COVERAGE

Abstract

To be effective, the scope of deposit insurance coverage and its level must be set to meet the objectives of the deposit insurance system while mitigating the deposit insurer's exposure to potential costs, including those arising from moral hazard. Deciding what to cover and where to set the level of coverage involves trade-offs. Coverage that is set at a low level and with a narrow definition of what is covered, may not meet the deposit insurer's objectives. In turn, coverage that is set at a high level and that uses a broad definition of what is covered, may reduce any potential incentive depositors have for monitoring bank risk-taking and may increase the funding requirements for providing deposit insurance. In addition, for a credible deposit insurance system to exist, the public needs a well-defined and enforceable specification of what is covered by deposit insurance. Coverage needs to be specified in advance and should not be subject to interpretation after failures have occurred.

COVERAGE

This paper represents the work of the Subgroup on Coverage Issues.[1] The scope of deposit insurance coverage and its level depend on a country's willingness and ability to balance the achievement of the deposit insurer's objectives with the introduction of incentives for depositors to exercise some discipline. Deciding what to cover and where to set the limits involves trade-offs between these objectives. Coverage that is set too narrowly and levels that are set too low may fail to prevent runs, while coverage that is set too broadly and levels that are set too high may eliminate incentives for depositors to monitor risk-taking.

The question of coverage is intertwined with issues that are covered in various other papers.[2] The scope and level of deposit insurance coverage vary considerably across countries. This paper will explore these variations and the considerations that go into selecting them. It will identify issues, describe trade-offs, and make recommendations on appropriate guidance for deposit insurance systems.

Setting Coverage Limits

Establishment of coverage limits should take into consideration the scope and level of coverage needed to fulfil the public-policy objectives of the system, as well as the potential costs that different coverage limits may imply. Whatever scope and level of coverage is selected, it must be credible and must be internally consistent with other features of the deposit insurance system, including its funding arrangements.

The potential costs of coverage take two forms. First, there is the possibility that moral hazard may arise with high levels of coverage. This will depend on practices that govern the financial sector in each country. There are practices that can curtail the moral-hazard problem. Countries that have adopted these practices may opt for high levels of coverage without much cost.[3]

The second potential cost is the additional funding requirement that higher levels of coverage may bring. Since a higher coverage level does not affect the recovery rate of assets, the deposit insurance system will require a larger amount of funds when coverage is increased, other things being equal. However, practices can be adopted to counteract the need for more funding. In particular, the adoption of early-warning systems and

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[1] The Subgroup on Coverage is comprised of representatives from Chile (coordinator), Germany, Hungary, Italy, the United States and the International Monetary Fund. Members of the Subgroup on Coverage contributed information on their deposit insurance systems for this paper. Comments received from the Working Group's consultative process also were considered in the drafting process.

[2] See the papers on public-policy objectives, moral hazard, situational analysis, transitioning, membership, funding, depositor priority, depositor reimbursement and cross-border issues for in-depth discussions of these issues.

[3] The practices to curtail moral hazard are discussed at length in the paper on moral hazard.

prompt corrective action can minimise the expected loss in case of failure and counteract partially, or even totally, the increase in funding needs.

The outcome of this process will be a combination of instruments to be covered—the scope of coverage—and their coverage levels. This combination will vary from country to country, depending upon the objective(s) of the deposit insurer. For example, if the public-policy objective is to protect small depositors, the type of financial instruments held by these depositors should be determined. Such instruments may include savings deposits, term deposits, demand deposits, or other instruments. Availability, tradition, and tax treatment likely will be factors that will determine the set of instruments in each country.

Once the scope of instruments is determined, the level of coverage must be set. To determine the level of coverage, data on the financial instruments held by the population must be gathered. A useful set of information are data that describe the relative importance of holdings of different financial instruments in terms of both the number of accounts and their size distribution. Such data will allow policymakers to determine the fraction of the number of accounts and the fraction of total deposits that will be covered under alternative coverage levels. This could provide an objective measure of the appropriateness of a given scope and level of coverage. Such information could be obtained without imposing a heavy burden on individual insured institutions. For example, a representative sample of deposit accounts across different institutions can produce the necessary information at relatively low cost.

