

The Role of Deposit Insurance in Contributing to Financial Stability: A Global Perspective

Remarks of John Raymond LaBrosse, Secretary General, International Association of Deposit Insurers, at the Public Lecture of the First Deposit Protection Awareness Week and 16th Anniversary of the Nigeria Deposit Insurance Corporation, Abuja, Nigeria, 15 September 2005.

Welcome. It is a pleasure to be here to provide a global perspective on the role of deposit insurance in contributing to financial stability.

I am pleased to be here to deliver this lecture as part of the first deposit insurance awareness week in Nigeria. This is my second trip to Nigeria and I am most happy to join in the celebrations for the 16th anniversary of the Nigeria Deposit Insurance Corporation. I bring you the very best wishes from the International Association of Deposit Insurers. The Chair of the Executive Council, Jean Pierre Sabourin, asked me to convey his very best wishes on behalf of the Executive Council.

I am also pleased to have Victor Odozi join as the discussant for my paper. I understand that Mr. Odozi was the Deputy Governor of the Central Bank of Nigeria at the time that NDIC was created. Much of what I have to say today draws on lessons learned in establishing deposit insurance systems around the world. I hope that some of comments will be useful in looking back to the way that NDIC was established.

Overview

Let's start with a truism. Every country has some form of deposit insurance, whether they know it or not. Why? Because the public wants to have, and governments want to promote, confidence in the banking system. This is due to the fact that intermediation is an important means of transforming depositor funds into loans which help generate economic activity and growth. Today, from a global perspective, I would like to look at different forms and alternatives to deposit insurance and then focus on some key aspects of explicit

systems. I will spend a few moments talking about what IADI is doing to help deposit insurance systems contribute to financial stability.

We now accept that banks will fail, in one form or another in all jurisdictions around the world. So many failures that this has become accepted wisdom.

Financial institutions that accept deposits from the public are important in the economy because of their involvement in the payment system, their role as intermediaries between depositors and borrowers, and their function as agents for the transmission of monetary policy. Banks are in the business of assuming and managing risks. By their nature, banks are vulnerable to liquidity and solvency problems, among other things, because they transform short-term deposits into longer-term, less liquid loans and investments. They also lend to a wide variety of borrowers whose characteristics are not always readily apparent. I am certain that you all know about lending risks.

The importance of banks in the economy, the potential for bank runs and the need to mitigate contagion risk, and the potential for depositors to suffer losses when banks fail, lead countries to establish financial safety nets, that include deposit insurance systems.

Who is responsible for bank failures?

The solvency or the failure of a bank is first and foremost the responsibility of a bank's Board of Directors and the Management. However, in reality, when a bank fails, the public perceives the failure not as a bank responsibility or a supervisory or deposit insurer responsibility but a failure of the government to do its job.

When a bank does fail, depositors are relieved when they are informed that their deposits are protected and that they will be reimbursed as soon as possible.

Protecting Deposits: Why it Matters

Funds held as deposits with banks in many countries are viewed by the public as government guaranteed since banks are chartered, regulated and supervised by the government. Ultimately, for the public to have confidence in the banking system they must perceive that a dollar on deposit is the same as a dollar in their pocket.

To maintain confidence in the banking system and in the country, government's cannot afford to allow banks to fail where vast numbers of deposits are lost. There have been many examples of government

bail outs due to pressure put on them either by mass rallies or media coverage. There is a direct social cost if the depositors lose their funds because of a bank failure.

Forms of Protection

Let's remind ourselves what deposit insurance is all about. The principle objective of a deposit insurance system is to contribute to the stability of the financial system and protect less financially sophisticated depositors from the loss of their deposits when a bank fails. There are a variety of options available for achieving these objectives.

Some countries have implicit protection that arises when the public, including depositors and other creditors, expect some form of protection when a bank fails. This expectation usually arises because of the government's past behavior 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 promised or the form in which reimbursement will take. By its nature, implicit protection creates uncertainty about how depositors, creditors and others will be treated when a bank failure occurs.

