

# MEMBERSHIP

## **Abstract**

Decisions about membership in a deposit insurance system are ultimately based on a country's public-policy objectives. Major conclusions about membership are: (1) membership regimes should be consistent with the deposit insurer's public-policy objectives and mandate; (2) deposit insurance should normally be compulsory to avoid adverse selection and because deposit insurance tends to work best when there is a large number of members to share risks and costs; (3) moral hazard concerns suggest that membership should be extended only to institutions that are subject to effective supervision and regulation; (4) generally, membership criteria and financial requirements must be met by institutions before they become members of the deposit insurance system.

## MEMBERSHIP

This paper represents the work of the Subgroup on Membership.<sup>1</sup> The paper focuses on: (1) identifying which kinds of deposit-taking institutions typically are members of deposit insurance schemes; (2) whether membership should be compulsory; and (3) the basis for granting eligible institutions membership. The paper also reaches a number of conclusions about membership in a deposit insurance scheme.

### Background

The choices relating to membership in a deposit insurance system are influenced strongly by the institutional setting countries choose for their financial system. Countries have diverse methods for determining which types of deposit-taking institutions are eligible, or mandated to become, members of their deposit insurance system. Countries also look at the nature of the deposits to be included, or excluded, from coverage. How a deposit is defined and which institutions may offer those deposits often is specified in law.

Increasingly, determining what qualifies as a deposit is becoming a complex task. Traditionally, deposits were monies placed by individuals or entities with depository institutions for the purpose of investment, safety, or storage. Deposits usually fell into two categories: those that were payable on demand, which may be used for transaction purposes in lieu of currency, and longer-term deposits that were payable at fixed dates and primarily served investment purposes. Previously, it was relatively simple to identify which financial institutions offered deposits and thereby qualified for membership in a deposit insurance system. The distinction between insured deposit-taking institutions and other financial firms was defined by law.

Given current trends, the distinction between insured deposit-taking institutions and other financial firms has become problematic. For example, technological developments are allowing a variety of financial and non-financial entities to offer products that have the same characteristics as traditional deposits placed with depository institutions. Financial firms such as insurance companies and mutual-fund companies are able to join the payments system in certain countries, which allows such companies to offer products with the characteristics of traditional deposits. As part of the globalisation trend in the financial-services industry, depository institutions are increasingly expanding their operations into foreign jurisdictions. As a result, membership in the deposit insurance system becomes a complex issue that requires careful consideration by policymakers.

Countries have taken a number of factors into consideration in order to determine the rules by which membership is granted in the deposit insurance system. These include:

- The existence of effective regulatory and supervisory arrangements to oversee the operations of member institutions.
- The degree of competition among financial institutions.
- Diversification of membership to spread risk to the deposit insurance system.

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<sup>1</sup> The Subgroup is comprised of representatives from Argentina (coordinator), Germany, Italy, and The World Bank.

- The institutions' importance to the country's financial system.
- The threat of contagion.
- Constitutional or jurisdictional considerations that may limit the scope of a deposit insurer's powers and responsibility for particular institutions.
- The nature of individual and household financial activity, such as where chequing and savings accounts are held.

These considerations may constitute grounds for including or excluding certain financial institutions from a country's deposit insurance system. Membership decisions ultimately should be based upon national circumstances and the public-policy objectives a country chooses for its deposit insurance scheme. Separate insurance systems for institutions with other characteristics also may be created depending upon a country's public-policy objectives.

## **Which Financial Institutions Typically Are Members of Deposit Insurance Systems?**

### **Domestic banks**

Domestic banks form the membership base for most deposit insurance systems for a number of reasons.<sup>2</sup> First, domestic banks play a central role in domestic financial markets. Second, such institutions hold the bulk of the deposits of small savers. In addition, domestic banks are normally subject to prudential supervision and regulation.

### **Foreign-bank branches and subsidiaries**

Countries treat foreign-bank branches and foreign-bank subsidiaries in different ways with respect to membership in their deposit insurance systems.<sup>3</sup> Some countries require all foreign-bank branches and subsidiaries to participate in their deposit insurance system, while others permit foreign banks to remain outside the system.<sup>4</sup> Arguments in favour of including the onshore operations of foreign banks tend to focus on: (1) the notion that foreign banks benefit from a stable financial system and should therefore regard participation in a deposit insurance system as part of doing business in a host country; (2) the belief that wider membership may be needed to diversify the deposit insurance system's exposures and perhaps its funding base; and (3) the desire to minimise competitive advantages or disadvantages by according foreign banks comparable treatment to domestic banks.