Depositors often hold multiple accounts at a given depository institution. Gathering data for depositors—which would, in effect, aggregate multiple accounts for individual depositors—would require additional effort. The necessary information, in principle, could be obtained from the banks or through a survey of the population. Whether such a survey is feasible and would produce accurate data may vary from country to country. The gathering of such information could be repeated every few years in order to track changes in the holdings of financial instruments by the population.

Some commentators have suggested that the adequacy of a country's coverage level should be judged by how closely it conforms to a uniform measure across countries—such as the oft-cited level of twice per capita gross domestic product (GDP). However, this approach fails to consider that countries do not share the same characteristics with respect to their financial systems or the same objective(s) for their deposit insurance system.

The process for making choices regarding coverage limits is country-specific. For example, a coverage level of twice per capita GDP may prove adequate in a country that desires to provide deposit insurance to small depositors. However, in a country with a similar level of GDP, but a different income distribution, the same criteria could product different results. Moreover, what is considered a "small depositor" depends on the particular situation of a country and may not be captured by a single parameter such as the level of GDP. Additionally, objectives of the system may differ among countries.

Therefore, countries that are otherwise identical may end up with different levels of coverage with respect to GDP if they have different objectives for their systems.

Exceptions to the Coverage Limit

Once the scope and level of coverage are set, consideration can be given to treating certain deposits and/or depositors as special cases. For instance, many countries exclude from coverage the financial instruments of depositors who are deemed capable of ascertaining the condition of an insured institution and of exerting market discipline. Examples include deposits held by other banks—interbank deposits—or other professional investors, such as investment funds. Similarly, the deposits of government departments and of regional, provincial, and municipal governments and other public bodies also may be excluded. In some cases, the deposits of individuals who are regarded as bearing responsibility for the deterioration of an institution are excluded. These may include deposits belonging to the directors, managers, large shareholders, and auditors of banks.

In other countries, by contrast, the process of assessing the public-policy objectives and the conditions within the country may lead to the opposite conclusion with regard to the coverage of certain instruments. For example, if the public-policy objective is to promote stability in the payments system and if the distribution of banks is such that there are a number of small banks that hold accounts in a few large banks for clearing purposes, then it may be desirable to extend coverage to include interbank deposits—possibly up to a limit.

Likewise, there may be cases in which the public-policy objectives imply varying coverage limits according to the legal status of the depositor. For example, some countries provide coverage only to natural persons while in other countries coverage is extended to entities such as small businesses. The later coverage may be justified because small businesses, like small unsophisticated depositors, may not be able to assess the risks of financial institutions. In such cases, a system would have to be designed such that the personal funds of the small-business owner are not co-mingled with the business-related funds. In other cases, countries have opted to give separate coverage to deposits held in trust and joint ownership.

In some countries, the public-policy objectives lead to the exclusion of deposits that carry excessively high interest rates. These deposits may be excluded in order to discourage weak institutions from being able to bid away deposits from stronger, more prudently managed institutions. In addition, countries that provide per-depositor coverage generally exclude those deposits that are not registered to a particular owner—bearer deposits—since there is no way of calculating the coverage limit or proving eligibility when the depositor is unknown. Some countries exclude deposits that are associated with money-laundering activities.

Application of the Coverage Limit

After it is determined which financial instruments will be covered, and for how much, the issue of how to apply the coverage limit must be addressed. In general, there are three possibilities to consider. The first is that the coverage limit may be applied per deposit, per member institution. This limit easily could be circumvented by opening multiple deposits of an amount equal to or below the maximum covered limit.[4] If a country wants to enforce a maximum coverage limit, then this approach is not advisable.

