Depositor protection has become an important feature of most banking systems. Deposit insurance is a common approach—nearly all industrialized countries now have formal deposit insurance systems, although the form and scope of these insurance systems differ significantly from one country to the next. Deposit insurance is now taking hold in developing countries as well. About a dozen developing countries have adopted these schemes, and others are considering whether and how to do so.

However, deposit insurance is not the only way to protect depositors. Another option is so-called implicit depositor protection, which usually means taxpayers rescue banks that would otherwise fail. Governments also have the option of providing no protection—but this is a rare policy choice. In the course of deciding which option to choose, policymakers have to consider some wider public policy objectives, including the prevention of contagious bank runs, and promoting market discipline. They need to weigh the risk of shifting depositor losses to other parties, such as the government or the banking system. And they need to focus on who they want to protect: usually small depositors rather than all depositors. The direction of the effects of each depositor protection option on these objectives and risks is generally clear. What is not clear is the magnitude of these effects in individual countries, given the unique characteristics of each country's banking system, and how conflicting policy objectives should be traded off. This is why the best solution may vary for each country.

This Note looks first at whether or not protection is a good idea. It reviews the strengths and weaknesses of insurance-based or implicit protection systems and then suggests some good design rules for governments that choose the insurance option.

Should the government protect depositors—most governments say yes

Depositor protection can have three positive effects. The first is to offer a country at least some protection against contagious bank runs that can undermine the stability of the banking and payments systems. When depositors believe that they have some protection against failing banks, they are less likely to lose confidence in the
banking system. Then, widespread bank runs are much less likely to happen. The second positive effect is protection for small depositors. These small depositors do not have the information to evaluate the financial condition of individual banks. This means they are not in a good position to protect their own interests. Deposit insurance addresses this "market failure." Moreover, a bank failure could wipe out all the accumulated savings of small depositors. Therefore, protecting small depositors can contribute to social welfare. Third, protecting depositors can have the beneficial effect of increasing the national savings rate and promoting financial intermediation by providing a safe financial asset for the public to hold.

Protecting depositors can also have undesirable results. It may reduce market discipline. When depositors are protected, they are likely to be less careful evaluating the riskiness of individual banks and more likely to be guided only by promises of high returns. As a result, bank management is less prudent about risktaking than would otherwise be the case. A second problem with protecting depositors is that someone else will always have to absorb the losses. Depending on the deposit protection mechanism, that "someone else" is likely to be either the government or the banking system.

In balancing the pros and cons, the vast majority of developing countries have decided to protect depositors, at least some of the time. About a dozen have done so by setting up deposit insurance systems. The rest have usually resorted to bailouts of failing banks, particularly when the banks are government owned, or when the banking system is faced with a general loss of public confidence. Very few countries have announced that they intend to "let the market work" and allow depositors to suffer losses in all bank failures, irrespective of the circumstances that may prevail.

**Insurance versus implicit systems**

Insurance-based and implicit protection systems have several key design differences. The first is that deposit insurance represents a legal obligation on the part of the insurer to pay off depositors of failed banks up to the maximum amount stipulated in the program. By contrast, with an implicit system the government has no legal obligation to protect depositors. Instead, the government has total discretion about whether to protect, whom to protect, how much to protect, and the form of the protection.

Second, deposit insurance systems operate under rules and procedures that are typically set forth in a deposit insurance law. With implicit systems, there are no rules or procedures—everything is ad hoc and discretionary on the part of the government.

Third, the funding of the two systems is different. A deposit insurance system is typically funded by an initial government capital contribution to a deposit insurance fund, and this fund is then built up over time through periodic premium payments made by insured banks. By contrast, the government funds implicit protection systems, typically by recapitalizing failing banks. In most cases, this government funding comes from the national government budget, but it also can come from the resources of the central bank.

Deposit insurance systems and implicit systems have different strengths and weaknesses. In general the relative strengths of deposit insurance are:

- Deposit insurance tends to provide somewhat greater protection against contagious bank runs because the protection is in the form of a legal obligation, rather than being a matter of government discretion.
- Deposit insurance gives small depositors greater protection because the amount of protection typically covers a small depositor's entire outstanding balance. By contrast, with an implicit system, small depositors may or may not be protected, depending on how the government chooses to act in specific cases.
- Deposit insurance shifts some of the costs of depositor protection to the banking system by requiring insured banks to make periodic premium payments into an insurance fund. This shifting of some of the costs is reasonable because deposit
insurance lowers the risk of deposits and tends to lower banks' cost of funds. With an implicit system, on the other hand, the government absorbs all of the costs of protecting depositors, even though banks derive the benefit of a lower cost of funds. Consequently, an implicit system tends to confer a government subsidy on the banking system.

