

Deposit Insurance

Deposit Insurance is a system established by the Government to protect depositors against the loss of their insured deposits. The role of the banking sector, the financial safety net, and other financial institutions that accept deposits from the public are important in the economy because of their involvement in the payments system, their role as intermediaries between depositors and borrowers, and their function as agents for the transmission of monetary policy. By their nature, banks are vulnerable to liquidity and solvency problems, among other things, because they transform short-term liquid deposits into longer-term, less-liquid loans and investments.

They also lend to a wide variety of borrowers whose risk characteristics are not always readily apparent. The importance of banks in the economy, the potential for depositors to suffer losses when banks fail, and the need to mitigate contagion risks, lead countries to establish financial safety nets. Financial safety net is usually made up of three components: prudential regulation & supervision, a lender of last resort and deposit protection scheme. The distribution of powers and responsibilities between the financial safety-net participants is a matter of public-policy choice and individual country circumstances. For example, some countries incorporate all financial safety-net functions within the central bank, while others assign responsibility for certain functions to separate entities.

A deposit insurance system is preferable to implicit protection if it clarifies the authorities' obligations to depositors and limits the scope for discretionary decisions that may result in arbitrary actions. To be credible, however, and to avoid distortions that may result in moral hazard, such a system needs to be properly designed, well implemented and understood by the public.

A deposit insurance system needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced, and sound accounting and disclosure regimes. A large variety of conditions and factors that can have a bearing on the design of the DIS system need to be assessed. These include: the state of the economy, current monetary and fiscal policies, the state and structure of the banking system, public attitudes and expectations, the strength of prudential regulation and supervision, the legal framework, and the soundness of accounting and disclosure regimes.