The second possibility is to apply the coverage limit per depositor, per institution. In this case, a depositor cannot increase his or her level of coverage by opening multiple accounts in one institution. Information requirements in this case are higher than in the previous case. If this approach is chosen, there has to be a method for identifying deposit holders. The additional costs to implement this requirement are likely to be quite low, particularly in countries that require a standardised identification form or a general-purpose ID number in order to open a deposit account.[5]

A third possibility is that in a country with multiple insured institutions, the coverage limit may be applied per depositor across all institutions. In this case, it is highly unlikely that the depositor will be able to increase coverage beyond the stated limit, but the costs of administering such a system could be high. This type of coverage limit tends to be very difficult to administer as it requires not only a great deal of information regarding ownership of the instruments in the failed institutions, but also a process for determining when to combine accounts at different institutions. To manage this system effectively, a time element would have to be attached to the coverage limit—such as per calendar year—and there would have to be a mechanism to track depositor reimbursements to determine when a particular depositor had reached the coverage limit. This option is seldom used because of the high information and reporting requirements it entails.

Coinsurance

To foster market discipline and limit the costs of deposit insurance associated with moral hazard, some countries have adopted a system of coinsurance whereby depositors bear a pre-specified share of the resultant loss from the failure of an insured institution.[6] There are drawbacks to such systems, however. One drawback is that it is possible that small unsophisticated depositors would not monitor insured institutions or exert sufficient market discipline because the costs of doing so exceed the benefits. In this case, coinsurance would inflict a cost on certain depositors without increasing market discipline. As a result, these depositors may opt to stay out of the financial system. To be effective, coinsurance requires that adequate information be provided to the public

[4] The opening of multiple accounts in order to increase deposit insurance coverage is referred to as "deposit stacking."

[5] There may be other variations on how the coverage limit is applied. For example, the coverage limit may be applied per depositor, but a depositor may be able to increase his or her coverage limit by holding deposits under different rights and capacities. See the paper on reimbursing depositors.

[6] See the paper on moral hazard for a description of the mechanisms that countries may use to limit the exposure of their deposit insurance system.

regarding the condition of insured institutions than otherwise might be the case. Such information, however, may not be forthcoming.

One way to protect against some of the potentially adverse effects of coinsurance is to apply coinsurance only above a certain amount. Under such a system, small unsophisticated depositors would be protected against the risk of loss. This, in turn, would presumably lower the risk of runs. At the same time, such a system could maintain the incentive for larger depositors to monitor insured institutions.

Adjusting Coverage Limits

Over time, inflation can diminish the real value of deposit insurance. In addition, changes in the composition and the size of deposits, and the development of new financial instruments may make the current coverage structure irrelevant. As the real value of deposit insurance declines and the percentage of deposits covered by deposit insurance decreases, it may become more difficult for the deposit insurer to carry out its mandate. Periodic adjustments to the scope and level of coverage may therefore be necessary. However, a trade-off exists between the objective of maintaining the level of deposit insurance constant for a sufficiently long period of time so that depositors can know the coverage limit with certainty and the objective of preserving the real value of deposit insurance coverage. This problem is especially acute for high-inflation countries.

Adjustments to the scope and level of deposit insurance coverage may take place either on an *ad hoc* basis or they may be made systematically, such as through indexing. When adjustments are made on an *ad hoc* basis, policymakers are in control of the process. This may be viewed as either desirable or not, depending on the circumstances within the country. Alternatively, indexation of coverage levels may be viewed as a way to "de-politicise" the coverage question.

Indexed adjustments may be implemented automatically, which would require care in choosing the frequency and amount of adjustments. If adjustments occur too often or for odd amounts, this could lead to confusion among the public as to the insurance limit. It also could be expensive to implement such adjustments, as the public would have to be informed about the new limits. On the other hand, if adjustments occur too infrequently, this could produce large increases in uninsured deposits and significant declines in the number and amount of deposits insured over time.

