

CONCEPT, PRACTICE AND MANAGEMENT OF DEPOSIT INSURANCE

Introduction

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.

Concept of Deposit Insurance

Based on its role and focus in the financial system, a deposit insurance scheme has been defined as a financial guarantee to protect depositors in the event of a bank failure and also to offer a measure of safety for the banking system (Ebhadaghe 1997). In most economies where the scheme exists, it serves as one of the complementary supervisory agencies employed by the monetary authorities for effective management and orderly resolution of problems associated with both failed and failing depository institutions. In addition, the scheme also offers some form of deposit guarantee to depositors such that their confidence in the banking system is not

eroded in situations where deposit-taking financial institutions fail. The scheme also provides government with a framework for intervention and sterilization of disruptive effects on the economy following the failure of deposit-taking institutions.

Policymakers have many choices regarding how they can protect depositors. Some countries have implicit protection that arises when the public, including depositors and perhaps other creditors, expect some form of protection in the event of a bank failure. This expectation usually arises because of the governments' past behaviour or statements made by officials.

Implicit protection is, by definition, never formally specified. There are no statutory rules regarding the eligibility of bank liabilities, the level of protection provided or the form which reimbursement will take. By its nature, implicit protection creates uncertainty about how depositors, creditors and others will be treated when bank failures occur. Funding is discretionary and often depends on the government's ability to access public funds. Although a degree of uncertainty can lead some depositors to exert greater effort in monitoring banks, it can undermine stability when banks fail.

Statutes or other legal instruments usually stipulate explicit deposit insurance systems. Typically, there are rules governing insurance coverage limits, the types of instruments covered, the methods for calculating depositor claims, funding arrangements and other related matters. 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. A deposit insurance system can also provide countries with an orderly process for dealing with bank failures.

The introduction of a deposit insurance system can be more successful when a country's banking system is healthy. A deposit insurance system can contribute effectively to the stability of a country's financial system if it is part of a well-designed safety net. To be credible, a deposit insurance system needs to be properly designed, well implemented and understood by the public. It also needs to be supported by strong prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws. A deposit insurance system can deal with a limited number of simultaneous bank failures, but cannot be expected to deal with a systemic banking crisis by itself.

A well-designed financial safety net contributes to the stability of a financial system; however, if poorly designed, it may increase risks, notably moral hazard. Moral hazard refers to the incentive for excessive risk taking by banks or those receiving the benefit of protection. Such behaviour may arise, for example, in situations where depositors and other creditors are protected, or believe they are protected, from losses or when they believe that a bank will not be allowed to fail. In these cases, depositors have less incentive to access the necessary information to monitor banks. As a result, in the absence of regulatory or other restraints, weak banks can attract deposits for high-risk ventures at a lower cost than would otherwise be the

case.

Moral hazard can be mitigated by creating and promoting appropriate incentives through good corporate governance and sound risk management of individual banks, effective market discipline and frameworks for strong prudential regulation, supervision and laws. These elements involve trade-offs and are most effective when they work in concert.

Specific deposit insurance design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; using certain forms of coinsurance; implementing differential or risk-adjusted premium assessment systems; minimising the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts.

Many of the methods used to mitigate moral hazard require certain conditions to be in place. For example, differential or risk-adjusted differential premium assessment systems may be difficult to design and implement in new systems and in emerging or transitional economies. Early intervention, prompt corrective action and, when warranted, bank closure require that supervisors and deposit insurers have the necessary legal authority, in-depth information on bank risk, financial resources, and incentives to take effective action. Personal-liability provisions and availability of sanctions can reinforce incentives of bank owners, directors, and managers to control excessive risk, but they depend on the existence of an effective legal system that provides the necessary basis for action against inappropriate behaviour.

Origin and Evolution of DIS

Deposit Insurance Scheme (DIS) developed out of the need to protect uninformed small depositors from the risk of loss of their deposits and also to protect the banking system from instability occasioned by runs and loss of depositors' confidence. The origin of the scheme is credited to the United States of America (USA), where it is on record that six states established deposit insurance schemes during the pre-civil war years in that country, to protect state bank notes. However, it was in 1924 that the first nation-wide deposit insurance scheme was introduced by former Czechoslovakia (now Czech and Slovak Republics). Following suit, the United States government in 1933 established the Federal Deposit Insurance Corporation (FDIC). India, the Philippines and Sri Lanka all in the Asian Continent established their schemes in 1961, 1963 and 1987 respectively. In Continental Europe, the Germans' scheme which is administered by private institutions was established in 1976. In Britain, the scheme was established in 1979 while France introduced its own scheme in 1980. In Africa, Kenya established its scheme in 1985 while the Nigerian scheme was established by Decree No. 22 of 1988.

Design Features of DIS

Mandates, powers and structure

Mandates and powers

A mandate is a set of official instructions or statement of purpose. There is no single mandate or set of mandates suitable for all deposit insurers. Existing deposit insurers have mandates ranging from narrow, so-called paybox systems to those with broader powers and responsibilities, such as risk-minimisation, with a variety of combinations in between. Whatever the mandate selected, it is critical that there be consistency between the stated objectives and the powers and responsibilities given to the deposit insurer.

Paybox systems largely are confined to paying the claims of depositors after a bank has been closed. Accordingly, they normally do not have prudential regulatory or supervisory responsibilities or intervention powers. Nevertheless, a paybox system requires appropriate authority, as well as access to deposit information and adequate funding, for the timely and efficient reimbursement of depositors when banks fail.

