DEPOSIT INSURANCE SCHEMES: ITS NATURE, ROLE AND ISSUES

Maria L. Fres-Felix

The South East Asian Central Banks (SEACEN)
Research and Training Centre
Kuala Lumpur, Malaysia
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FOREWORD

The financial liberalization that swept the international community in recent years led to increased competition in banking and ultimately hiked the risks in the industry. As banking systems continue to evolve and face ever increasing risks, some bank failures occur. It is during such times of crisis that the question of protection of deposits is underscored.

In the SEACEN region, only two countries, the Philippines and Sri Lanka have deposit insurance systems in place. Some other member countries have also considered establishing such a scheme. The concept and practice of deposit insurance seems simple on the surface, but it also presents some complexities.

This study is aimed at informing users of the nature, role and issues confronting deposit insurance and as such, it is hoped that it would be able to foster better understanding of such a scheme.

This in-house research study was conducted by Mrs. Maria L. Fres-Felix, Research Economist seconded from the Central Bank of the Philippines to The SEACEN Centre. At the initial stage of the project, Mrs. Felix was assisted by Miss Sally Ho Ngeok Ying, Senior Research Associate, who took care of data compilation and proof-reading work. The manuscript was typed by Miss Karen How.

The SEACEN Centre wishes to express its sincere gratitude to the participating member central banks for their useful comments and suggestions at various stages, contributing to a successful completion of this project.

The views expressed in this volume, however, are those of the author and do not necessarily reflect the views of the member central banks or that of The SEACEN Centre.

Dr. Vicente B. Valdepeñas, Jr.
Director
The SEACEN Centre

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INTRODUCTION

Significance

Out of the nine SEACEN member countries, only two, the Philippines and Sri Lanka have deposit insurance schemes in place. The Philippine system has been in operation since the 1960s, while that of Sri Lanka is in its preparatory stages, having been set up in the late 1980s. In recent years, interest in deposit insurance has become keen due to the spate of bank runs previously experienced. Hence, a number of member countries without deposit insurance had looked into the possibility of adopting such a system.

On the other hand, the recent crisis faced by the now bankrupt Federal Savings and Loan Insurance Corporation (FSLIC) in the United States (U.S.) could dampen interest in deposit insurance. Indeed, there are conflicting views on the system, which make a thorough discussion of its advantages and disadvantages imperative especially in a world where deregulation and stiff competition among banks at times heighten risk-taking and uncertainty in the financial sector. Data and insights from such an exercise would be useful for policy-makers when considering the appropriateness of deposit insurance given the conditions prevailing in their respective countries.

Objectives

The primary objectives of this research project as approved by the SEACEN Board of Governors are as follows:

(1) To study the nature and mechanics of the deposit insurance scheme, drawing from the experiences of countries which have the scheme in place;
(2) To compare the various systems of deposit insurance as practised by different countries; and,
(3) To raise other issues concerning deposit insurance such as those relating to mobilization of deposits, protection of depositors and the supervision and inspection of banks.

Scope

The study will discuss the theory of deposit insurance and its practice in selected countries, namely, the Philippines and Sri Lanka among member countries and the U.S., England, France and Germany among the non-members. The U.S. was included because it is the oldest and the most publicized and well-known scheme. The European countries were also included to present approaches different from the U.S. and Philippine versions, the latter being adopted from the former.

Research Design

This study was approved as an in-house project and is basically informative in nature. Its value lies on the quantity and quality of facts and information it can provide. These should be sufficient enough so as to give central banks and monetary authorities the necessary data for evaluating the applicability and desirability of deposit insurance in their respective countries.

The study will present the different approaches to deposit insurance as practised by countries which currently adopt this scheme. It will also devote a portion on the SEACEN member countries without deposit insurance systems. The issues concerning deposit insurance would also be discussed.

The main sources of data will be published information on the scheme, such as previous studies on the matter, relevant brochures and annual reports. Going by the literature survey, there is a paucity of in-house data sources on the subject. Hence, working on latest available information from various sources which yielded a list of countries with deposit insurance systems in place, a preliminary survey of said countries was mounted. This was supplemented by surveys addressed to regional bodies (African Centre for Monetary Studies, Asian Development Bank, Centro de Estudios Monetarios Latinoamericanos, etc.) requesting for information on member countries with deposit insurance systems.

As previously stated in the initial articulation of this project presented during the Meeting of the Directors of Research and Training of the SEACEN member banks from 7-11 December 1987, and approved in the Governors Conference from 20-22 January 1988, the impact of deposit insurance is hard to quantify as it is centered on perceptions, feelings of confidence and assessment of risk. The bulk of the data will come from countries with deposit insurance schemes. In this connection, surveys were conducted in the Philippines involving the Central Bank of the Philippines, the Philippine Deposit Insurance

Corporation and selected private bankers; as well as in England involving the Bank of England and the Deposit Protection Board; France involving the Banque de France and the Commission de Bancaire; and, Germany involving the Deutsche Bundesbank and the three associations of the three major bank groups.

Chapter 1

GENERAL INFORMATION ON DEPOSIT INSURANCE

Definition

Deposit insurance is a mutual insurance system supported by the insured banks themselves and administered either through a government-controlled agency or a privately held one. While it seeks to maintain a sound and efficient banking system, it is not by itself a guarantee for these ends.

Rationale

There are a number of reasons advanced to justify setting up deposit insurance. The major ones are financial stabilization, competitive efficiency and equity considerations. With regard to the first reason, deposit insurance is aimed at building and maintaining confidence in the financial system and in the individual institutions that make up the system. The primary purpose of deposit insurance is to protect the banking system against destructive runs on deposits.[1]

This importance attached to the banking system stems from the crucial role played by banks in the payments mechanism, control of money supply and financial intermediation. This is specially so in developing countries where banks are the major financial intermediaries. Furthermore, bank deposits are vulnerable to panic withdrawals because switching deposits between banks or converting bank deposits into cash is virtually free of transaction costs. Hence, if a certain bank is perceived to be in difficulty, withdrawals resulting in a bank run may ensue. Since banking is based on trust, perceptions of instability may contaminate the whole system and hence a systemic run may erupt. Once system-wide runs set in, no bank, no matter how stable, can withstand on its own a hemorrhaging of funds.

1.Robert E. Barnett, "FDIC: Six Alternatives to the Present Deposit Insurance System", address before the Nebraska Correspondent Bank Conference, 1976, FDIC News Release PR-82-71 (24 September 1976), p. 1.

Therefore, from the viewpoint of monetary authorities, the major rationale for deposit insurance is that it fosters confidence and stability in the financial system, thereby reducing the external diseconomies associated with frequent bank failures.

With regard to competitive efficiency, it is argued that with deposit insurance lessening the pain and incidence of bank failures, monetary authorities can adopt a more liberal stance toward bank regulation and licensing of new institutions. This freedom of entry will result in an increase of competing banks. Additionally, banks will be in better positions of assuming greater risks in lending, further enhancing competition. Another aspect is that deposit insurance is seen as contributing toward competitive equality among different kinds of banks. In its absence, larger banks will be perceived as more stable than smaller ones, older banks may be regarded as stronger than newer ones and foreign banks may be seen as more secure than domestic ones.

Lastly, there are considerations of equity. Deposit insurance is aimed at the protection of small depositors, who are deemed unsophisticated and lacking the necessary information to evaluate the stability of the banks where their savings are kept. Hence, deposit insurance systems usually have a cut-off point. The idea behind this is that the bigger depositors are more sophisticated, knowledgeable and have more access to information regarding the soundness of banks and hence, are in a better position to assess their stability and take the necessary steps to protect themselves.

Historical Background

In 1924, a nationwide deposit insurance system was introduced in Czechoslovakia. It consisted of a system of credit and deposit insurance with two special funds: a Special Guarantee Fund to help banks recover World War I related losses; and, a General Guarantee Fund designed to encourage savings by increasing the safety of deposits and ensuring the best possible development of banking.[2] The Special Guarantee Fund covered commercial banks, cooperatives and savings banks. It is funded by contributions related to profits as well as contributions by the Government. The General Guarantee Fund covered institutions that accepted savings or demand deposit. Funds came from contributions levied deposit liabilities and investments.

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2. A.M. Allen, et.al., *Commercial Banking Legislation and Control*, London, 1938, p. 137; also cited in McCarthy, 1980.

In the United States of America (U.S.), the Federal Deposit Insurance Corporation (FDIC) was chartered by Congress under the Banking Act of 1933 as an independent agency of the Government. On 1 January 1934, the FDIC commenced operations. This was during the peak of the Great Depression and in the wake of a banking crisis that left thousands of banks closed. The FDIC covers banks. Another agency, the Federal Savings and Loans Insurance Corporation (FSLIC) was established in 1935 to cover the insurance needs of savings and loans associations (collectively known as thrifts).

Prior to 1933, however, various state-wide schemes were established in the U.S., with varying degrees of success. The first formal system of deposit insurance on a state-wide basis was established in 1829 in New York state to guarantee both bank notes and deposits. It was devised by a Syracuse businessman, Joshua Forman.[3] A number of other states subsequently established their own schemes. However, the panic of 1837 prompted some of them to stop insuring deposits, though bank notes continued to be insured. Nevertheless, some of the schemes were voluntarily terminated after long and successful operations. Thus, by the end of the 1800s, all of the deposit insurance schemes had ceased operations.