With implicit protection, funding is discretionary and often depends on the government's ability to access public funds. Although some advance that a degree of uncertainty can lead depositors to exert greater effort in monitoring banks, in reality most depositors are not capable of doing so, or have little incentive given the diversity of interests.

Since decisions to reimburse depositors are discretionary and based on the willingness and capability to fund depositors, depositors in failed banks are often treated differently. This creates inequities and does not promote stability. Finally, there are cases where countries have had to fund failures through government appropriations which have forced them to reduce spending on needed social programs and infrastructure programs for several years.

Some countries have had to introduce explicit blanket guarantees during a financial crisis to fully protect all bank depositors and creditors. The provision of such guarantees may be unavoidable in periods of extreme financial distress to maintain domestic and international confidence in a country's banking system.

However, such blanket guarantees are the extreme in moral hazard and it can have a number of adverse effects. We can identify many countries which have had to resort to blanket guarantees – Sweden, Mexico, Japan, Malaysia, and Thailand. Blanket guarantees are easily announced but difficult to eliminate or reduce, Japan being an example.

Alternatives to Depositor Protection

There are many views about depositor protection. The one most talked about is moral hazard. We should remember that there is moral hazard in all parts of the safety net: central banks, deposit insurance and supervisors. Many academics advance that there are alternatives to depositor insurance. My remarks today will focus mainly on deposit insurance as I believe that the authorities in Nigeria through the creation of NDIC have decided not to pursue other forms of protection.

1. Market Discipline and Disclosure

One for sure is greater reliance on market discipline as it is a very important measure to address moral hazard. Disclosure has been offered up as an alternative to deposit insurance and as a means to reduce the level of supervision and regulation involved in safety nets.

At its extreme, this view encompasses “unregulated banking” where entry and exit are uncontrolled, supervision is nonexistent or minimal, competition is intense and there are no implicit or explicit guarantees. It is argued that given market discipline and full disclosure, depositors would have the incentives and capabilities to look after their own interests. Losses to depositors and creditors would occur, but it is argued that such a system would see fewer problems to begin with and losses would be minimal. The model is very conceptual and no country I am aware of follows it exclusively. Although, some would argue that New Zealand is close to this model – it should be noted, however, that they do not have any domestic banks.

Disadvantages with this approach are numerous and include difficulties in creating well functioning markets through disclosure of financial information, a propensity for runs (although some argue this is not bad for a financial system), difficulties for lenders of last resort in determining whether problems are due to illiquidity or insolvency, and a strong tendency for governments to intervene to rescue all creditors when faced with failures.

Although this pure “unregulated banking” model has not been used, elements of the model can be helpful. For instance, extensive disclosure requirements and efforts to expose owners, managers and large creditors to as much market discipline as possible are valuable whether one has explicit deposit insurance or not.

Market discipline and disclosure are highly important. Note, the proposed Basel II Accord and the Sarbanes-Oxly requirements – both are focused on increased disclosure.

2. Depositor Preference

Let’s take a brief look at depositor preference. Countries without deposit insurance can provide their depositors with some protection from loss by giving them priority over the assets that are recovered from a failed bank. Essentially, this means that while secured creditors have first priority, followed by liquidation/ receivership expenses, depositors are ranked immediately afterward with all other unsecured creditors (e.g. employees, unsecured central bank claims, taxes) and subordinated claims and shareholders following them.

Depositor preference is used in a number of countries. In the U.S. it is used in conjunction with deposit insurance for domestic depositors. Germany provides depositors priority over secured as well as unsecured creditors. In Australia, depositors receive priority over all other unsecured creditors and it is used in a financial system without explicit deposit insurance (although some observers argue that an implicit deposit protection regime exists in Australia). Australia is now seriously considering establishing an explicit deposit insurance system.

3. Governance Incentives

A key element in promoting market discipline is to ensure that there are strong governance incentives for owners, directors and managers of institutions. It has been my experience in Canada in dealing with failures that deficiencies in corporate governance are among the most important causes of problems.