A risk-minimiser deposit insurer has a relatively broad mandate and accordingly more powers. These powers may include: the ability to control entry and exit from the deposit insurance system, the ability to assess and manage its own risks, and the ability to conduct examinations of banks or request such examinations. Such systems also may provide financial assistance to resolve failing banks in a manner that minimises losses to the deposit insurer. Some risk-minimisation systems have the power to set regulations, as well as to undertake enforcement and failure-resolution activities.

Ownership and Management

Fundamentally, the ownership of a DIS takes three forms. There is the purely public sector ownership in which the equity is held entirely by the government and/or its agency. An alternative arrangement is the purely private ownership of the scheme. Under this arrangement, the decision to establish a DIS may be that of the government which enacts the necessary legislation to enable the privately-owned banks to establish and manage the DIS. Another alternative arrangement is where the DIS is jointly owned by the public and private sectors. Under this type, the equity shares are held in specific ratio and the board is made up of representative of both parties.

Membership

(i) Compulsory Membership

In general, membership should be compulsory to avoid adverse selection. There are some cases, however, where a strong commitment of banks to participate in a deposit protection system can be observed and broad participation of banks may be achieved without a legal obligation. This can occur if depositors are aware of and sensitive to the existence of deposit insurance, thus creating strong incentives for banks to be part of a system. In other cases, if depositors are less

concerned about deposit insurance or are not aware that coverage is limited to certain banks, then the stronger banks may opt out. Further, in a voluntary system strong banks may opt out if the cost of failures is high and this may affect the financial solvency and the effectiveness of a deposit insurance system.

There are two circumstances that may require different approaches to granting membership to banks. First, when a deposit insurance system is established and second, when membership is granted to new banks in an existing system.

When a deposit insurance system is created, policymakers are faced with the challenge of minimising the risks to the deposit insurer, while granting extensive membership. Generally, two options are available: automatic membership or requiring banks to apply for entry.

Automatic membership for all banks may be the simplest option in the short term. However, the deposit insurer may then be faced with the difficult task of having to accept banks that create an immediate financial risk or that pose other adverse consequences for the deposit insurance system.

Alternatively, banks may be required to apply for membership. This option provides the deposit insurer with the flexibility to control the risks it assumes by establishing entry criteria. It also can serve to enhance compliance with prudential requirements and standards. In such cases, an appropriate transition plan should be in place that details the criteria, process and time frame for attaining membership. The criteria should be transparent.

(ii) Coverage

Scope and Level

Insurable deposit should be defined clearly in law or by private contract. In doing so, the relative importance of different deposit instruments, including foreign-currency deposits and the deposits of non-residents in relation to the public-policy objectives of the system should be considered. Once the relevant deposits are selected, exclusions of specific deposits and/or depositors can be determined.

Many deposit insurance systems exclude deposits held by depositors who are deemed capable of ascertaining the financial condition of a bank and exerting market discipline. Examples include deposits held by banks, government bodies, professional investors such as mutual funds, and deposits held by bank directors and officers. In some cases, deposits held by individuals who bear responsibility for the financial well-being of a bank are excluded from reimbursement. Also, deposits with extremely high yields are sometimes excluded from coverage; or reimbursement may be limited to the principal owed, with a lower rate of interest applied.

Once the scope is determined, the level of coverage can be set. This can be done through an examination of relevant data, such as statistical information describing the size distribution of deposits held in banks. This gives policymakers an objective measure, such as the fraction of

depositors covered, with which the adequacy of a certain level of coverage can be assessed. Whatever coverage level is selected, it must be credible and internally consistent with other design features, and meet the public-policy objectives of the system. The relationship between coverage levels and moral hazard should always be considered by the policymakers.

Deposit insurance assessments: Flat-rate versus risk-adjusted differential premium systems

Countries have a choice between adopting a flat-rate premium system or a premium system that is differentiated on the basis of individual-bank risk profiles. The primary advantage of a flat-rate premium system is the relative ease with which assessments can be calculated and administered. However, in a flat-rate system, low-risk banks effectively pay for part of the deposit insurance benefit received by high-risk banks.

Most newly established systems initially adopt a flat-rate system given the difficulties associated with designing and implementing a risk-adjusted differential premium system. However, because flat-rate premiums do not reflect the level of risk that a bank poses to the deposit insurance system, banks can increase the risk profile of their portfolios without incurring additional deposit insurance costs. As a result, flat-rate premiums may be perceived as encouraging excessive risk taking by some banks, unless there is a mechanism to impose financial sanctions or penalties.

Risk-adjusted differential premium systems can mitigate such criticisms and may encourage more prudent risk-management practices at member banks. When the information required to implement a risk-adjusted differential premium system is available, relating premiums to the risk a bank poses to the deposit insurer is preferable.

Public awareness

In order for a deposit insurance system to be effective, it is essential that the public be informed about its benefits and limitations. Experience has shown that the characteristics of a deposit insurance system need to be publicised regularly so that its credibility can be maintained and strengthened.

A well-designed public-awareness program can achieve several goals, including the dissemination of information that promotes and facilitates an understanding of the deposit insurance system and its main features. Also, a public-awareness program can build or help restore confidence in the banking sector. Additionally, such a program can help to disseminate vital information when failures occur, such as guidance regarding how to file claims and receive reimbursements.