



Transitioning from a Blanket Guarantee to Limited Coverage System

Introduction

In a number of situations where economies have been threatened by systemic financial crises, governments have introduced explicit blanket guarantees to fully protect all bank depositors and creditors in order to maintain domestic and international confidence in financial and payments systems. Recently, the UK government announced that it would fully protect all the deposits of one of its lenders in an attempt to cease a run on a financial institution.

Although such guarantees are often unavoidable, many such measures are intended to be temporary. When financial stability is restored governments need to consider techniques to be able to restore limited coverage through supporting measures that can accomplish a smooth transition. This Research Letter highlights key points that are articulated in investigations into this area by the Research Subcommittee of Asia Regional Committee (ARC)¹.

What are the key features of blanket guarantees adopted in different countries?

Based on the Subcommittee's survey results and other information sources, the ARC examined key features of 11 blanket guarantee systems that were implemented since the 1990s. According to their questionnaire-based survey, countries that adopted explicit blanket guarantees during the 1990s and 2000s can be divided into two groups i.e. those with and those without an explicit deposit insurance system (DIS) during the period of blanket guarantee:

- Countries without a DIS were Sweden, Thailand, Malaysia, Indonesia and Jamaica.²
- Countries with a DIS were Finland, Japan, Korea, Turkey, Mexico and Taiwan.³

The ARC paper notes that in most countries the blanket guarantee covers depositors and creditors of core commercial banks. However, non-bank financial institutions were also covered in some countries. Moreover, in Korea and Malaysia the overseas branches of domestic banking institutions were covered during the blanket guarantee period.

¹ The Subcommittee was chaired by Central Deposit Insurance Corporation (CDIC) and the final version of this paper will be posted on the IADI web site soon. An objective of this Research Letter is to highlight the findings of the paper which is being reviewed by the IADI's Research and Guidance Committee and the Guidance Group.

² Most of these countries established their explicit DIS in the aftermath of financial crises except Thailand: Sweden in 1996, Jamaica in 1998, Malaysia in 2005, Indonesia in 2006 and Thailand (pending).

³ Most of these countries shifted their then existing limited coverage deposit insurance provisions to a blanket guarantee while confronting a financial crisis. In the case of Mexico the coverage of banking system liabilities was practically unlimited, even before its 1994 financial crisis.

Blanket guarantee periods vary greatly from less than two to as much as ten years: Finland (February 1993 to December 1998), Indonesia (January 1998 to January 2007), Jamaica (January 1997 to August 1998), Japan (June 1996 to March 2002), Korea (December 1997 to December 2000), Malaysia (1998 to August 2005), Mexico (1990 to 1999), Sweden (from January 1993 to July 1996), Taiwan (July 2001 to July 2005) and Turkey (December 2000 to July 2004). Most countries implemented blanket guarantees during only for a few years, while announcing specific target dates for removing the blanket guarantee.⁴ In the case of Thailand, however, a blanket guarantee has been in place since 1997 without a specific deadline but an explicit limited depositor protection system is being discussed.

Public funds that would eventually become a burden on taxpayers turned out to be the main form of support for blanket guarantees in most of the countries with or without explicit DIS.⁵ The ARC paper further notes that public funding as a share of GDP amounted to 20% or more in the case of Korea, while the corresponding figures stood at 10% or more in Sweden, Thailand and Mexico and under 10% for Indonesia and Taiwan.⁶

Why is there a need to prepare a transition plan and what are the key factors to be considered in determining the transition timing?

As previously mentioned in the *FSF Guidance on Deposit Insurance*, blanket guarantees have a number of adverse effects if retained for a long time. If a country decides to transition from a blanket guarantee to a limited coverage DIS, the transition should be as fast as circumstances permit.⁷ An effective transition plan is crucial to control moral hazard linked to the blanket guarantee and limit the overall cost therewith to society. When determining timing policymakers should consider each country's overall economic situation and the potential impact of the transition on their financial market. When a financial system shows signs of instability or weakness, transition might only deepen that instability and increase the overall costs to the financial system. Hence, countries that consider transitioning should at least achieve a certain degree of financial stability before the transition is completed.⁸

Factors to consider in undertaking a transition to limited coverage

The ARC research paper hints at some policy issues that need to be considered in undertaking a transition to a limited coverage DIS.

⁴ Some countries, however, extended the deadline due to slower-than-anticipated progress of financial recovery and reconstruction. The paper addresses that Japan, Indonesia and Taiwan had this experience.

⁵ Even in the countries that had explicit deposit insurance systems, deposit insurance funds accumulated from premium collection were not sufficient to cover the massive cost of implementing the blanket guarantee system.

⁶ However, the ratio for Indonesia would reach up to 40% if we include the cost of their capital restructure fund.

⁷ See page 14 of the *FSF Guidance on Deposit Insurance* at the following link:
<http://www.iadi.org/Final%20Reports/FSF%20Final%20Report.pdf>

⁸ The ARC paper illustrates that the Korean financial institutions suffered a negative ROE of 14.2% in December 1997 when the government decided to enact a transitional blanket guarantee, and the rate became improved through the transitional period, reaching -11.9% in 2000 and 15% in 2001.



First, the transition from a blanket to a limited coverage needs to address the ability of the authorities to undertake prompt reimbursement of depositor funds, if the situation arises.

Second, policymakers may need to consider which of the following two distinct transition approaches mentioned in the ARC paper is more appropriate to their specific conditions and factors: 1) a '*fast transition approach*' with a specific deadline or; 2) a '*gradual transition approach*' by modifying the scope and ceiling of the coverage step by step until the transition deadline.⁹

Third, policymakers may need to modify certain design features of their DIS such as deposit coverage limits, scope and premiums in order to mitigate possible impacts on financial markets.

Fourth, the public needs to clearly understand the coverage limit and scope under DIS when the transition is completed.¹⁰ In this regard, the FSF Guidance notes that policymakers should pay particular attention to public attitudes and expectations.

Finally, policymakers may need to amend bank resolution regimes in order to minimize time and the potential cost of restructurings and the liquidation of the failed institutions.

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⁹ Gradual transition approaches were adopted by Japan, Indonesia, Turkey and Mexico. In those cases, the transition was accomplished through a phased lowering of the scope and ceiling of coverage. In contrast, a fast approach transition was adopted in Jamaica, Finland and Sweden following the completion of financial reconstruction.

¹⁰ In Korea, for example, a public awareness campaign was launched two years before the transition to limited coverage.