A variety of mechanisms exist for enhancing corporate governance. Although shareholders are exposed to the potential for investment losses in most market systems, “double liability” proposals have been made whereby investors could be subject in a failure to covering shortfalls and losses to creditors. It has even been proposed that “double liability” could be used as an alternative to deposit insurance. Double liability was in place in Scotland in the 19th century and in

many states of the USA prior to the 1930s where it appeared to play a positive role in limiting bank failures. It was a feature of the Canadian system until 1954.

The problems with practically implementing such schemes are numerous however, and include creating incentives for investors to participate knowing their further potential liability and in creating the legal structure necessary to enforce the contracts.

In addition to double liability there are a number of other innovations which can be implemented to increase director accountability. For instance, in Canada, directors are required to sign (attest) to compliance with Standards of Sound Business and Financial Practice, thereby creating a strong contingent legal liability if institutions disclose knowingly false information to supervisors. New Zealand requires directors to sign-off on the accuracy of very detailed publicly disclosed financial statements.

4. Explicit Systems

An explicit deposit insurance system is preferable to any other type of deposit protection. It is preferable because it clarifies the authorities obligations to depositors and limits the scope of discretionary decisions that may result in arbitrary actions. To be credible 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. However, an explicit system needs to be part of a well designed financial safety-net, supported by strong prudential regulation and supervision, effective laws that are enforced, sound corporate governance and risk management in banks and sound accounting standards and disclosure regimes.

In designing an explicit system to protect insured depositors against the consequences associated with bank failures we should remember that it should not be designed to protect banks from failing. An effective system limits government fiscal exposure since banks pay the cost of the system and it also reduces the political risks of allowing banks to fail. It can also contribute to the maintenance of confidence and reduce the likelihood of bank runs.

To be effective, an explicit system needs a clear mandate to reinforce the stability of the financial system and to contribute to its own sound governance and greater accountability. An explicit system also requires the powers to fulfill the mandate. All deposit insurers require

the ability to enter into contracts, set appropriate requirements, and access to timely and accurate information to ensure that they can meet their obligations to depositors promptly. Interrelationships between safety net players need to be well defined to ensure close coordination of activities.

There are a number of design features that need to be decided upon to ensure that an explicit deposit insurance system is effective. These are: which institutions should be eligible for membership (commercial banks, foreign banks, state banks and non-financial institutions), the need for compulsory membership to avoid adverse selection, what considerations are necessary for granting membership (when the deposit insurer is established and after new banks are chartered), coverage and limits (scope and level, co-insurance, adjusting coverage limits, foreign currency deposits), funding (levies, ex-ante or ex-post premium assessments, flat rate or differential premiums) level and size of a Fund (target ratio or range), public awareness, bank resolutions, reimbursement of depositors claims, claims and recoveries, among other things.

As we can see, the establishment of an effective explicit deposit insurance system is rather complex. But the benefits far outweigh the complexity of establishing one.

There are always criticisms of explicit systems. But if one considers the options, effective explicit deposit insurance systems do promote and contribute to the stability of the financial system.

One word of caution. Effective explicit systems can deal with a bank failure or a wave of failures but cannot by themselves deal with a financial system crisis. That is the role of the government. Finally, the complexity of explicit systems require appropriate skills and resources to be effective. Such skills are in short supply, more so expert practitioners. That is why, IADI was established.

Designing a System

In designing deposit insurance systems much can be learned from the experiences of other countries. The experience from the Asian financial crisis, which not only had an effect in Asia, but also put pressure on both emerging markets and developed countries can be helpful to many countries. We can also take into consideration the experience and lessons learned from nations who dealt with past crisis,

such as the U.S., S & L crisis, the Mexican Crisis and from other countries that had varied experiences with bank failures. All of this to say that there are no "cookie cutter" approaches to establishing an effective deposit insurance system. It cannot be imported and imposed!