On the other hand, the inclusion of foreign institutions may expose the deposit insurer to risks that it or some other authority has a limited capacity to mitigate. The inclusion of foreign banks

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<sup>2</sup> Whether a bank is considered to be domestic may depend on a number of factors including ownership, where the institution is licensed, and where the institution transacts most of its business.

<sup>3</sup> Foreign-bank branches and foreign-bank subsidiaries are different legal entities. A foreign-bank subsidiary is incorporated as a unique entity in the host country. A foreign-bank branch, on the other hand, is a direct extension of the foreign bank into a host country. Foreign-bank branches and foreign-bank subsidiaries may be subject to different rules and supervised differently by a host country. The difference between a branch and a subsidiary relates primarily to the degree of "separateness" from the parent bank.

<sup>4</sup> This subject as well as membership in the European Union are covered in greater detail in the paper on cross-border issues.

also may complicate the claims and recovery process because many of their assets may be located offshore and subject to another country's insolvency regime.

### **Deposit insurance systems and the European Union**

A special situation prevails in Europe where the harmonisation of banking regulations in the European Union (EU) has led to the creation of the European passport. Included among the features of the passport is the fact that banks, including their branches in other member states, are supervised only by their home authority. According to the deposit protection directive adopted by the EU, the deposit protection scheme in a bank's home state also has to cover deposits of branches in host member states. This coverage may be enlarged—or topped up—by the statutory deposit protection scheme of the host member state.<sup>5</sup>

### **Non-bank financial institutions**

Countries take different approaches toward the issue of membership for non-bank financial companies—finance companies, credit unions and cooperatives, for example—that offer deposits and deposit-like products and are subject to an appropriate level of prudential supervision. The rationale for expanding membership to non-bank financial institutions includes, the desire to accord similar treatment to institutions that offer similar deposit-like products and the desire to enhance financial stability by expanding the safety net to include those institutions that offer deposit-like products.

On the other hand, there are many cases where non-bank financial institutions are not eligible for membership. The most common reason for excluding these institutions is that they are subject to less stringent supervisory standards. For some countries, a different governmental authority licenses non-bank financial institutions. In such cases, extending membership may lead to constitutional or political issues that are difficult to overcome. Some countries have addressed this problem by establishing a separate insurance system or fund.

### **State-owned banks**

State-owned banks present unique issues for deposit insurance schemes. Because state-owned banks are normally the beneficiaries of an implicit, full government guarantee, their inclusion in a deposit insurance system may appear to be unnecessary.

However, some countries have chosen to include state-owned banks in their deposit insurance systems. Some of the reasons cited for inclusion are: to replace the implicit guarantee of the state-owned bank with explicit, limited coverage, thereby leveling the playing field for all deposit-taking institutions; to diversify the risks and revenue base of the deposit insurer; to facilitate the privatisation of state-owned banks; and to introduce an enhanced supervisory regime.

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<sup>5</sup> Countries considering the transition into the EU framework should consult the relevant directive.

## **Should Membership Be Compulsory?**

Experience has shown that voluntary deposit insurance systems have been more prone to crisis than compulsory ones because of problems such as adverse selection, among others.<sup>6</sup> Compulsory membership allows a deposit insurance system to avoid this problem. Moreover, all banks—even the safest and soundest—benefit from the existence of a well-designed deposit insurance system.

In some cases depository institutions have demonstrated their commitment to join a deposit insurance system without the necessity of statutory obligation. The commitment of banks to participate in deposit protection schemes, without being legally obligated to do so, may be driven by the strong desire of depositors for such coverage. On the other hand, if depositors are less concerned about the availability of deposit protection or are not aware that coverage may be limited to certain financial institutions, then depository institutions may opt-out of participation in the deposit insurance system. Their decision to do so may have implications for the financial solvency of the deposit insurance system or its ability to meet a country's public-policy objectives.

Incentives for eligible institutions to join a voluntary deposit insurance system may be enhanced if the system is privately organised and operated through a private contract.<sup>7</sup> Membership criteria for voluntary private systems may encompass members' viability and financial strength, thus reducing the potential cost of membership for participants. Members that do not meet the criteria or do not want to participate for other reasons—for example, they may have reservations about possible examinations conducted on behalf of the system—may in fact be signaling to their depositors an adverse standing, which will have consequences in their marketplace. Such a "benchmark function" of voluntary systems should enhance the effectiveness of the deposit insurance system.