This eventual collapse was brought about mainly by two factors. The first was the emergence of the "free banking" movement of the 1830s. This was a response to the void created by the closing of the Second Bank of the United States in 1836, prompting many states to enact laws designed to ease bank entry restrictions. The movement gave rise to an alternative for insurance of bank notes, which permitted a bank to post bonds and mortgages with state officials in an amount equal to its outstanding bank notes. Banks which took advantage of this alternative were excluded from insurance (except in Michigan). With the increase in the number of "free banks" came the decline in participation in state insurance programs. Hence, the original intent to include all banks in the individual state insurance programs was undermined.

The other factor was the establishment of the national bank system in 1863. Congress levied a prohibitive tax on state bank notes in 1865, causing many state-chartered banks to convert to national charters so as to escape the tax. With the increase in conversions came a decline in membership in state insurance programs, to the point where these programs ceased to exist.[4]

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3. Federal Deposit Insurance Corporation, *FDIC: The First Fifty Years*, FDIC, Washington D.C., 1984, p. 13.

4. Ibid, p. 22.

However, after the panic of 1907, eight states introduced deposit insurance schemes.[5] The experience of these schemes was disappointing because at that time, agricultural failures led to multiple insolvencies and high failure rate among banks. This underscored the weakness of funded schemes without lender-of-the-last-resort facilities. Consequently, bankers distrusted such schemes. On the other hand, political interest in deposit insurance remained high. According to the FDIC, a total of 150 bills relating to national deposit insurance were introduced in Congress from 1886-1930. Finally, the Great Depression of the 1930s convinced the American nation that positive measures of a national scope were needed to protect against the disastrous losses associated with bank failures.[6]

Based on FDIC data, from 1900-1919, an average of 82 banks failed each year. It rose to 588 per year during the 1920s and from 1930-1933, failures escalated to an average of 2,277 per year. It peaked in 1933 when around 4,000 banks closed. A sharp decline followed after the introduction of deposit insurance. Failures dropped to an average of 43 per year from 1934-1942. Failures declined further to 11 per year from 1943-1985.[7]

However, the failure rate in recent years for banks as well as for thrifts has risen sharply due to economic difficulties in sectors such as agriculture, energy development and commercial and residential real estate. In the case of the FSLIC, rapidly rising interest rates in the late 1970s and early 1980s bred problems. Since savings and loans assets were mainly long-term fixed-rate mortgages, the rising rates created capital losses that were large enough to wipe out the net worth of the industry. Even after interest rate levels fell in the mid-1980s, FSLIC losses continued to escalate. Consequently, steps are now being undertaken in the U.S. to reform deposit insurance.

Going back to the historical accounts of establishment of deposit insurance schemes, it is notable that after the FDIC and FSLIC were established, it took more than 20 years before the next country, Turkey, introduced its Bank Liquidation Fund in 1960. It was quickly followed by India in 1962 and the Philippines in 1963. The first of Germanys three deposit insurance schemes was set up in 1966, the

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5. Ian McCarthy, "Deposit Insurance: Theory and Practice", *IMF Staff Papers*, vol. 27, no. 3, September 1980, International Monetary Fund, Washington D.C., 1980, pp. 579-580.

6. Op. Cit., p. 3.

7. Federal Deposit Insurance Corporation, *Information Booklet*, FDIC, Washington D.C., 1986, p. 4.

second in 1969 and the third in 1976. All are operating quite successfully. Towards the end of the 1970s and most of the 1980s, a number of countries, mostly European, established their own systems. Table 1 lists countries with deposit insurance.

Objectives of Deposit Insurance

From the three major rationales for deposit insurance cited in the previous section flow the objectives of deposit insurance. The main objectives are protection of individual depositors; prevention of bank runs; maintenance of public confidence in banks; and, promotion of stability in the economy as a whole.

1. Protection of Individual Depositors

Deposit insurance protects depositors through the following: first, by guaranteeing payment of deposits up to a certain amount, depositors are assured of getting their money back in the event of back closure; and, second, by paying the depositors promptly, personal losses stemming from loss of money, even if temporary, are averted. In the absence of deposit insurance, depositors have to wait for the liquidation of bank assets before their claims can be honored, thus, depriving them use of their funds in the interim.

2. Prevention of Bank Runs

As mentioned in the foregoing, deposit insurance gives an assurance of prompt payment in case of bank failure. With this guarantee, depositors are less likely to listen to rumors regarding bank difficulties and would be less prone to go rushing to withdraw their funds at the first indication of trouble. This is because the business of banking is anchored on trust. It is the faith of the depositors that persuade them to keep their money in banks, confident of the availability of such funds upon demand. It is also trust which enables banks to keep in reserve only a portion of deposits to service withdrawals, freeing the other portion for relending. Remove the element of trust and the spectacle of endless queues for withdrawal emerges. With the assurance of payment from deposit insurance, such conditions can be minimized.

3. Maintenance of Public Confidence in Banks

A bank run on even the smallest and weakest of banks can cause ripples in the banking community, resulting in a couple of other

Table 1
COUNTRIES WITH DEPOSIT INSURANCE SYSTEMS
(Grouped according to geographical areas)

Country	Year Established	No.	Percent to Total
Asia		4	21.1
India	1962		
Philippines	1963		
Japan	1971		
Sri Lanka	1987		
North America		2	10.5
U.S.A.	1934		
Canada	1967		
South America		2	10.5
Chile	1977		
Argentina	1979		
Europe		9	47.4
Czechoslovakia	1924		
Germany	1966		
Spain	1977		
Netherlands	1979		
United Kingdom	1982		
France	1980		
Belgium	1985		
Italy	1987		
Ireland	1989		
Middle East		2	10.5
Turkey	1960		
Lebanon	1967		
Total:		19	100.0

casualties in the event that the public perceives the risk that they will not be able to get their deposits back in case of bank failures. This becomes a self-fulfilling prophecy as nervous depositors have a high propensity to withdraw their money at the slightest hint of trouble. In some instances, this can precipitate the failure of a bank which would have otherwise weathered temporary difficulties. By standing ready to pay off depositors of closed banks, deposit insurance aims to instill confidence in the safety of bank deposits and hence in the whole banking system.

4. Promotion of Stability

Promotion of stability in the economy as a whole — this is the ultimate goal of deposit insurance. By assuring the individual depositor of payment in case of bank failure, thereby strengthening the banking system, deposit insurance seeks to promote overall economic stability. In view of the key role played by the banking system in the payments mechanism and financing of economic activities, a stable banking system would be a major element in the strengthening of a country's economy. It may be recalled that during the banking crisis of 1933 in the U.S., systemic runs led to the declaration of a bank holiday and economic activities suffered.[8]

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8. Op. Cit., p. 4.

Chapter 2

THE PRACTICE OF DEPOSIT INSURANCE

Points of Divergence Among Different Systems

Deposit insurance could be implemented in a variety of ways. Although the U.S. model is the most widely publicized and has been adopted by a number of other countries, there are other modes of implementation. Generally, there are four points of divergence, namely, membership, coverage, administration and funding. Table 2 is a comparative summary of deposit insurance in selected countries covered by this study.

1. Membership

This could either be voluntary or compulsory. In the U.S., membership is voluntary, but is compulsory for major banks since both the Comptroller of the Currency and the Federal Reserve require their member banks to join the FDIC. In Germany, membership is also voluntary for private commercial banks, while in the Philippines, where the system is patterned after the U.S., it diverges by requiring compulsory membership for all banks.

One disadvantage which is associated with voluntary membership is that of adverse selection. In other words, only those banks which are really in danger of collapsing may opt to join the system. Healthier banks will see no reason to spend on insurance premiums and hence will not join. Therefore, with membership limited to the weaker institutions, the deposit insurance system is bound to fail. A more detailed discussion will be dealt with in the latter sections.

2. Coverage

Coverage may be limited, as is widely practised among countries with schemes in place. On the other hand, it could be virtually unlimited as in the case of Germany. A criticism usually arises against unlimited insurance coverage is that of moral hazard. It is argued that when deposits are 100 percent insured, bankers will be

Table 2
DEPOSIT INSURANCE SCHEMES IN SELECTED COUNTRIES

Country	Institutions Covered	Year Est'd	Insurance Coverage	Financing of Scheme	Membership	Administration
U.S.A.	Commercial banks	1934	Maximum of US$ 100,000 (excluding foreign deposits)	Premiums of 1/12% with a subsequent rebate	Voluntary, but compulsory for nationally chartered banks and members of the Federal Reserve System	Official - Federal Deposit Insurance Corp. (FDIC)
	Savings & loans associations or "thrifts"	1935	Maximum of US$ 100,000	Premiums of about 0.6 per mill of total deposits	Voluntary, but compulsory for federally chartered savings and loans associations	Official - Federal Savings & Loans Insurance Corp. (FSLIC) [1]
	Credit unions	1970	Maximum of US$ 100,000	Premiums of 1/12%	Voluntary, but compulsory for nationally chartered credit unions	Official - National Credit Union Administration (NCUA)
Philippines	Commercial banks, thrift banks & rural banks	1963	Maximum of P 40,000	Premiums of 1/12% with a subsequent rebate	Compulsory	Official - Philippine Deposit Insurance Corp. (PDIC)
Sri Lanka	Commercial banks, regional rural dev. banks & cooperative rural banks of the multi-purpose co-operative societies	1987	Maximum of Rp. 100,000	Quarterly premium of one rupee for every ten thousand rupees	Voluntary	Official - Central Bank of Sri Lanka