One lesson learned and still being learned is that there has to be a fit between public policy objectives and the design of the deposit insurance schemes or system. Too often countries implement schemes without understanding fully what objectives are most important, since there are many important policy trade-offs such as moral hazard and market discipline in the context of country specifics.

There are no ideal conditions that should exist in order to establish an effective and credible deposit insurance system. But, one can make some important observations.

A sound legal regime includes: the regulatory system, the judicial and parliamentary system. If laws are non-existent for the well functioning of the financial system or the system is froth with conflicts (e.g. secrecy laws), then it is very difficult for any deposit insurance system to be effective. If laws for closure regimes, valuation methodologies, liquidation of assets, and resolving creditor's claims are non-existent or deficient, no deposit insurer can weather the costs of bank failures or handle failures efficiently.

Others conditions that must be considered are: a stable macroeconomic environment; appropriate regulation; effective supervision; compliance with recognized accounting, auditing and regulatory standards and transparent disclosure regimes.

Common Features

We know from experience that countries have different public policy objectives that account for a wide range of deposit insurance systems and structures. Nevertheless, there are common features identified that are essential to an effective deposit insurance system to promote public confidence and contribute to the stability.

1- An explicit and well-publicized framework. The public needs to understand the benefits and limitations of the deposit insurance in place. The deposit insurance system also needs to be explicit as to benefits, coverage limits, payment process, etc.

2- There should be mandatory participation for all banks, if not there may be adverse selection. The benefit of deposit insurance in contributing to the stability and public confidence applies to all players.

Therefore, all banks should be members and pay the cost, even those that are considered too big to fail.

3- To manage moral hazard, coverage should be limited (The Study Group had some interesting discussions on the issues of limits, but did not make any conclusions. This will be part of further work.) What were the lessons learned? None of these will surprise you!

Lessons Learned

I want to focus for a minute on some lessons learned:

1- One of the most important lessons is that deposit insurers can deal with a bank failure or a wave of failures, but cannot, by themselves, cope with a systematic financial crisis. This requires broad and coordinated government action. Too often, deposit insurance schemes fail because of lack of understanding on their limitation. Deposit Insurance is not the mother of all solution!

2- In a crisis, government may have to adopt blanket guarantees, which increases moral hazard.

3- Financial sector liberalization needs to be well-conceived, well-executed and accompanied with necessary changes to the regulatory, supervisory and deposit insurance systems. Too often, countries forget the need to enhance the safety net to deal with financial sectors liberalization.

4- Appropriate incentives need to be in place to ensure early detection of problems and prompt corrective action. Financial incentive or job loss are two examples. Incentives do work!

5- Weaknesses in bank supervision, lack of qualified resources and "forbearance" contributed to delays in dealing with bank problems and increased costs to governments and depositor insurers. Problems will recede, if we give them more time!

6- Roles and responsibilities among the safety net players were often not well defined or understood. In some cases, clear accountability was absent and not compatible with public policy objectives. Mandates were not legislated or understood. It is important to note that this is not an emerging market issue. Most countries have some issues.

7- Accounting and auditing standards need to be put in place and applied consistently.

8- Transparency and disclosure regimes, bank risk-management and corporate governance practices , and asset-valuation methodologies need to be enhanced.

9- Inadequate public awareness of deposit insurance contributed to lack of public confidence, thereby, eliminating any benefit that one deposit insurance can bring to the stability of the financial system

10- Safety net employees should not be personally liable for actions taken on behalf of their organizations seriously impeding will to act and performance.

11- Legal regimes need to be adequate to deal with bank failures, liquidating assets and resolving creditors' claims.

12- Information-exchange arrangements between safety net members were inadequate in a number of countries. This is a big problem in most countries. Information is king - proprietary and coveted.

International Experience

Our approach was to assess recent experiences brought on by the Asian financial crisis, which not only had an effect in Asia, but also put pressure on both emerging markets and developed countries. We also took into consideration the experience and lessons learned from countries who dealt with past crisis, such as the U.S., S & L crisis, the Mexican Crisis and from other countries that had varied experiences with bank failures.

