

# **PUBLIC-POLICY OBJECTIVES FOR DEPOSIT INSURANCE SYSTEMS**

## **Abstract**

Countries base their deposit insurance systems on a variety of public-policy objectives. After consultation and analysis, the Subgroup on Public-Policy Objectives identified a number of common objectives that may be classified under three broad categories: 1) those contributing to the stability of the financial system; 2) the protection of less-financially-sophisticated depositors; and 3) other. Although countries often choose similar objectives, analysis suggests that there is variation in how they are achieved. Thus, policymakers should endeavour to understand the trade-offs and implications associated with particular objectives, and should structure their deposit insurance systems accordingly. It is also important to revisit these objectives over time.

# **PUBLIC-POLICY OBJECTIVES FOR DEPOSIT INSURANCE SYSTEMS**

The following represents the work of the Subgroup on Public-Policy Objectives.<sup>1</sup> The paper focuses on: 1) the identification of public-policy objectives used by different countries; 2) the trade-offs associated with particular public-policy objectives; and 3) the structural and other implementation issues that may arise when particular public-policy objectives are chosen.

## **Background**

The development of public policy by governmental bodies and officials involves the selection of goals and the means of achieving them within a specified context. Public-policy objectives, which involve formal and informal expressions of normative intent, provide purpose and focus. These objectives can be stated explicitly—for example, through a legislative mandate—or implicitly by the way a particular activity is conducted or structured. Implicit public-policy objectives by their nature can be more difficult to identify since they must be inferred from the way activities are undertaken or administered. At times, the public-policy objective may result in a decision not to act; at other times, multiple public-policy objectives may be pursued through a single activity.

The implementation of a public policy may lead to unintended or unforeseen consequences. In certain cases, such unintended consequences may be inevitable; in other cases, unintended consequences may be addressed by restructuring the policy and activity to make it more consistent with the original intent of policymakers.

Although the determination of public-policy objectives is the responsibility of governments, the private sector often plays a role in the implementation and administration of particular public policies. With respect to deposit insurance, many countries have privately operated systems that fulfill public-policy objectives. The choice of how a deposit insurance system is to be operated depends on factors that are unique to each country.

The selection of public-policy objectives is often a complex process. The Financial Stability Forum's Working Group on Deposit Insurance (the Working Group) suggested in its *Background Paper* that when countries select public-policy objectives, they should take certain conditions into consideration such as the state of their economy, the legal and supervisory framework, the structure of the banking system, the quality of accounting, regulatory and auditing standards, and the disclosure regime.<sup>2</sup> The Working Group also suggested that for countries to fulfill their public-policy objectives, there should be congruence between the objectives and how the deposit insurance system is structured. Although this paper does not examine structural issues

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<sup>1</sup>The Subgroup on Public-Policy Objectives is comprised of representatives from Canada (coordinator), Jamaica, Mexico, Philippines, and the International Monetary Fund.

<sup>2</sup> Financial Stability Forum Working Group on Deposit Insurance, *A Consultative Process and Background Paper*, June 2000.

specifically, it is important to emphasise that the effectiveness of the deposit insurance system will depend on the level of congruence or fit between public-policy objectives and structures.

A variety of methods exist for determining public-policy objectives. One method suggested by the Working Group is for policymakers to begin with a public-policy paper. The analysis contained in the paper should take into account relevant conditions referred to above. The paper also could set out the key attributes and elements that are important to a deposit insurance system, so as to determine the mandate and the powers to be given to the deposit insurer. As well, the paper should outline the role of the deposit insurer within the financial safety net and the deposit insurer's relationship with the other participants in the regulatory and supervisory regime. The paper would form the basis for discussion and help policymakers formulate their decisions.

### **Public-Policy Objectives for Deposit Insurance Systems**

Public-policy objectives vary according to national conditions. Countries may structure their deposit insurance system to achieve one or more objectives. These objectives may shift over time in response to changes in economic, financial and/or social circumstances. Policymakers may alter the mandate, roles and responsibilities of the deposit insurance system in response to these changes.