Table 2 (cont'd)

Country	Institutions Covered	Year Est'd	Insurance Coverage	Financing of Scheme	Membership	Administration
Germany	Cooperative banks & rural credit associations [2]	1976 amended 1985	100% of deposits & credits	Annual levy of 0.05% on most dep. & some loans; special calls as warranted	Compulsory (membership in assoc. required by FBSO)	Private - Bundesverband der Deutschen Volksbanken un Raiffeisenbanken (BVR)
	Savings banks	1969 amended 1975	100% of deposits & credits	Premiums of 0.03% of claims on customers; special calls up to 0.06% p.a. as warranted	Compulsory (membership in assoc. required by FBSO)	Private - Deustcher Sparkassen und Giroverband e.V. (DSG)
	Private banks	1976 [3]	30% of net worth of insured bank	Premiums of 0.03% p.a. on all non-bank deposits; special calls up to 0.06% p.a. as warranted	Voluntary	Private - Bundesverband deutscher Banken e.V. (BDB)
France	Members of the Association Francaise des Banques	1980	FF 400,000	Ex-post assessments in case of loss	Voluntary	Private - Association Francaise des Banques [4]
United Kingdom	Banks and licensed deposit takers	1982	Maximum of _20,000 are protected for 75% of their value	Levy based on percentage of deposits. Minimum amt. set at _2,500 & maximum at _300,000; special levies as needed. Cumulative contributions of an institution does not exceed 0.5% of deposit base	Compulsory	Official - Deposit Protection Board [5]

1 The FSLIC was dissolved in 1989. It has been replaced by the Savings Association Insurance Fund (SAIF) operated by the FDIC.
2 The present scheme supersedes the security system established in 1977 which in turn replaced two earlier schemes.
3 The present scheme supersedes the common funds established in 1966.
4 The insurance scheme is called the Deposit Guarantee Fund.
5 The insurance scheme is called the Deposit Protection Fund.

Sources: Annual Reports and By Laws of institutions concerned.
Ian McCarthy, "Deposit Insurance: Theory & Practice", IMF Staff Papers, vol. 27, no. 3, September 1980, IMF, Washington, D.C., 1980.

very risk prone and thus endanger their deposit liabilities. However, by the same token, even limited deposit insurance could give rise to the question of moral hazard. Coverage in terms of institutions eligible for membership could also differ. Generally, banks are covered but in countries like the U.S., there is also a deposit insurance scheme for savings and loans associations, or thrifts, which are near banks. The question of coverage also crops up in terms of types of accounts covered. In some countries, only accounts denominated in the home currency are covered. In others, like the Philippines, even accounts denominated in U.S. dollars are covered, up to the maximum amount allowed under the Philippine laws. Detailed discussions are contained in succeeding sections.

3. Administration

The insurance scheme could be administered officially, as is the case in the U.S., the Philippines and England. It could be privately administered as is the case in Germany. In some countries, representatives of the private sector financial institutions are not allowed to participate in the management of deposit insurance schemes primarily because it is felt that this would produce conflicts of interest. Banks have no incentive to agree to premium payments larger than their marginal private return, but societys welfare maximization may well imply a greater marginal social return on deposit insurance. Resolutions of this dichotomy may therefore require state participation in the scheme. Most of the deposit insurance systems have been organized and to some extent, imposed by the monetary authorities (McCarthy, 1980).

In contrast, Germany, Japan, Lebanon and the United Kingdom explicitly provide private sector participation. It may also be mentioned that while the FDIC and FSLIC of the U.S. are officially administered, a number of early successful state-wide deposit insurance schemes were privately administered by the insured banks themselves.

4. Funding

Deposit insurance systems can be funded in a variety of ways. It can be financed through a permanent fund derived from members contributions. It could be financed through ex-post assessments levied after bank failures. It could also be fully funded by the insured institutions, or also through contributions by the monetary authorities. In Turkey, where bank failures occurred prior to the establishment of the deposit insurance scheme — called Bank Liquidation Fund, the monetary authorities paid off the depositors and subsequently assessed the remaining banks.

According to McCarthy, 1980, "the major argument of the authorities bearing part of the cost of a deposit insurance scheme is that the authorities may have contributed to some of the failures through their policy measures. Moreover, they also benefit from the schemes existence, since it contributes to financial stability. Despite such argument, most countries have preferred to finance the schemes solely by premiums levied on the insured institutions."[9]

5. Mechanics of Deposit Insurance

Deposit insurance is practised in various modes in different countries as was discussed previously. At this point, it may be useful to have an idea of the mechanics of deposit insurance based on the Philippine experience.

The PDIC which administers deposit insurance in the Philippines charges insured banks an annual assessment fee of 1/12 of 1 percent. The depositors do not pay the premium as it is paid by the banks.

When a bank is closed, a depositor must file a claim for payment of deposit within 18 months of the closure. The claim could be filed in the banking office where the depositor maintained his deposit. As an alternative, the PDIC may also make a transfer deposit with another bank against which the depositor may withdraw his deposits. If the depositor fails to file a claim within 18 months, he can no longer file a claim against PDIC, but he can still file a claim with the receiver of the closed bank. The PDIC undertakes pay-offs immediately after the verification, offset and consolidation of bank records upon receipt of the master list of deposits from the Central Bank Deputy Receiver.

Depositors have to bring documentary proof of deposit with the closed bank which can be in the form of savings passbooks, certificates of time deposit, checkbook stubs, bank statements, cancelled checks and trust agreements. He must also bring with him an identification card. These documents need to be surrendered if the deposit is less than P 40,000.00, otherwise these evidences of deposit will be stamped "Subrogated up to P 40,000.00" then returned to the depositor. These could later on be presented to the receiver of the closed bank to claim the uninsured portion of the deposit.

Pay-offs are made by duly appointed claim agents or banks authorized by the PDIC. This may be in the form of cash or check.

9. Ian McCarthy, "Deposit Insurance: Theory and Practice", *IMF Staff Papers*, vol. 27, no. 3, September 1980, International Monetary Fund, Washington D.C., 1980, p. 596.

Deposit Insurance in the United States of America

As mentioned previously, deposit insurance in the U.S. dates back to 1934 when the Federal Deposit Insurance Corporation (FDIC) which insures bank deposits became operational. A year later in 1935, the Federal Savings and Loans Insurance Corporation (FSLIC) which insures thrift institutions also became operational.

Although the FDIC has grown and modified its operations over the years in response to changing economic conditions, its mission remained unchanged: to insure bank deposits and reduce the economic disruptions caused by bank failures.[10]

In its present form, the FDIC covers insurance of banks which voluntarily opt for membership. However, membership is de facto compulsory for major banks because both the Comptroller of the Currency and the Federal Reserve require their member banks to join the insurance system. In terms of amount covered, the basic insured amount for a depositor is currently pegged at US$ 100,000. The original limit was US$ 2,500 in the 1933 Act, but was upgraded several times — the last one being in 1980 when the US$ 100,000 limit for all types of accounts was set. Insurance does not cover foreign deposits.

Aside from the aforementioned basic insurance, depositors are also afforded effective coverage in two other ways. First is that protection can be expanded beyond the basic insurance limit by use of multiple accounts held in different forms of ownership. Second and perhaps more importantly, effective coverage depends on the way the FDIC chooses to handle a failed bank. The US$ 100,000 insurance becomes relevant only in cases where pay-offs of depositors of failed banks are made. Sometimes, the FDIC will provide direct assistance or facilitate an open-bank merger with another bank. Often, a failed bank's non-subordinated liabilities will be assumed by another banking organization. Consequently, all depositors and other creditors with equal or preferred standing enjoy the benefits of 100 percent insurance coverage.[11]

The FDIC could also opt to handle the bank failure through a deposit transfer. This is a form of pay-off wherein depositors are paid by transferring their insured deposits to an agent bank in the area, funded by an FDIC payment to the agent bank equal to the insured

10. Federal Deposit Insurance Corporation, *FDIC: The First Fifty Years*, FDIC, Washington D.C., 1984, p. 3.
11. Ibid., p. 69.

deposits. Customers of the failed bank then are able to withdraw their funds immediately from the assuming bank.[12]

The FDIC has a permanent insurance fund. As provided for by the 1935 Act, the FDIC levies annual premia on banks with assessments based on a flat rate of 1/12 of 1 percent of total deposits. To provide for emergency situations, the FDIC was authorized to borrow up to US$ 975 million from the Treasury. Thus, the Deposit Insurance Fund was built up from US$ 306.0 million in 1935 to US$ 1,243.9 million in 1950. Under the Federal Deposit Insurance Act of 1950, a rebate system was introduced whereby after deducting operating expenses and insurance losses from gross assessment income, 40 percent of the remainder was to be retained by FDIC and 60 percent to be rebated to insured banks.

Table 3 shows that the FDIC's Deposit Insurance Funds ratio to insured deposit from 1960-1988 ranged from a high of 1.50 percent in 1963 to a low of 0.80 percent in 1988 (Chart 1). Based on FDIC data, the highest ratio since 1934 was 1.96 percent in 1941. The year 1988 was a particularly trying one for the FDIC as it handled more problem bank assets taken together during the said year than it did in its entire previous 55 years combined. The Corporation sustained its first operating loss in its 55-year history during the year owing to the failure of 200 banks and the completion of 21 assistance transactions, including two of the costliest banking problems ever handled by FDIC.[13]

The FDIC also conducts bank supervision to promote and maintain the soundness of banks, thus minimizing the tendency towards bank failure and giving the FDIC a better understanding of the risks it assumes in insuring the banks deposits. The FDIC supervises and regulates insured state-chartered banks that are not members of the Federal Reserve System and insured state-licensed branches of foreign banks. It works in close coordination with the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, which agencies also supervise national banks and federal branches of foreign banks and state-chartered banks that are members of the Federal Reserve System, respectively. As a supplement to its own examinations, the FDIC reviews reports of examinations undertaken by the aforesaid agencies. In the case of national banks, the FDIC often joins the Comptroller's staff in bank examinations.

