Types of deposit insurance systems

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Deposit insurance protection can be either explict or implict. Kunt and Kane (2006) argued that explicit deposit protection coverages are contractual obligations while implicit coverages are only conjectural and exists to the extent political incentives that influence a government's reaction to large or widespread banking problems make taxpayer bailouts of insolvent banks seem inevitable.

Banking crises puts pressure on government officials to rescue at least some banks resulting in implict deposit insurance being applicable in every country. Although there are some differences between implicit and explicit deposit insurance systems, their main objectives are basically the same that is to protect depositors and enhance financial system stability.

Implicit deposit insurance protection

Under implict deposit protection system, the government's protection of depositors is discretionary, (Garcia 2000). This system does not have any formal laws or regulations relating to the compensation of depositors in the event of a bank failure. The reimbursement amount and the form of protection is based on an adhoc decision solely made by the government and is responsible for the financing of depositors. Under this system the government can make direct payments to depositors or arrange for the failed bank's deposits to be assumed by another bank, or arrange and facilitate the merger of a problem bank with a healthy bank, or bail out the troubled bank through direct capital injection.

This system has drawbacks in that it creates uncertainty about how and when depositors will be compensated, funding depends on government's ability to access funds after a bank failure as a result in some countries depositors have not been reimbursed at all, as witnessed in Zimbabwe in the past.

Explicit deposit insurance protection

On the other hand explicit deposit insurance protection systems have laws that provide for bank deposit guarantees and establish basic aspects of the deposit insurance system, such as coverage limits, if and how the system will be funded, how depositors are to be paid in the event of a bank failure, types of instituions and deposits eligible for protection and whether membership is voluntary or compulsory. It is normally created by an Act of Parliament. An example is the creation of the deposit insurance scheme in Zimbabwe under the administration of the Deposit Protection Corporation.

Explicit deposit insurance systems (DIS) can have 100 percent or limited depositor coverage with the latter being now more popular than implicit protection. The number of explicit DIS have increased from 12 in 1974 to over 110 in 2012 (www.iadi.org/di.aspx). Adopting a system of explicit DIS does not eliminate implicit guarantees by government, especially during a systemic crisis and they can be privately or publicly administered.

Its merits are that it helps the government's to meet its obligations to depositors, limits the scope for discretionary decisions and enhances public confidence, enhances financial stability by establishing a framework for the resolution of failing/failed banks and help to contain the costs of resolving bank failures. It also has its draw backs including; limited coverage, deposit protection will not prevent bank runs when there is a financial crisis, moral hazard –explicitly protected depositors may have less incentives to monitor their banks and that banks have more incentive to take excessive risks when depositors are protected.

Categories of mandates under explicit deposit insurance protection

These types differ in powers and mandates but they share the same overall objective of promoting financial system stability by providing depositors with clarity, reassurance and confidence regarding their savings placed with banks. According to the Financial Stability Board (FSB) Peer Review Report (2012) the mandates of deposit insurance protection in FSB member jurisdictions are generally well defined and formalized, and may be broadly classified into four categories;

The paybox mandate is narrow and insurers have limited set of powers that facilitate payment of claims to depositors. Decisions regarding membership in the deposit insurance scheme usually are made solely by the financial supervisory authority.
Paybox plus mandate, the deposit insurer has additional responsibilities such as resolution functions.

A loss minimiser mandate, the deposit insurer actively engages in the selection from a full suite of appropriate least-cost resolution strategies.
A risk minimiser mandate, the deposit insurer has comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities.Insurers operating under this mandate have more extensive powers to assess and limit their risk, access to examination data from the supervisory agency, direct access to information from insured institutions, or authority or some influence over decisions to grant or terminate deposit insurance. A number of jurisdictions are responsible for, or participate in, the resolution of failed institutions and some have receivership/liquidation powers to dispose of the assets and settle the claims of failed institutions (www.iadi.org). Islamic deposit insurance system

Islamic DIS is a form of explicit DIS but different from conventional DIS. Islamic DIS is an arrangement to protect insured Islamic deposits in the event of collapse of an Islamic banking unit. The IDIS differs from the conventional system in the sense that it is subject to Sharia requirements but both systems have the same objective of protecting depositors and maintaining financial system stability.In this regard, the system must be free from the elements that Islam strictly prohibits such as interest, uncertainty and gambling. Examples of countries with Islamic DIS include Sudan, Malaysia, Turkey and Indonesia (IADI Survey on Islamic DIS, March 2010).
Integrated deposit insurance system

Financial markets have witnessed a shift from distinct banking, insurance and securities business to more integrated financial services offering many types of complicated financial products. An integrated DIS is whereby a deposit insurer has a wider mandate to provide protection to insurance policyholders, stock exchange investors, and non bank financial institutions as well as banks for example in the UK, Malaysia and Korea. The development of integrated DIS is an attempt by deposit insurers to improve their crisis responsiveness and enhance the protection of financial consumers and contribute to the stability of the financial system.Malaysia Deposit Insurance Scheme has been extended to protect insurance policyholders and depositors effective 31 December 2010. Following the Asian financial crisis in 1997, the Korea Deposit Insurance Corporation was transformed into an integrated deposit insurer covering almost all the compensation schemes. In UK the Financial Services Compensation Scheme (FSCS) operates an integrated compensation scheme covering depositors, Insurance policy holders for both short term and Life products and Investors.

John Chikura is the Chief Executive of the Deposit Protection Corporation.
He can be contacted at jchikura@dpcorp.co.zw; website: www.dpcorp.co.zw