To aid its deliberations, the Subgroup examined information provided by members of the Working Group on the public-policy objectives underlying their deposit insurance systems. The Subgroup also considered information provided through the Working Group's public Web site and Outreach Sessions. As a result of this consultative process the Subgroup identified three broad categories of public-policy objectives. First, contributing to financial system stability; second, protecting less-financially-sophisticated depositors; and third, other objectives. In certain circumstances some objectives may be closely related to, or components of, broader objectives. A general discussion of these broad categories follows.

#### **Contributing to financial-system stability**

A common public-policy objective for deposit insurance systems is to contribute to the stability of a country's financial system. This objective is based on a concern that depositors may lose confidence in an institution under certain circumstances.

##### *Minimising the risk of runs*

Without deposit insurance there is a greater likelihood that depositors might "run" by removing their deposits from an institution in response to difficulties—either real or perceived—at that institution. Once a run begins at one institution, it may lead to runs at others—regardless of their condition—as depositors may find it difficult to differentiate between sound and unsound institutions. This is often called the contagion effect. As a result, sound institutions may face difficulties when they are compelled to liquidate their asset portfolios, often at depressed prices, in order to meet withdrawals.

The ability of a deposit insurance system to stem or avoid bank runs depends on the extent to which depositors feel protected from loss in the event of a failure. The level of coverage, the speed with which insured deposits are repaid, and the credibility of the guarantee will affect whether the deposit insurance system is capable of enhancing financial stability. However, a policy trade-off exists between maximising financial stability through a blanket guarantee and the problem of maintaining market discipline. Over the long term, financial stability may be enhanced by limiting coverage and fostering market discipline since distortions in market incentives may be lessened.

It is important to note that a deposit insurance system on its own cannot ensure financial system stability. This is especially true in cases of a systemic crisis. A deposit insurance system is more effective when it is part of a coordinated financial safety net that includes, among other things, supervisory and regulatory arrangements and lender-of-last-resort facilities. Bankruptcy and insolvency laws and a government's economic policies also will play a crucial role in mitigating and avoiding problems in the financial sector.

#### *Creating formal mechanisms for resolving failed institutions*

The introduction or reform of a deposit insurance system may be linked to a country's attempt to put in place laws and mechanisms that deal with failed institutions. Experience suggests that the failure of depository institutions must be handled in unique ways to deal with the tendency of troubled institutions to deteriorate rapidly, while minimising adverse effects on the overall financial system. The introduction of deposit insurance may be linked to the creation of a country's failure-resolution framework.

#### *Contributing to an orderly payments system*

Deposit insurance helps to promote financial stability by contributing to the smooth functioning of the payments system. Deposits allow individuals and businesses to save and withdraw money when it is needed. By promoting confidence in the system, deposit insurance facilitates the smooth transfer of deposits between parties. For the payments system to function, depositors must be certain that their money on deposit is as sound as currency.

In addition, some deposit insurance systems are able to provide a form of emergency financial assistance, which may involve guaranteeing the payment transactions of troubled institutions. Such assistance may help to avoid interruptions in payment and settlement flows. In so doing, such assistance provides time for safety-net participants to devise solutions to resolve troubled institutions.

#### *Resolving a financial crisis*

Deposit insurance systems are often introduced when a country is undergoing or has undergone a period of significant financial instability. When problems within the financial sector occur, deposit insurance facilitates the ability of institutions to maintain a stable deposit base and is a means of assuring depositors that their funds are secure.

There are certain issues that should be considered when a deposit insurance system is introduced. As mentioned earlier, a deposit insurance system by itself cannot restore financial stability. In addition, deposit insurance will be more effective when it is introduced as part of a comprehensive framework that includes sound macroeconomic policies, regulatory and supervisory arrangements, legal frameworks, and lender-of-last-resort facilities. These statements are valid regardless of whether the financial system is in crisis.