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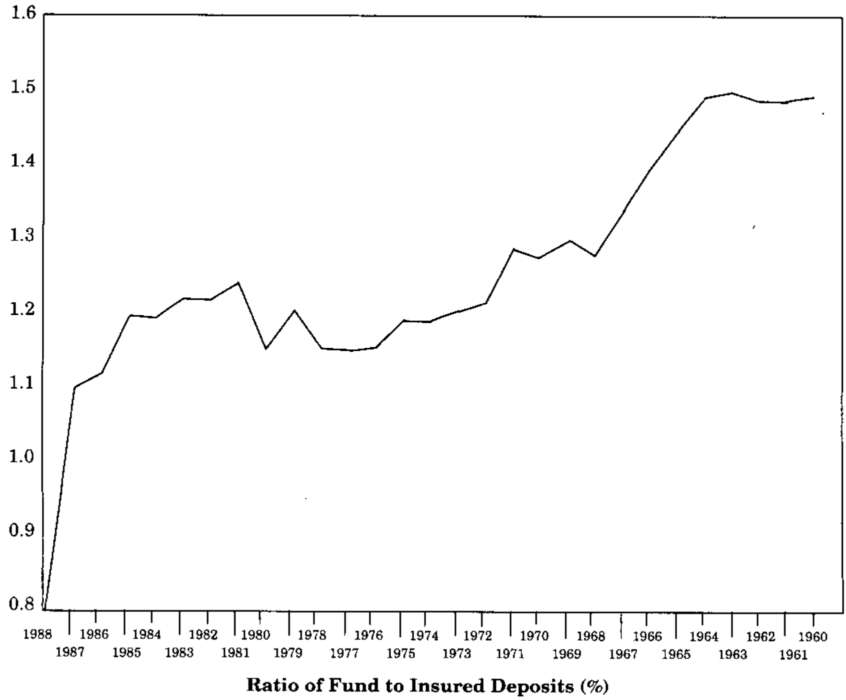
12. Federal Deposit Insurance Corporation, *When A Bank Fails*, FDIC, Washington D.C., 1988, p. 6.
13. FDIC Annual Report 1988, p. xii.

Table 3
FDIC DEPOSIT INSURANCE FUND

Year	Networth Amount (US$ million)	Ratio of Fund to Insured Deposits (Percent)
1988	14061.1	0.80
1987	18301.8	1.10
1986	18253.3	1.12
1985	17956.9	1.19
1984	16529.4	1.19
1983	15429.1	1.22
1982	13770.9	1.21
1981	12246.1	1.24
1980	11019.5	1.16
1979	9792.7	1.21
1978	8796.0	1.16
1977	7992.8	1.15
1976	7268.8	1.16
1975	6716.0	1.18
1974	6124.2	1.18
1973	5615.3	1.21
1972	5158.7	1.23
1971	4739.9	1.27
1970	4379.6	1.25
1969	4051.1	1.29
1968	3749.2	1.26
1967	3485.5	1.33
1966	3252.0	1.39
1965	3036.3	1.45
1964	2844.7	1.48
1963	2667.9	1.50
1962	2502.0	1.47
1961	2353.8	1.47
1960	2222.2	1.48

Source: FDIC Annual Report 1988.

Chart 1
FDIC Deposit Insurance Fund
Ratio to Insured Deposits



Source: Table 3

FDIC examiners conduct around 10,000 bank examinations a year. They entail:

(1) Examinations into the safety and soundness of bank operations;
(2) Examinations for bank compliance with consumer protection and civil rights laws;
(3) Examinations of bank trust department and electronic data processing operations;
(4) Special investigations; and,
(5) Investigations in connection with bank applications to obtain insurance, establish branches or merge, or other applications that would affect a bank's structure or ownership.[14]

Examiners look into the adequacy of the bank's capital, the quality of its assets and the adequacy of available funds. Special attention is likewise given to the effectiveness of internal and external controls, the use of sound accounting procedures and the adequacy of fidelity bond coverage to protect against extraordinary losses resulting from dishonest acts of officers and/or employees. Ultimately, the overall quality of the banks management is likewise carefully evaluated.

Based on examination findings, FDIC recommends suggestions for improving a bank's policies and practices. Close coordination with bank management is also maintained to ensure management's familiarity with any emerging problems. If a bank persists in operating in an unsafe and unsound manner, the FDIC may initiate proceedings towards the issuance of a cease-and-desist order against the bank or one or more of its officers. This could result in civil penalties, removal of top management and termination of the bank's insurance. These formal enforcement actions are taken only with prior warning to the bank and only after efforts have been made with the bank and other supervisors to correct unsound and unsafe practices. As of year-end 1988, 267 cease-and-desist orders were in effect.

Insurance termination rarely occurs because the problems are corrected or the bank merges with a healthy bank. Even in cases when insurance is terminated, existing deposits, net of subsequent withdrawals, continue to be insured by the FDIC for a period of two years.

In addition to its safety and soundness role, the FDIC enforces a number of consumer protection and civil rights laws, including, among others, the Truth in Lending Act, the Fair Credit Reporting Act and the Equal Credit Opportunity Act. The FDIC carries out these enforcement responsibilities primarily through a program of separate

14. Federal Deposit Insurance Corporation, *Symbol of Confidence*, FDIC, Washington D.C., 1986, pp. 6-7.

examinations devoted specifically to checking compliance with these statutes and their implementing regulations.[15]

Other agencies providing deposit insurance in the U.S. are the FSLIC which covers thrifts and the National Credit Union Administration (NCUA) which covers credit unions. As previously mentioned, the FSLIC was established in 1935. Deposit insurance limit is also US$ 100,000, with premiums equal to about 0.6 per mill of total deposits. Membership is voluntary, but is compulsory for federally chartered savings and loans associations. The FSLIC has been terminated following the Savings and Loans Industry Debacle of the late 1980s. Savings and Loans Associations (SLAs) are now insured under the Savings Association Insurance Fund (SAIF) which is operated by the FDIC. Insured thrifts are supervised by the Office of Thrift Commission. Some discussions will be devoted to the SLAs crisis in a subsequent section.

The NCUA, established in 1970, also has an insurance limit of US$100,000. Premia of 1/12 percent are collected from members. Membership is voluntary, but compulsory for federally chartered credit unions. Most of the discussions in subsequent sections will dwell on the FDIC and FSLIC as they cover banks and near banks.

Deposit Insurance in the Philippines

The Philippine Deposit Insurance Corporation (PDIC), an agency created by law, administers deposit insurance in the Philippines. Like the FDIC, it was engendered by the necessity of containing a banking crisis. The PDIC was chartered under Republic Act No. 3591 dated 22 June 1963. However, its permanent insurance fund was released only a year later by virtue of Republic Act No. 4083 dated 18 June 1964 which appropriated P 5.0 million as initial capitalization or permanent insurance fund. Under its original charter, membership was voluntary.

The year 1968 was a tumultuous one for Philippine banking. There was a mild bank run in the country, stemming from rumors that a number of banks were in precarious financial condition. The eventual closure of eight banks, consisting of one commercial bank, three thrift banks and four rural banks, further exacerbated the nervous situation. Given the failure of some depositors to withdraw their money from closed banks, depositor confidence in the banking system thus sank to very low levels.

15. Ibid., p. 11.

To avert a full-blown bank crisis by restoring depositor confidence, a Special Fund was created under Republic Act 5517 dated 19 June 1969 to be used for the payment of depositors of closed banks in amounts not exceeding P 10,000. The fund was administered by the PDIC. Under its own charter, the PDIC started paying off insured deposits in closed banks in 1970. In the same year, membership in PDIC was made compulsory under Republic Act No. 6037 dated 4 August 1969.

Over the years, the PDIC has undergone a number of changes. At present, insurance coverage is P 40,000 per depositor, including foreign currency deposits covering demand, savings and time deposits. The permanent insurance fund is now P 2.0 billion by virtue of Presidential Decree No. 1985 dated 4 October 1985. The PDIC collects a premium equivalent to 1/12 of 1 percent per annum of total deposit liabilities (including trust funds) from member banks. The Corporation is authorized to borrow from the Central Bank in amounts consistent with monetary policy. It may also issue bonds, debentures and other obligations. Income is derived from assessments and interests from holdings of government securities. The functions of the PDIC include: (1) assessment of premia to be paid by member banks on a semi-annual basis in accordance with the pertinent provisions of law; (2) extension of financial assistance to member banks in order to prevent closure; (3) payment of claims for insured deposits in banks closed due to insolvency; and, (4) receivership/liquidation of a closed bank. Additionally, as a regulator, the PDIC has the power to examine banks and require information/reports from them. However, due to manpower constraints, the examination function has not been actively carried out in the past, with the PDIC relying mainly on reports of examinations from central bank examiners. With the ongoing organizational strengthening, PDIC aims to more actively engage in this function in the near future. With regard to the PDIC's function to prevent bank closures, the Corporation is authorized under Section 12(c) of the PDIC Law to provide direct financial assistance to an operating member bank in the presence of the following findings:

(1) Danger of bank closure;
(2) The grant of financial assistance will prevent bank closure; and,
(3) The continued operation of the bank is essential in providing adequate banking services to the community.