- From an administrative perspective, a deposit insurance system tends to be a faster, smoother, and more consistent mechanism for resolving failing bank situations. The reason is that these systems operate according to rules and procedures usually set out in a deposit insurance act. By contrast, an implicit system is not based on any preexisting rules and procedures—everything is ad hoc and subject to a "political solution."

- Deposit insurance would tend to provide a more level playing field in countries that have both state-owned and private banks. The reason is that deposit insurance would protect depositors of both types of banks. By contrast, with an implicit system the government may be more willing to protect depositors of state-owned banks, thereby providing these banks with a competitive funding advantage.

The strengths of implicit deposit protection schemes are:

- Implicit schemes are less likely to erode market discipline. The reason is that depositors can never be sure whether they will be protected. Consequently, depositors always have at least some incentive to evaluate the financial condition of banks and avoid those that are relatively risky. Depositors who are fully protected by deposit insurance have little incentive to monitor the financial condition of banks.

- Implicit protection schemes are a more flexible device for resolving failing bank situations because the government has total discretion in fashioning remedies—whether to protect, how much to protect, and the form and timing of the protection. Deposit insurance systems, which operate according to preexisting rules, do not have such flexibility.

The choice is not clear cut

In general, it is not clear cut whether developing countries would be better off protecting depositors through a deposit insurance system or relying on implicit protection. It depends on specific conditions in each country—the susceptibility of the country to instability; the level of social concern over the fate of small depositors; the need to foster as much market discipline as possible; the fiscal implications of government bailouts of failing banks; and the structure and ownership of the banking system. Also, much would depend on the form of deposit insurance or, alternatively, how frequently and in what manner implicit protection would be used.

While a majority of developing countries are now relying on implicit protection, there has been a gradual shift to deposit insurance systems—a shift that seems likely to continue, if the current interest in creating such systems is any indicator. Some of this shift may reflect the movement of some banking systems away from publicly owned banks, as well as a move to a more "contractually based" economy.

Good design for deposit insurance systems

While deposit insurance is a relatively simple concept, deposit insurance systems are complex to implement. Consequently, countries that elect to create these systems will have to wrestle with many policy issues, some of which will prove to be difficult to resolve. The following are several major recommendations for the design of these systems:

1. Amount of protection

Probably the most important variable in a deposit insurance system is the amount of protection extended to depositors. There are three basic types of deposit insurance systems: (1) a limited (or small depositor) protection system that protects depositors only up to a certain relatively small amount, and does not authorize the insurer to extend protection to uninsured deposits under any circumstances; (2) a 100 percent deposit insurance system that fully protects all depositors; and (3) a discretionary
deposit insurance system that normally protects depositors only up to a relatively small amount, but authorizes the insurer to extend full protection to uninsured depositors if the banking system is threatened by a likely loss of public confidence. There is almost universal agreement that 100 percent deposit insurance systems should be avoided because they result in an almost total loss of market discipline—a particularly undesirable result in developing countries that typically lack adequate managerial and supervisory discipline. Therefore, the real choice is between a limited system and a discretionary system, both of which have certain advantages. A limited system does not tend to erode much market discipline, but does not give the banking system much protection against contagious bank runs. A discretionary system gives the banking system considerable protection against runs, but erodes more market discipline.

2. Proper Funding
It is extremely difficult to predict the losses that the deposit insurer will have to absorb over the years. Moreover, from a public policy perspective it is extremely dangerous for an insurer to become illiquid. The reason is that if the insurer cannot meet its legal obligation to protect depositors of failed banks, the bank supervisory agency will be reluctant to close insolvent banks. When insolvent banks are allowed to continue to operate, the management of these banks are likely to take high risks in a desperate attempt to return to solvency. These gambles often turn out badly, and the bank becomes even more insolvent, thereby increasing the losses that the insurer ultimately will have to absorb. Given this situation, it is critical that the insurer be properly funded. This can best be done by: (1) providing the insurer with adequate initial capital to give the insurer credibility in the eyes of the market and the capacity to handle any known losses; (2) having insured banks make reasonable periodic premium payments into the deposit insurance fund; and (3) giving the insurer legal authority to borrow or receive an equity injection from the government in order to honor its obligation to protect depositors.

3. Flexibility
The deposit insurer should be given maximum flexibility in resolving failing bank situations, so long as the method employed is consistent with the stated objectives of the deposit insurance system. For example, if a nation sets up a limited deposit insurance system for the sole purpose of protecting small depositors, the insurer should have the flexibility to honor its obligations either by paying out cash to insured depositors or by arranging for the transfer of all insured deposits of the failed bank to another bank. However, the insurer should not be authorized to arrange for the transfer of all deposits of the failed bank to another bank. The reason is that this action—contrary to the stated objective of the system—would extend protection beyond small depositors to large, deliberately uninsured depositors.

Bibliography


Samuel Talley, Financial Sector Development