A deposit insurance system that is introduced to avert short-term financial instability may lead to long-term problems if issues such as moral hazard are not addressed.<sup>3</sup> Mechanisms exist that minimise such costs, although they may be difficult to introduce during periods of financial instability.

### **Protecting less-financially-sophisticated depositors**

An oft-cited public-policy objective for deposit insurance is the protection of less-financially-sophisticated depositors, who often are distinguished by the small size of their deposits. Less-financially-sophisticated depositors are protected for the following reasons. First, deposit insurance protects individual depositors against the consequences associated with the failure of an insured institution. Second, the provision of deposit insurance relieves insured depositors of the difficult and complex task of monitoring and assessing the condition of their financial institution. The opaqueness of information on depository institutions makes it difficult, if not impossible, for less-sophisticated depositors to obtain and analyse the financial condition of these institutions. This is often not the case for sophisticated depositors and other general creditors. As a result, less sophisticated depositors may be at an informational disadvantage. A deposit insurance system can help address the inequity that exists between sophisticated and unsophisticated creditors, and as a result may help improve discipline on institutions.

If the main public-policy objective is to protect less-financially-sophisticated depositors, then the level of coverage may be such that sophisticated depositors will run when an institution is perceived to be in trouble. This is the nature of the trade-off between choosing financial stability as a public-policy objective and choosing protection of less-financially-sophisticated depositors.<sup>4</sup> Conversely, limited coverage may provide an incentive for financially-sophisticated depositors to exert market discipline, which helps constrain overly risky behaviour by insured institutions.

### **Other public-policy objectives**

Although financial stability and the protection of less-financially-sophisticated depositors are the primary objectives of numerous deposit insurers, some countries have identified other public-policy objectives as important to their system. In some cases, these may be subsidiary objectives or by-products of the pursuit of financial stability or the protection of less-financially-sophisticated depositors. What follows is a sample of some of the less prominent public-policy objectives identified by commentators and the Working Group.

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<sup>3</sup> These issues are discussed in the papers on moral hazard and transitioning.

<sup>4</sup> See the papers on moral hazard and coverage for further discussion of these issues.

### *Redistributing the cost of failures*

In countries where there is no formal deposit insurance system the cost of protecting depositors often falls on the government. Establishment of an explicit deposit insurance system can reduce the government's financial obligation for such protection by limiting coverage and by providing a mechanism through which surviving institutions may cover all or a portion of the costs associated with resolving failures. However, the ability of surviving institutions to contribute to the cost of failures will depend on their financial condition. It may be necessary for the deposit insurer to adjust premiums to reflect the remaining institutions' ability to contribute. The government also may have to contribute to part of the cost, at least in the short term.

### *Promoting competition in the financial sector by reducing competitive barriers in the deposit-taking industry*

By facilitating the entry of new firms into the deposit-taking industry and by helping smaller institutions compete for deposits against larger institutions, deposit insurance may promote competition. In the absence of deposit protection, depositors are likely to prefer using large, well-known institutions that are perceived to be less risky. This perception reflects a number of factors. First, large institutions may have more-diversified portfolios than smaller institutions. Second, larger institutions may be protected by an implicit government guarantee because they are considered to be too big to fail. Third, such institutions may have a long history with a high level of brand and franchise awareness among the public. The benefits of encouraging new entry and competition may be improved economic efficiency, lowered interest rates and spreads, and increased investment and economic development.

