department's net assets so severely that it would be unable to meet the subsequent risk of insolvency among the others. This is particularly relevant given that the current law imposes no limit on the amount of payments from the Deposit Department for as long as its assets last. Thus it cannot be ruled out that the insolvency of one credit institution would seriously deplete the Department's assets, even down to a level that could prevent it from providing other depositors in other credit institutions with the minimum statutory protection. Such a situation could also prove burdensome for the remaining member institutions, which would need to make substantial increases in their contributions to the Fund.

## Conclusion

The objective of the Depositors' and Investors' Guarantee Fund is to guarantee a minimum level of protection to depositors in commercial banks and savings banks, and to customers of companies engaging in securities trading pursuant to law, in the event of insolvency. This minimum coverage enhances the resilience of the financial system against conceivable setbacks in the activities of individual member companies. Thus the Fund has an important role to perform in contributing to a sound and secure financial system in Iceland. However, it

---

9. At the same time, there were 31,879 ID numbers against which deposits were registered for an amount equal to or higher than the minimum coverage (then 1,740,000 kr. or more) in commercial banks and savings banks. There were 107,424 accounts registered against these ID numbers.

is clear that the Fund is not intended to provide full protection for all depositors and investors against losses that may result from setbacks in the financial system. Nor would it be desirable to assign such a function to the Fund, because this could increase moral hazard and relax requirements for efficient and effective financial supervision. It is important for the Guarantee Fund always to have a legal and operating framework that enables it to perform the limited function assigned to it as effectively as possible. To this end, a review is needed of the Fund's capability, in the ever-changing financial environment, to provide depositors and investors with the minimum coverage stipulated by the legislation governing it, if member companies in Iceland were to encounter difficulties in their operations.

#### *References*

- Key, Sydney J.: Deposit-Guarantee Directive. *Banking and EC Law Commentary*. Amsterdam Financial Series. Kluwer, 1994, pp. 7-66.
- Norges Bank: *Innskuddsikring i Norden og virkninger av å filialisere Nordea*, March 26, 2004.
- Parliamentary reply by the Minister of Commerce to a question by Jóhanna Sigurðardóttir, MP, on deposit protection, parliamentary session 2004-2005, parliamentary record 780-421, February 10, 2005.