Financial assistance granted by the PDIC is presently limited to making deposits with the ailing institutions, extending loans and purchasing assets. Funding for these activities is sourced from the permanent insurance fund and additional appropriations.

Presently, the PDIC's Board of Directors is chaired by the Central Bank Governor, with the PDIC President and the Undersecretary of Finance as members. The PDIC Bill pending with the Senate proposes to change the Board's composition as follows: Secretary of Finance as Chairman; PDIC President as Vice-Chairman; and, Central Bank Governor and two private sector representatives as members.

In order to further strengthen the PDIC and improve its delivery on pay-offs, a number of proposals to amend Republic Act No. 3591 as amended were submitted to Congress. They include among others raising PDIC's equity base to P 5.0 billion. This is considered crucial as it will enable the Corporation to fully discharge its obligations to depositors as well as to the whole banking system. At the same time, PDIC would be able to maintain an adequate Permanent Insurance Fund. The assessment rate is proposed to be increased to a rate not exceeding 1/5 of 1 percent. This will make the (insured) private sector contribute more proportionately to the maintenance of a strong system of deposit insurance, from which they benefit.

Another proposal is the increase in the present insurance coverage from P 40,000 to P 60,000. This is aimed at further protection of the banking public. At the present level, data as of 30 June 1990 show that 94.57 percent of all deposit accounts are fully covered. With the proposed increase, 96.26 percent of all deposit accounts will be fully insured (Table 4 and Chart 2).[16]

The PDIC also seeks authority to issue cease and desist orders in order to make itself a more active participant in the bank supervision process. This is also aimed at minimizing losses and damage associated with the continued operation of insolvent banks who even in their distressed conditions would still continue to attract deposits which are in turn insured with the PDIC. Corollary to this is the mandatory appointment of the Corporation as receiver and/or liquidator of closed banks. Since the PDIC has a stake in the speedy liquidation of closed banks, it is felt that they should participate in the receivership and liquidation activities. Under the present set up, the PDIC may be appointed as the receiver/liquidator of closed banks.

Other proposals submitted to Congress include:

(1) Additional mode and grounds for financial assistance. As previously mentioned, financial assistance extended by the PDIC to troubled banks is limited only to making deposits and loans, which help to solve liquidity problems. However, when

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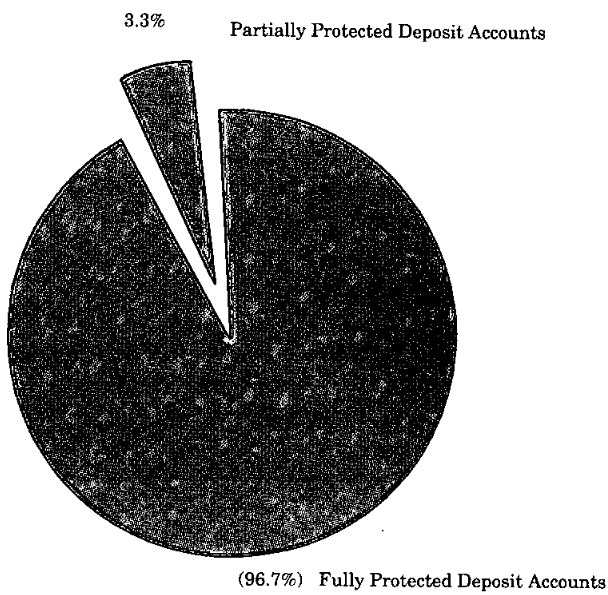
16. Philippine Deposit Insurance Corporation, Unpublished, Second PDIC Interagency Ad Hoc Committee Report, Manila, 1989.

Table 4
PHILIPPINE DEPOSIT INSURANCE CORPORATION:
ESTIMATED RISK EXPOSURE AT DIFFERENT LEVELS OF INSURANCE COVERAGE
For Periods Indicate
(Amounts in million pesos)

	Total Banking System					
	Total No. of Account		Percent to Total		Amount	
	31 Dec.'87	30 Jun.'90	31 Dec.'87	30 Jun.'90	31 Dec.'87	30 Jun.'90
P 40,000 Coverage						
Fully Protected	17345315	16264866	96.69	94.56	40002	52441
Partially Protected	593282	934763	3.31	5.44	23731	37391
Total	17938597	17199629	100.00	100.00	63733	89832
P 60,000 Coverage						
Fully Protected	17593318	16556355	98.07	96.26	52340	66404
Partially Protected	345279	643274	1.92	3.74	20717	38596
Total	17938597	17199629	100.00	100.00	73057	105000
P 80,000 Coverage						
Fully Protected	17665511	16684176	98.48	97.00	57446	74911
Partially Protected	273086	515453	1.52	3.00	21846	4123
Total	17938597	17199629	100.00	100.00	79292	116147
P 100,000 Coverage						
Fully Protected	17719427	16783002	98.78	97.58	62333	83593
Partially Protected	219170	416627	1.22	2.42	21918	41663
Total	17938597	17199629	100.00	100.00	84251	125256

Sources: Appendix B, Philippine Deposit Insurance Corporation, Unpublished Second PDIC Interagency Ad-Hoc Committee Report, Manila, 1989.
PDIC Estimated Risk Exposure Under Increased Insurance Coverage, June 1990.

Chart 2
FDIC Estimated Risk Exposure at
P 40,000.00 Insurance Coverage



Source: Table 4

the problem is that of insolvency and if it is less costly for the PDIC to infuse additional equity rather than to pay off depositors, then the PDIC would have to infuse additional equity. Hence, the proposal for the grant of authority to purchase stocks from troubled banks to effectively prevent bank closures;

(2) Changes in the composition and membership of the Board of Directors;

(3) Upgrading the preference of PDIC in case of liquidation of banks for their claims for insured deposits to the same level of government taxes;

(4) Provide for the lowest lending rate as the basis for interest charges on PDIC borrowings from the Central Bank;

(5) Provide for additional authorities for PDIC to enforce its rules as well as existing banking laws and regulations;

(6) Provide higher optional insurance coverage over and above the existing flat rate coverage. This is envisioned to increase depositor confidence since a high insurance level is available to those who are willing to shoulder the additional costs;

(7) Increase in the permanent insurance fund (PIF) to at least P 7.49 billion;

(8) Authority to charge special assessments when the PIF is at critical levels, inhibiting the adequate response to closure preventions and pay-offs;

(9) Extension of deposit insurance coverage to cooperatives;

(10) Require the immediate settlement of claims for insured deposits within one year; and,

(11) Make clear certain definition of terms, succession provisions and prohibitions for the President, members of the Board of Directors, and other officers/employees of the Corporation.

As of year-end 1988, the PDIC has paid a total of P 2,859.1 million to depositors of 213 closed banks since the beginning of operations. For 1988 alone, the PDIC paid off 64,854 accounts amounting to P 368.4 million (Table 5).

The year 1988 also witnessed the first time that the PDIC was appointed as receiver of closed banks. This involved four rural banks closed during the year. In the same year, the Corporation granted financial assistance amounting to P 400 million to a large bank to boost its financial condition.

As of year-end 1988, the PDIC had a total of 982 member banks, or 12 less than the 1987 total owing to the closure by the Central Bank of ten rural banks, one private development bank and one savings and loan association (Table 6).

Table 5
PDIC PAYMENTS OF INSURED DEPOSITS IN CLOSED BANKS
For the Year 1988
(Amounts in million pesos)

Bank Group	No. of Offices Serviced		PDIC Payments	
	Head Office	Branches	No. of Accts.	Amount
Commercial Banks	2	92	39228	325.473
Thrift Banks	24	122	7054	14.242
Savings & Mortgage Banks	2	93	5564	1.754
Private Development Banks	3	13	197	4.678
Stock Savings & Loan Banks	19	16	1293	7.810
Rural Banks	67	5	18572	28.672
All Banks	93	219	64854	368.387

Source: Philippine Deposit Insurance Corporation Annual Report 1988.

Table 6
PDIC MEMBER BANKS, 31 DECEMBER 1988
(By Type of Bank)

Bank Group	Total Offices	Head Offices	Branches	Change from 31-12-1987		
				Total	H.Offices	Branches
Commercial Banks	1746	29	1717	13	-	13
Thrift Banks	664	110	554	6	(2)	8
Savings & Mortgage Banks	250	8	242	7	-	7
Private Development Banks	205	41	164	-	(1)	1
Stock Savings & Loan Assoc.	209	61	148	(1)	(1)	-
Rural Banks	1048	840	208	(10)	(10)	-
Specialized Govt. Banks	104	3	101	-	-	-
All Banks	3562	982	2580	9	(12)	21

Source: Philippine Deposit Insurance Corporation Annual Report 1988.

Deposit Insurance in Sri Lanka

The deposit insurance scheme in Sri Lanka is in its preliminary stage. It was established in April 1987 with the promulgation of the Regulations under Section 32E of the Monetary Law Act. The scheme is administered by the Central Bank of Sri Lanka. It is voluntary in nature and covers commercial banks, regional rural development banks and cooperative rural banks of the multi-purpose cooperative societies.