Because of the crisis, many countries provided (either explicit or implicit) blanket guarantees to all creditors to prevent their financial and payment systems from collapsing. I am not passing judgment here. What realistic choices did they really have? However, blanket guarantees bring extensive exposures and moral hazard.

Among the measures to reduce blanket guarantees is to establish a deposit insurance system over time. Why? Because an effective deposit insurance system can promote confidence and contribute to the stability of the financial system, but only if it is properly designed and implemented.

In our Report, we acknowledge that in a competitive market system, banks will fail! An interesting comment all of us agreed with, but in

reality many policy-makers are not prepared to disclose publicly. There is a clear need to publicize this, so that depositors really understand the risks they may face.

We identified the primary objectives of a deposit insurance scheme, which are to contribute to the stability of the system and protect small depositors when banks do fail. We also noted that there are varied objectives and trade-offs.

However, a well-constructed scheme can achieve these objectives by significantly reducing the risks of bank runs and the disruptive breakdown in essential banking activities that accompany runs.

It can also contribute to the smooth functioning of the payment system and the credit mechanisms and facilitate bank exits.

All of this to say that there are no "cookie cutter" approaches to establishing an effective deposit insurance system. It cannot be imported and imposed!

Another lesson learned and still being learned is that there has to be a fit between public policy objectives and the design of the deposit insurance schemes or system. Too often countries implement schemes without understanding fully what objectives are most important, since there are many important policy trade-offs such as moral hazard and market discipline in the context of country specifics.

The Report addresses (and no report on deposit insurance can ignore) moral hazard. In a nutshell, it is a public policy trade-off and more importantly, moral hazard can be managed. Indeed, policy-makers have a number of measures to limit moral hazard without negating the benefits of deposit insurance. They have not, for whatever reason, adopted many of the measures available, such as imposing differential premium systems, introducing personal liability incentives on directors, officers of banks and enhancing disclosure, and transparency of banks and supervisory information.

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But, please, one word of caution. Effective explicit systems can deal with a bank failure or a wave of failures but cannot by themselves deal with a financial system crisis. That is the role of the government. Finally, the complexity of explicit systems requires appropriate skills and resources to be effective. Such skills are in short supply, more so expert practitioners. That is why, IADI was established.

Self Assessment Model

To help policymakers we have been promoting a self assessment process (SAM) as a tool to help them determine how to design, implement and enhance deposit insurance schemes in order to make them effective and to contribute to the stability of the financial system. The model has a 6 step process. However, in reality, it is a never ending process. In order for a deposit insurance scheme to remain effective, it must adapt to a changing environment and must have in place a continuous improvement process. It is too easy to become complacent during a long period of growth and prosperity, when banks fail rarely or their failure is insignificant to the stability of the financial system. We don't have the time now to go into the model in detail. Perhaps we can do this at another time.

Under a blanket guarantee there is no incentive for banks to clean up their lending practices or manage their affairs prudently.

Delays in closing or dealing with problem banks can lead to substantial fiscal costs.

Bank runs are costly to the economy.

There needs to be a mechanism to reimburse depositors accurately and on a timely basis and to ensure that recoveries are optimized to reduce the losses.

Views on Deposit Insurance

I think that it is interesting to refer to some recent quotes on deposit insurance.

"...it is clear that deposit insurance has played a key – at times even critical – role in achieving the stability in banking and financial markets that has characterized the past almost seventy years".

This quote is from Alan Greenspan from his remarks at the Chicago Bank Structure Conference.

".. the positive effects of deposit insurance schemes now seem generally agreed at least by government and international officials. One important benefit is consumer protection for those deemed incapable of adequately assessing the risks of individual banks themselves."

That quote was from Bill White, Economic Adviser, Bank for International Settlements.