## **Granting Membership When the Deposit Insurance System Is Established**

When a deposit insurance system is created, policymakers are faced with the difficult task of integrating it into the country's financial system and financial safety net, while simultaneously trying to minimise the risks to the deposit insurer.<sup>8</sup> Two distinct approaches generally are utilised. First, eligible institutions automatically can be granted membership in the deposit insurance system. This is the simplest option available from an administrative and political standpoint. However, the deposit insurer may be faced with the difficulty of having to insure institutions that may pose inordinate risks to the system. For this to be a viable option, provisions would have to be made to minimise losses to the deposit insurance scheme in the event of a newly insured institution's failure.

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<sup>6</sup> Other issues such as weak legal and regulatory or supervisory regimes and financial instability are dealt with in the papers on situational analysis and structure and organisation.

<sup>7</sup> A limited-coverage deposit insurance system must be well-defined whether by voluntary agreements or by law. To be effective, voluntary agreements underlying deposit insurance arrangements must be enforceable.

<sup>8</sup> This issue is primarily relevant to countries undertaking the transition to an explicit, limited-coverage deposit insurance system. See the paper on transitioning for more information.

A second option is to require institutions to apply for membership in the deposit insurance system. This option may provide the deposit insurer with a degree of flexibility to control the risks it is assuming. This option also may provide a mechanism for bringing eligible institutions into compliance with prudential regulatory standards. However, reviewing all eligible institutions at the outset will be time-consuming and requires a substantial commitment of administrative resources on the part of the deposit insurer.

The ability of the deposit insurer to function may be called into question if a sufficient number of institutions that have applied for membership do not qualify. A transition period may be necessary to give institutions time to satisfy the necessary membership requirements. In this case, an appropriate transition plan should be in place that details the process and time frame for attaining membership.

### **Granting Membership to New Institutions in a Functioning Deposit Insurance System**

In cases where the financial safety-net functions reside within one agency, the steps required for determining membership tend to be relatively straightforward. Eligible institutions usually are required to meet basic entry requirements such as minimum capital, appropriate business plans, and effective governance structure, among others. Institutions meeting established standards may be granted a license or charter to operate and membership in the deposit insurance scheme simultaneously.

When responsibility for the financial safety net is shared by different agencies, the process may be more complex. Some countries with separate agencies grant deposit insurance membership automatically when a depository institution receives its license or charter to operate. This method ensures that only one set of entry standards is applied and that only one approval is required, thus streamlining the process. Automatic membership in the deposit insurance system, however, may limit the deposit insurer's ability to manage its risk exposure and effectively meet the requirements of its mandate.

Some countries require that eligible institutions receive two approvals before commencing operations, first from the supervisory authority or government; and then a separate membership approval from the deposit insurer. In such cases, the deposit insurer is granted an enhanced ability to control its exposure to risk because it can determine which institutions it will insure. However, mechanisms should be in place to ensure effective coordination by financial safety-net participants.

The way a country grants membership in its deposit insurance system should be consistent with the country's public-policy objectives and the deposit insurer's mandate—whether paybox or risk-minimisation. In all cases, appropriate mechanisms to encourage coordination and dialogue are necessary to ensure that the approval process transpires smoothly, and that eligible institutions meet minimum prudential standards and entry requirements.

## **Should institutions reapply for membership?**

Generally, countries do not require member institutions to reapply for membership as long as they are subject to periodic or continuous examination by a regulatory or supervisory authority. Reapplication requires a significant commitment of resources from the deposit insurer and may also create a certain amount of uncertainty regarding an institution's operations. In any case, the application procedure should be consistent with a country's regulatory or supervisory activities.

## **Conclusions**

- Membership requirements should be consistent with the deposit insurer's public-policy objectives and mandate. Determining which institutions are allowed to join the system and the basis for their inclusion will have a significant effect on the effectiveness and overall risk profile of the deposit insurance system.
- A deposit insurance system tends to work best when there is a large number of members to share risks and costs. It is generally agreed that deposit-taking institutions benefit from the positive effects of a well-designed deposit insurance system and that adverse selection should be avoided. For these reasons, most deposit insurance systems require that membership be compulsory.
- Decisions must be made on which type of institution to include. Although country-specific issues will play a large role in these decisions, moral-hazard concerns suggest that membership should be extended only to institutions that are subject to effective supervision and regulation.
- Generally, membership criteria and financial requirements must be met by institutions in order to join the deposit insurance system. Whether a country's public-policy objectives favour a paybox or a risk-minimising system, experience shows that conditions of membership are required to make deposit insurance effective.