The Monetary Board of the Central Bank has provided Rs. 50.0 million to meet the liabilities of the scheme. Quarterly premia amounting to one rupee for every ten thousand rupees are collected from member banks. Insurance coverage is fixed at a maximum of Rs. 100,000. The scheme does not cover the deposit liabilities of the Government, any local authority, public corporation, banking institution or society in the same capacity.

As of end-1989, a number of institutions have applied to the scheme including 2 commercial banks, 5 regional rural development banks and 179 multi-purpose cooperative societies comprising 764 cooperative rural banks. Financial positions of the said applicants are subject to examination by the Central Bank prior to admission into the scheme.

As of the same cut-off period (end-1989), a total of 23 entities have been registered as insured. They include: 2 commercial banks, 3 regional rural development banks and 18 cooperative rural banks of 3 multi-purpose cooperatives.[17]

Deposit Insurance in Germany

Deposit insurance in Germany is privately administered. There is no general, statutory deposit insurance scheme comparable to the American system. In place, however, are three separate deposit insurance schemes (Einlagensicherung). These are arrangements which do not merely insure deposits, but which ensure the security of deposits. This is because these schemes ensure the security of other liabilities than deposits and in many cases ensure the existence of a bank.[18] The schemes are administered by the banking associations of each of the three large groups of the German banking industry, namely, the private commercial banks, savings banks and credit associations (cooperatives).

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17. Central Bank of Sri Lanka, Economic Research Department.

18. The Anglo-German Foundation, *The British and German Banking System: A Comparative Study*, Anglo-German Foundation, 1981, p. 399.

Historical roots of German deposit protection date back to the 1930s when, as a result of the economic crisis, agricultural and commercial credit cooperatives formed assistance or guarantee funds. The two other major banking groups had no such arrangements. For the private banks, it began in the late 1950s and early 1960s. The savings banks introduced their scheme in 1969.

Prior to that, in 1958, a High Court ruling authorizing the opening of bank branches without any prior examination of the need therefore prompted the proposal to introduce a deposit insurance scheme similar to the U.S. system. The new Banking Statute of March 1961 called upon the Government to examine ways of improving the security of deposits with banks. Based on the findings of the inquiry on deposit insurance requested by the Federal Parliament published in 1968, the Government, for social reasons as well as to promote the formation of wealth, advocated more security for depositors. It envisaged a joint insurance system for the entire banking industry. Savings banks and credit cooperatives, however, opposed such a solution and this then led to individual banking groups making their own specific arrangements.

Private banks composed of the commercial banks, regional banks, private bankers and mortgage banks increased their joint "fire-fighting fund" — which had already been created in 1966 — from DM 10 million to DM 20 million. Deposits on savings, wage and salary accounts were insured up to DM 10,000. Insurance coverage was later increased to DM 20,000. However, with the collapse of a big bank, the Herstatt Bank in 1974, when each depositor was compensated only up to the DM 20,000 level, some further discussion and thinking on deposit insurance took place. The social hardships and loss of confidence attendant to the Herstatt collapse led to stronger calls for increased depositor protection. But savings banks and cooperatives were still averse to insuring deposits on a comprehensive joint basis for all banks as proposed by the Government. The private banks thereupon developed their own ideas on how to secure deposits and the two other types of banks continued operating their own deposit insurance schemes.[19] It could therefore be said that the German deposit insurance system is based on a voluntary agreement of the relevant institutions. It was established in order to avoid governmental regulations and their negative consequences.[20] Each of these schemes will be discussed

19. Dr. F. Wilhelm Christians, "Deposit Insurance in the Private Banking Sector in the Federal Republic of Germany", in *The World's Banking System, Volume III*, United Nations World, Austria, 1977, p. 24.

20. Dr. Hans Strack, Chairman, Deposit Protection Committee, Federal Association of German Banks, Unpublished lecture at the Meeting with American Bank Representatives, June 1985, p. 3.

in subsequent sections. However, to better understand these schemes, what follows is a brief backgrounder on the German banking industry and its structure.

The banking system in Germany possesses special features when compared with other industrialized countries. While there are differences between the various types of credit institutions ("banks" and "credit institutions" are synonymous) in terms of the structure of their business, organization, legal form and size, the commercial banks — irrespective of whether they are private, cooperative or public institutions — engage in all conceivable forms of banking operations. Although these banks differ in the priority they set in their business policies, there is no division of functions.

The commercial banks may be grouped into the following main categories:

(1) The cooperative banks - these are the commercial and agricultural credit cooperatives and their central banks with a share of just over 20 percent;
(2) The public sector banks - these are the savings banks and their central institutions with a share of about 50 percent; and,
(3) The private commercial banks - these are the large banks, regional banks, and branches of foreign banks with a market share of 30 percent as at end-1988.

The commercial banks are universal banks of the continental European type. They engage in lending, deposit taking, payment transactions, issuing business and securities trading. They accounted for approximately 78 percent of the business volume of credit institutions (excluding home loan societies) as at end1988.

In addition to the commercial banks, there are many specialist banks, such as mortgage banks and other real estate credit institutions, postal giro and postal offices and others. The specialist banks account for about a quarter of the total business volume.

All banks are subject to government supervision exercised by the Federal Banking Supervisory Office (FBSO) in Berlin in coordination with the Deutsche Bundesbank, the German central bank.[21]

What follows is a discussion of the various deposit insurance schemes for the three major types of banks:

1. Cooperative Banks

The deposit insurance scheme of cooperative banks is administered by the association of cooperatives, the Bundesverband der Deutschen Volksbanken un Raiffeisenbanken (BVR). It is governed by the

21. Jurgen Stein, *The Banking System in Germany*, Bank Verlag GmbH, Cologne, 1989, pp. 5-7.

Statutes of the Security System of the Federal Association of German Commercial and Rural Credit Associations. The system was adopted in 1985, superseding the security system established in 1977, which in turn replaced the long-standing separate protection schemes for commercial credit associations and rural credit associations, respectively. Members of the system include the credit associations, their regional institutions (zentralbanken), their central institutions (Deutsche Genossenschaftsbank), and various other banks belonging to the credit associations sector. Membership is compulsory.

The guarantee fund is sourced from contributions by its members. It comes in the form of an annual levy of 0.05 percent on most deposits as well as some loans. In some instances, such as in 1984 and 1987, special calls had to be made, amounting to as high as 0.02 percent premium.[22] The fund is used to help banks which are in difficulties, to forestall the difficulties becoming public knowledge and prevent bank closures. This is done through guarantees, loans or direct support. Hence, liquidity support is virtually unlimited.[23] These have to be paid back once the bank recovers.

Investigations follow these non-interest bearing financial assistance and the association gives advice on improving a bank's performance. Continued membership depends on implementation of said recommendations. In other instances, mergers are arranged or top management changed. Since 1945, there has been no case of a cooperative leaving the movement.

Central to the cooperatives deposit insurance scheme is the supervisory scheme or Prufverban. Every cooperative must submit to regular examinations of their books and annual reports as well as special examinations when necessary. This auditing is a necessary condition to membership in the BVR, and is over and above the bank supervision conducted by the FBSO in Berlin.

It may be noted, however, that no bank included in this scheme has a legal right to assistance. Nevertheless, there are no known cases where depositors of a member bank have suffered losses by reason of a financial crisis of a cooperative bank.[24]

Since the 1930s, no cooperative bank in Germany has been forced to close down due to loan losses. Neither has it ever been necessary to fall back on members obligations to pay up their contingent liability. In addition to the guarantee fund, there is also a "Garantieverband".

22. Interview with officers of the BVR, 1990.

23. Ibid.

24. Schneider, et.al., *The German Banking System*, Fritz Knapp Verlag, Frankfurt Am Main, 1986, pp. 49-50.

It is an association of almost all credit cooperatives which gives guarantees for loans or deposits when there are signs of difficulties. As such, it is a first line of defence before calls on the guarantee funds are made. The Garantieverband is financed by contributions which are called when needed.

Despite the fact that it is administered by the banking association, officials of the BVR state that there have been no instances of bank fraud.

2. *Savings Banks*

Savings banks in Germany are guaranteed by their respective local communities (city or country), in the same manner as the 11 central giro institutions (Landesbanken-Girozentralen) which serve as the savings banks regional money centers, are guaranteed by the relevant Landesbanken. Hence, these banks were not too concerned about establishing their own deposit insurance scheme.

The savings banks deposit protection scheme in its present form was set up in 1975 by the German Savings Banks and Giro Association (Deutscher Sparkassen und Giroverband e.V.). This was prompted by fears that local authorities would be slow in responding to their guarantee obligations. There was also the issue of competition as both the cooperative banks and private banks had their own deposit insurance system which was funded by members contributions representing costs to the aforesaid two other banks.

The purpose of the savings banks scheme is to ensure swift help with no danger of moves getting stalled in local politics. Like the cooperative scheme, this system aims to provide help long before the difficulties of a bank have become public knowledge.

The savings banks guarantee fund is called the Sparkassenstutzunsfonds. It is similar to that of the cooperatives, although not as closely tied up with the savings banks supervisory scheme as that of the cooperatives. The funds are financed by a levy of 0.03 percent on all loans and are supposed to accumulate about DM 910 million, half of which is earmarked as an uncalled liability. Special calls of up to 0.06 percent per annum may be levied if warranted.[25] At the moment, the funds are fully built up.[26]

The 12 regional funds for Sparkassen are linked by a network of mutual guarantees; the fund for the Landesbanken-Girozentralen is also integrated with them. If one region cannot cover losses, all other funds have to help. The need for this has not yet occurred to-date.