The adoption of this objective may require adjustments in the structure of the deposit insurance system to address issues such as moral hazard. For example, a country may opt for generous coverage in order to encourage the formation of new institutions. However, generous coverage may require stronger supervisory discipline to compensate for any lost market discipline, as well as other measures to control risks to the deposit insurance system. This public-policy objective may have implications for which institutions are eligible for membership in the deposit insurance system.<sup>5</sup> In addition, a focus on promoting competition may compromise the ability of risk-minimising deposit insurance systems to carry-out their mandate. In this case the public-policy objective may conflict with the mandate of the deposit insurer.<sup>6</sup>

### *Encouraging economic growth*

The introduction of deposit insurance may encourage the flow of funds into depository institutions, thereby providing the basis for lending and investment. In addition, the risk premium depositors require on their funds may decrease, which may allow insured institutions to lower their lending rates. Lower financing costs, in turn, may stimulate investment and other economic activity. However, it should be noted that deposit insurance can only indirectly stimulate economic growth.

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<sup>5</sup> See the paper on membership.

<sup>6</sup> See the paper on structure and organisation.

### *Reducing the effect of a recession*

One of the benefits of deposit insurance is that it can mitigate the consequences of failures of insured institutions on depositors. This benefit, in turn, may be particularly important during a recession. However, the contribution made by the establishment of a deposit insurance system to solving macroeconomic problems, such as a recession, is limited.

### *Facilitate the enactment of legislation, regulation and supervisory regimes*

The establishment of a deposit insurance system may provide the impetus for legislators to overcome political barriers to institute other reforms as needed to maintain a sound financial system. The drawback of pursuing this objective is that the resultant framework eventually developed may only reflect the specific issues associated with deposit insurance, and may not be sufficiently comprehensive to contribute to overall financial stability.

### *Facilitate the transition from a blanket guarantee to limited coverage*

Countries may introduce an explicit, limited-coverage deposit insurance system as a way of facilitating the transition away from a full deposit guarantee provided by the government or other public entity.<sup>7</sup> In such cases, deposit insurance systems may allow governments to reduce coverage, and may provide a mechanism for managing the required change in public and market attitudes toward deposit protection. The successful implementation of this public-policy objective requires a well-developed transition plan, a commitment to limited coverage, and a period of relative financial stability.

## **Conclusions**

- Before structuring or modifying a deposit insurance system, policymakers should identify the public-policy objectives they are trying to achieve and the trade-offs involved.
- Public policies should address the specific needs and conditions of the country.
- The choice of public-policy objectives should be guided by a country's contextual conditions, including: the state of the economy; the legal and supervisory framework; the structure of the financial system; the quality of accounting, regulatory and auditing standards; and the disclosure regime. As time passes and conditions change, a country's public-policy objectives may need to be adjusted to account for the new circumstances. In many countries a process exists for periodically reviewing their deposit insurance system's public-policy objectives. In this way, countries can ensure that their deposit insurance system remains consistent with economic and social conditions, and is better able to deal with the challenges it encounters.
- The structure of the deposit insurance system should be consistent with a country's chosen public-policy objectives. Public-policy objectives can be stated explicitly—for example, through a legal mandate—or implicitly—for example, by the way the system is structured.

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<sup>7</sup> See, the paper on transitioning.

Implementation of an effective deposit insurance system involves understanding all of the relevant public-policy objectives and their implications, and structuring the scheme accordingly.

- Many public-policy objectives for deposit insurance systems exist. Although some objectives are more well-known than others, countries choose their objectives according to their country-specific goals and circumstances.
- Although the determination of public-policy objectives is the responsibility of governments, the private sector often plays a role in the implementation and administration of particular public policies. With respect to deposit insurance, many countries have privately operated systems that fulfill public-policy objectives.
- In practice, policymakers may present their objectives in a paper, such as a consultation document. This paper could contain analyses of country conditions and set-out key attributes and elements of the deposit insurance system. Consideration also should be given to the deposit insurer's role within the financial safety net and its relationship to other safety-net participants.
- Policymakers should review periodically the objectives and structure of the deposit insurance system and make changes as appropriate. Such a review may be needed in response to changes in economic, financial and/or social circumstances. Policymakers may alter the mandate, roles and responsibilities of the deposit insurance system in response to these changes.