A number of countries with histories of high inflation define coverage limits in terms of indexing units to maintain the real value of their deposit insurance coverage.[7] This provides for automatic adjustment of the coverage level for insured deposits without the need to change the information available to public—coverage in terms of the indexing units is constant.

[7] Some countries have used indexing units as a means to protect contracting parties from the effects of inflation.

Even within a system of indexing, the limit in real terms should be reviewed periodically in order to confirm that the objectives set for the deposit insurer are being met. Changes in the size of financial markets, expansion of the access to financial markets among households, and the growth of real income are likely to necessitate changes in the real value of deposit insurance.

Foreign-Currency Deposits

The decision of whether to cover deposits denominated in foreign currencies depends basically on the public-policy objectives of the deposit insurer and the country-specific circumstances. In particular, the decision to cover these deposits and its ramifications depend heavily on the country's usage of foreign currency—as represented by the amount of deposits denominated in foreign currencies as a percentage of the total amount of deposits in the country. When this ratio is high, it would be of little value to institute a deposit insurance system without covering these deposits. On the other hand, providing credible coverage for deposits denominated in a foreign currency requires the deposit insurer to be protected against foreign-currency risk.

When foreign-currency deposits are covered, two decisions have to be made. The first is whether deposits will be repaid in the foreign or local currency. At a minimum, a deposit insurance system that offers to repay depositors in a foreign currency must have access to sufficient foreign assets or other sources of foreign-currency funding to make this commitment credible. Alternatively, a deposit insurer may repay foreign-currency deposits in the local currency. Under this option, the rules should be clear with respect to which exchange rate will be used to calculate the repayment, in order for the public to understand the risks that they may face. If, for example, the rate prevailing on the date of failure is used to convert the foreign-currency deposit into the local currency, then the risk of devaluation between the date of failure and the date of repayment is bourne by the depositor. If the conversion of the foreign-currency deposit into the local currency is not made until the day of repayment, the risk of devaluation is bourne by the deposit insurer.[8]

The second decision is whether to express the coverage limit in the local or a foreign currency. If the limit is expressed in local currency, its devaluation effectively will diminish the limit for foreign-currency deposits. If the limit is expressed in foreign currency, devaluation does not affect the effective coverage level. Whichever approach is chosen, country officials have to be aware that changes in the exchange rate can introduce changes in the relative coverage of local- and foreign-currency-denominated deposits. Also, country officials should specify which exchange rate will be used to make the conversions when necessary.

[8] To illustrate, suppose that a depositor has a foreign-currency-denominated deposit of $10 and the local currency is the Peso. On the day of failure the exchange rate is 1 Peso = $1. By the day of repayment, however, the exchange rate is 2 Pesos = $1. If the deposit is valued at the prevailing exchange rate on the day of failure, then the depositor will receive 10 Pesos on the date of repayment, which can then be converted to $5. If, however, the deposit is paid at the exchange rate prevailing on the date of repayment, then the depositor will receive 20 Pesos, which can be converted to $10. Under the first scenario, the depositor bears the risk of a devaluation; under the second scenario, the deposit insurer bears that risk.

Conclusions

- Setting the scope and level of coverage requires striking a balance between the public-policy objectives, the need to limit moral hazard, and funding requirements. As a result, coverage limits are country-specific.

- Each country must assess its unique situation in setting coverage limits, considering: the public-policy objectives of the deposit insurance system, the state of its financial system, the distribution of deposits among depositors, and the nature and quality of the supervisory and regulatory system in its country.

- The selected coverage level must be credible and must be internally consistent with other features of the deposit insurance system, including its funding arrangements.

- Limits to coverage should be applied per depositor, per financial institution. This reduces the possibility that depositors will be able to circumvent the coverage limits without imposing excessive administrative costs on the deposit insurer.

- The scope and level of coverage should be revised periodically. Adjustments should be made as necessary in light of changes in the financial sector.

- A deposit insurance system must take a pro-active approach to determining what is and what is not insured and must communicate this effectively to insured institutions and the general public.