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25. The Anglo-German Foundation, *The British and German Banking System: A Comparative Study*, Anglo-German Foundation, 1981, p. 402.
26. Interview with official of Banking Association.

Membership is compulsory as it is required by the FBSO in Berlin prior to the grant of a banking licence. Hence, adverse selection is avoided.

The banking association gives members advice on mergers, but these have to be arranged by the banks themselves. The auditing office in the regional association checks on banks once a year. This auditing, which is apart from that carried out by the FBSO in Berlin, was being done even before deposit insurance was introduced. This is one aspect of the mutuality of interests binding members of the savings banks association, which is better appreciated in the light of the help member banks extend to members in difficulty.

3. Private Banks

The deposit insurance scheme of private banks is administered by the banking association, the Bundesverband deutscher Banken e.V. (BDB). This scheme is centered primarily on the protection of non-bank deposits, rather than on the continued existence of the banks, which forms part of the cooperatives and savings banks respective schemes. This is because private banks compete against each other more than cooperative and savings banks where there is a strong element of mutuality stemming from the fact that these latter groups of banks are common groups.

The private banks scheme was established in 1976 under the By-laws of the Deposit Protection Fund of the Federal Association of German Banks (Statut des Einlagensicherungsfonds des Bundesverbandes deutscher Banken e.V.). It superseded the Common Funds or Gemeinschaftsfonds created in 1966 which extended only a limited protection for deposits of private customers. The private banks scheme has a permanent fund, the Einlagensicherungsfonds administered by the BDB. It is funded by an annual levy of 0.03 percent on all non-bank deposits. The levy may be doubled when the need arises. It can also be lowered if the fund is deemed to be sufficiently large.[27]

The Deposit Protection Fund aims to "give assistance in the interest of depositors, in the event of imminent or actual financial difficulties of banks and to prevent the impairment of public confidence in private banks. The Fund protects, with few exceptions, all deposits with member banks made by non-banks and all liabilities of German investment fund assets, up to a limit, per creditor, of 30 percent of the

27. Ibid., p. 407.

equity capital of the bank."[28] This deposit protection limit makes coverage virtually 100 percent in view of its magnitude. Even in the case of small private banks with equity capital of DM 6.0 million, deposit protection will be up to DM 1.8 million per depositor. It may be mentioned that 5,000 of the 6,000 private banks have equity capital in excess of DM 100.0 million.[29]

It is noteworthy that although the fund can extend help to save a troubled bank as a whole, the only part of the bank's business which is expressly safeguarded are its non-bank deposits consisting of sight, time and savings deposits and savings bonds. Deposits by directors, owners or members of the banks supervisory board, their spouses and children and their representatives are not covered.[30]

Prospective members must have at all times a minimum equity capital in accordance with the requirements of the FBSO and two qualified managers. It must be operating profitably and must maintain adequate liquidity. The bank must also be a member of the Auditing Association of German Banks (Prufungsverband deutscher Banken) and of the appropriate State Association of Banks.[31]

The Auditing Association is an integral part of the deposit protection scheme of private banks, although it is distinct and separate from the BDB. Its main task is to recognize adverse developments in the industry to prevent failures. It is thus a major contributor to the satisfactory functioning of the private banks scheme by providing a sort of an early warning system. The auditing conducted by the Prufungsverband is distinct from that carried out by the FBSO.[32]

Deposit Insurance in France

The deposit insurance scheme in France is called the Deposit Guarantee Fund. It was established in 1980 and is administered by the banking association, the Association Francaise des Banques (AFB). Membership is voluntary. Insurance coverage is up to FF 400,000.

All member banks operating in France, including foreign-owned establishments, are covered by the Deposit Guarantee Fund. However,

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28. Schneider, et.al., *The German Banking System*, Fritz Knapp Verlag, Frankfurt Am Main, 1986, p. 47.
29. Bundesverband der deutscher Banken e.V., *The Deposit Protection Fund of the Private Sector Banks*, pamphlet.
30. Loc. Cit, p. 405.
31. Sections 3 and 4 of By-Laws of the Deposit Protection Fund of the Federal Association of German Banks.
32. Interview with official of the Prufungsverband deutscher Banken.

deposits held at foreign branches of French banks are not covered. Interbank deposits, certificates of deposits and deposits denominated in foreign currencies are likewise not covered.[33]

The scheme does not have a permanent insurance fund. Payoffs are sourced from contributions on the basis of ex-post assessments. When a bank is closed, the AFB organizes a system to refund deposits in order to avoid loss of confidence. They choose a bank and open an account which is some sort of an open credit line. They then repay eligible depositors up to a maximum of FF 400,000 by issuing notes payable by the bank where the AFB opêned a credit line. Depositors are usually repaid within a period of two months.

After this, the AFB asks members to refund the money used to pay off depositors in order that the AFB's advances from the bank where it opened the credit line could be repaid. The contribution of each member bank is based on a regressive scale related to the size of each bank's total deposits outstanding at year end. Should the need arise, the AFB can call on additional contributions due on the previous two years and advances on the two coming years. In principle, the schemes pay-offs are subject to a maximum ceiling of FF 200 million per year.[34]

Failure rate has been manageable so far, only 21 since 1955. Since 1980, when deposit insurance was established, there have been seven failures, mostly of small banks. The AFB has always been able to satisfactorily pay off all depositors.[35]

Another agency, the Association Francaise de Establishment de Credic (AFEC), was created to license banks and to act as the representative of commercial banks in interactions with the Government and other banks like the mutual banks, agricultural banks and savings banks.

Unlike the banking associations in Germany, the AFB does not conduct any self-inspection of member banks. Hence, one of their problems is that the AFB has no control over its members and yet is responsible for deposit insurance. On the other hand, the Banking Commission, which has control over banks, is not involved in deposit insurance.

It may be mentioned that in France, deposit insurance is not advertised and only very few people are aware of its existence, according to an AFB official. However, it is felt that deposit insurance

33. R.M. Pecchioli, *Prudential Supervision in Banking*, OECD, Paris, 1987, p. 271.
34. Ibid., p. 271.
35. Interview with official of AFB.

is still needed despite a sufficiently high standard of bank supervision in France because when fraud is committed, it is very difficult to detect it early enough and so depositor protection is still needed for such an eventuality.

The Banking Regulations Committee, a small body whose jurisdiction extends to all credit institutions, has regulatory control over banks. The Banking Regulations Commission has responsibility for ensuring that credit institutions observe the prudential rules and regulations and for taking disciplinary action when necessary.[36] The Banque de France works in coordination with these agencies.

Deposit Insurance in England

The deposit insurance system in England is called the Deposit Protection Fund. It is administered officially by the Deposit Protection Board which is attached to the Bank of England. The Deposit Protection Fund was established in 1982. It is a permanent fund financed by a levy on all recognized banks and licensed deposit takers based on a given percentage of their deposits. A minimum amount is set at £ 2,500.00 with a maximum amount at £ 300,000. A 1987 revision of the Banking Act set the minimum at £ 10,000. There are provisions for additional contributions in case of need and special levies can be imposed in exceptional circumstances, subject to the condition that the cumulative contribution of each institution would not exceed 0.3 percent of the deposit base.

Coverage of the scheme extends to sterling deposits booked in England, excluding interbank and secured deposits, deposits with an original maturity of five years and deposits made by related persons or group companies. Covered deposits up to a maximum of £ 20,000 are protected for 75 percent of their value. Effectively, the limit is £ 15,000.

Membership in the scheme is compulsory but the Treasury may grant dispensation to overseas banks whose sterling deposits booked in England are as well protected by arrangements in their home countries as they would be under the English scheme.

The Fund is administered by the Deposit Protection Board. It is a very small operation, working only as the need arises. The Board is comprised of the governor, deputy governor and chief cashier of the Bank of England as well as a number of ordinary members appointed by the governor, including three members qualified as controllers, managers or directors of participating institutions.

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36. Banque de France, *The Bank of France*, Banque de France, Paris, 1986, p. 27.

It may also be mentioned that the building societies at present operate a voluntary mutual guarantee protection for share accounts without limit on the amount of deposit and 100 percent protection for deposit accounts. New legislation before Parliament will provide for a statutory guarantee scheme. All deposits will then be protected up to £ 10,000 to the extent of 90 percent of the deposits. The scheme will rely wholly on the power to levy contributions from the societies and there will be no cash fund. The scheme will be administered by a board comprising representatives of the Building Societies Commission and the societies themselves.[37]

Unlike in Germany and France, the Bank of England licenses and supervises banks. This started in 1980 with the promulgation of the Banking Act. Prior to that, banks were able to set up businesses just like any ordinary business establishment. But the banking crisis in the mid-1970s, which saw the failure of small banks which over-concentrated in real estate, raised the question on the need for supervision of banks and led to the passage of the Banking Act. This same crisis also underscored the necessity for some form of deposit protection.

While bank supervision in England is considered quite adequate, there is always the chance of failure, specially if fraud is involved. Hence, deposit insurance is there to provide protection to small and unsophisticated depositors. However, this is just one means of consumer protection.