Lastly,

"It is the conviction of the FSF that this report (Final Report of the Working Group on Deposit Insurance), with such a pragmatic approach will serve as a useful tool for policy makers who want to design deposit insurance systems that preserve the benefits of heightened financial stability and small depositors' protection, without at the same time increasing moral hazard or reducing market discipline".

That quote was from Andrew Crockett, former Chairman of the Financial Stability Forum.

Moral Hazard

No discussion on deposit insurance can be complete without considering moral hazard.

Moral hazard refers to the incentive for excessive risk taking by banks and those receiving the benefits of protection. Such behavior may arise in situations where depositors, creditors, shareholders and bank management are protected, or believe that they are protected from losses or when they believe that a bank will not be allowed to fail.

Moral hazard exists in all parts of the safety net. Central banks when they provide lender of last resort facilities (e.g. liquidity or solvency support), the supervisor who provides forbearance and a deposit insurer that continually recapitulates troubled banks without requiring management or ownership changes.

Moral hazard can be mitigated, but it requires a concerted effort from all participants. Effective corporate governance and sound risk management of individual banks, effective market discipline through

sound accounting and disclosure regimes, attention by rating agencies, market analysts, financial commentators and other professionals.

The qualifications of directors and managers, sound business objects, fit and proper tests of controlling shareholders, standards of good corporate governance and risk management, strong internal controls and independent external audits.

Supervisory discipline can be exercised by ensuring that banks are monitored for safety and soundness as well as compliance issues and that prompt corrective actions are taken when problems arise, including early closure of banks when necessary.

Deposit insurance systems can also mitigate moral hazard. Placing limits on the amount insured, excluding certain categories of depositors, using some forms of co-insurance, implementing differential premium assessment systems, minimizing losses through early closure of troubled banks, and demonstrating a willingness to take legal action, when needed, against directors and others for improper conduct or for not exercising their fiduciary responsibilities.

Public awareness

Before I close and say a few words about IADI, I want to use this occasion of the first Public Awareness Week of Deposit Insurance in Nigeria to say address this issue.

Public awareness programs need to focus on the benefits, and limitations, of deposit insurance. Although the costs can be considerable, the need for it cannot be underestimated. The target audiences are very clear. They are the general public, who can often be best reached through the media, legislators and the banks. Practitioners should remember that the individuals in their organizations are "ambassadors" and they should be fully versed in all aspects of deposit insurance.

In the few minutes that I have remaining I would like to talk about the International Association of Deposit Insurance and our goals and objectives.

International Association of Deposit Insurers

IADI has been in existence for just over three years. In fact, we used the occasion of an International Conference in Almaty this past May to join in a celebration of our achievements. With the inclusion of the just-formed MDIC, we now have 41 enthusiastic Members in IADI plus 8 Associate, four Observers and 6 Partners. Members in IADI are deposit insurance organizations. Some are national in scope and operated by the central government.

Our objective is to help deposit insurance systems contribute to financial stability. We are meeting this object by providing highly useful conference and other forms of training and doing research and issuing guidance.

At the end of the month, the fourth annual general meeting and conference will take place in Taipei. The program for the conference focuses on challenges for deposit insurers in resolving bank failures. There will be six sessions touching on initiatives by safety-net participants to help make banks "too good to fail", techniques to develop more effective deposit insurance systems, cross-border challenges in handling bank insolvencies, guidance to aid the resolution of failed banks, promoting international co-operation, contingency planning and guidance for promoting effective interrelationships.

As part of our development of guidance, IADI has issued guidance on the design of deposit insurance systems, differential premium systems and following the fourth annual conference we shall issue guidance on bank resolutions and interrelationships. But, there is more work to be done. We soon will focus on a range of issues where best practices can be developed drawing on the experience of our membership and these topics will include areas such as structure and organization, coverage, legal trigger mechanisms, indemnification, etc.

Final Observations

Let me make some final observations. deposit insurers should be looking for models of efficiency and practices and learn from other deposit insurers; all systems benefit from a continuous improvement process; finally, the investment that you are making by learning from others is worth the cost and effort.

John Raymond LaBrosse