Since 1982, there have been 14 bank failures. There are no data prior to 1980. Most of these failures stem from economic reasons, one due to terrorist activity and some due to fraud.[38]

Scenarios in the SEACEN Countries

In most SEACEN member countries, except the Philippines and Sri Lanka, there is no deposit insurance scheme. Depositor protection is achieved through various other means which can be referred to as implicit depositor protection because the governments get involved in protecting depositors of failing banks, although they are under no legal obligation to do so. The amount protected and the means of protecting the same are not explicitly stated. These are carried out at the government's discretion and hence, the government has the option of not extending any protection when it feels that the banking system is not threatened.

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37. R.M. Pecchioli, *Prudential Supervision in Banking*, OECD, Paris, 1987, pp. 275-276.
38. Interview with Deposit Protection Board official.

In **Indonesia**, settlement of bank failures does not follow a clear-cut pattern. The central bank, Bank Indonesia, may provide a rescue package which is limited to a certain amount. However, after the bank has proven unable to fulfil its liabilities to depositors, and if there are no indications that it can recover, then the Government will revoke its licence. The final settlement between the bank and its depositors would be decided by the Court.[39] Bank failures eroded public confidence in the private banks, and the public had trust only in state-owned banks which hold a considerable stake in Indonesia's banking system. In an effort to improve supervision of banks and thus help lessen failures, the Private Bank Supervision Department of Bank Indonesia was reorganized.

The December 1989 Policy Package revoked government guarantees on certain types of deposits, such as Tabanas and Taska. Banks operate without deposit insurance. The Monetary authorities are emphasizing banking supervision and encouragement of sound banking practices as provided for by the February 1991 Policy Package which was principally aimed at preventing bank failures stemming from unsound banking practices. The Package also imposes the standardized capital adequacy ratio suggested by the Bank for International Settlements.

In **Korea**, the central bank, The Bank of Korea, plays the role of lender of last resort in case of bank runs. However, since commercial banks have been privatized, the role of the monetary authorities has also been reduced. In the early 1980s when there was a spate of banking scandals and difficulties, bank losses were primarily absorbed by the banks reserves. The central bank assisted banks facing liquidity constraints by injecting liquidity through the purchase of Monetary Stabilization Bonds or through the grant of emergency loans. The Government adopted an accommodative monetary policy to make liquidity available to the system.[40]

Although there is no deposit insurance scheme for banks in Korea, there is one for non-banks, called the Korea Non-Banks Deposit Insurance Corporation. It was established by an Act in 1983 to protect depositors and to stimulate the sound management of non-bank financial institutions. Included in its coverage are investment and

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39. Sukarwan and Puspo Sungkowo, Unpublished Country Paper on Indonesia presented at the SEACEN Seminar on Rescue Package for Ailing Financial Institutions in the SEACEN Countries, Kuala Lumpur, 1990, p. 3.

40. Dong-Hyuk Yang, Unpublished Country Paper on Korea presented at the SEACEN Seminar on Rescue Package for Ailing Financial Institutions in the SEACEN Countries, Kuala Lumpur, 1990, pp. 6 and 10.

finance companies, merchant banking corporations and mutual savings and finance companies.

Funds are sourced from contributions from members based on the outstanding amount of insured deposits. It is interesting to note that although the primary purpose of the fund is to compensate depositors for losses resulting from insolvency of member institutions, it may also receive deposits, make loans and extend credit guarantees for member institutions.

The Steering and Planning Committee composed of representatives from member institutions oversees the administration of the funds.[41]

In **Malaysia**, the central bank, Bank Negara Malaysia, also acts as a lender of last resort. The Central Bank of Malaysia Ordinance 1958 and the Banking and Financial Institutions Act 1989 (BAFIA) provide for such lender-of-last-resort function as well as authority to inject additional equity into the problem institution in order to rehabilitate it and to sell its shares to the public. The central bank is also empowered to apply to the High Court to reduce the capital of a financial institution to the extent of capital impairment. This is to prevent unscrupulous stockholders from benefitting from the central banks rescue operations. The central bank is also empowered to require these ailing institutions to reorganize their management as well as to appoint a receiver, or arrange for a merger.

Depositors claims are ranked by BAFIA above all other creditors in the event of liquidation. Additionally, the financial institutions are monitored regularly to ensure safety of depositors interest.[42]

In **Nepal**, the banking industry is dominated by state-owned banks and foreign banks. "Two problem banks are under government control and hence, they have a fairly good chance of survival."[43] The central bank, Nepal Rastra Bank, acts as a lender of last resort, providing liquidity in cases of mass withdrawals from banks.[44]

In **Singapore**, there has not been any financial institution whose condition has deteriorated to such a level as to prompt the Monetary Authority of Singapore to acquire direct control over it. Weak institutions have merged or been taken over by stronger ones. For

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41. The Bank of Korea, Financial System in Korea, December 1990.
42. Seow Boon Siew, et. al., Unpublished Country Paper on Malaysia presented at the SEACEN Seminar on Rescue Package for Ailing Financial Institutions in the SEACEN Countries, Kuala Lumpur, 1990, p. 2.
43. Bhagat Bista, Unpublished Country Paper on Nepal presented at the SEACEN Seminar on Rescue Package for Ailing Financial Institutions in the SEACEN Countries, Kuala Lumpur, 1990, p. 12.
44. Ibid., p. 8.

institutions considered recalcitrant, they are prosecuted for violations of the Banking Act.[45]

In **Thailand**, problem commercial banks are dealt with by some form of financial assistance or management restructuring or both to avert failure of the institution. Thailand has also practised a promissory note (PN) exchange program whereby holders of PNs of closed finance companies could exchange these PNs for those issued by certain finance companies chosen by the authorities. Although the total face value is the same, maturities were spread over a period of ten years and no interest was paid. The exchangers (e.g., finance companies chosen) were financed with low interest loans from the Central Bank which have to be reinvested in government bonds. Thus, returns from the interest margin would help facilitate the promissory note exchange program.[46] Later on, the Financial Institutions Development Fund (FIDF) was formed to take over the functions of the exchangers of PNs in the event of finance company closures.[47]

Functions of the FIDF include, among others, the following:

(a) Purchasing new shares issued by ailing financial institutions;
(b) Providing non-interest lending facilities to troubled financial institutions. The collaterals against the loans could be accounts receivables, fixed assets or government bonds; and,
(c) Encouraging ailing financial institutions to merge among themselves and with other competent financial institutions.

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45. Chan Yoon Cheong, Unpublished Country Paper presented at the SEACEN Seminar on Rescue Package for Ailing Financial Institutions in the SEACEN Countries, Kuala Lumpur, 1990, p. 4.
46. Department of Economic Research, Bank of Thailand, 1991.
47. Metha Suvanasarn, et. al., Unpublished Country Paper on Thailand presented at the SEACEN Seminar on Rescue Package for Ailing Financial Institutions in the SEACEN Countries, Kuala Lumpur, 1990, pp. 11, 13 and 14.

Chapter 3

ISSUES CONFRONTING DEPOSIT INSURANCE

Arguments For and Against

Like any system devised by man, deposit insurance has its advantages and disadvantages. Additionally, the recent bankruptcy, of the FSLIC in the U.S. and the attendant bail-out using tax payers' money has underscored a wide range of issues concerning deposit insurance. The pros and cons of deposit insurance will be discussed, after which the current issues faced by the system will be highlighted.

Most of the arguments in favor of deposit insurance have been dealt with in the preceding section on the rationale for deposit insurance. Additionally, it can be said that the strongest argument for deposit insurance is depositor protection, followed by the mitigation of contagious bank runs. Given these, deposit insurance would help in the efficient functioning of the economy by strengthening the banking system.

Deposit insurance protects depositors through the following. First, by guaranteeing payment of deposits up to a certain amount, depositors are assured of getting their money back in the event of bank closure. Second, by paying the depositors promptly, personal losses stemming from loss of money, even if temporary, are averted. In the absence of deposit insurance, depositors have to wait for the liquidation of bank assets before their claims can be honored, thus depriving them of the use of their funds.

With the guarantee of deposit insurance, contagious bank runs could be avoided. Depositors would not be as prone to panic withdrawals of their deposit from banks as they would without deposit insurance. As mentioned previously, a run on even a small bank, which is made worse by fears of a systemic failure, could result in even the bigger and more stable banks facing difficulties. By itself, this contributes to the minimization of bank failures, as even troubled banks will have the necessary breathing space to recover. With a lower incidence of bank runs comes a lower rate of bank failures, such that confidence is built up, further strengthening the banking sector.

This is a self-perpetuating cycle. With a healthy banking sector, business and industry will have an efficient and reliable source of financing, thus enabling them to contribute to the economy's productivity and stability in general.

It is difficult to quantify the extent to which public confidence in banks is maintained or enhanced by deposit insurance. An approximation may be made by looking into the amounts deposited, the average size of deposits and the number of bank accounts. An upward growth in these measures would indicate growing confidence in banks as they signify that more people place their funds in banks and more funds are placed in existing accounts.

With regard to financial stability, the number of bank failures could be used, but then banks fail not only because of instability in the banking system but also due to economic reasons and frauds. A spate of bank failures does not necessarily mean a systemic malady, especially if the other banks remain stable.

Using data from the Philippines, Tables 7 and 8 show a quickening in the pace of deposit growth in recent years. From 1948-1967, deposits grew at an annual average of 12.1 percent. From 1968-1989, when deposit insurance was in place, the growth was 19.2 percent. There was also a considerable growth in the size of deposits. In 1952, the average size of bank deposits was P 3,505.18. In 1989, it reached P 14,957.12. From 1952-1967, the average size of deposits posted an annual average decrease of 3.5 percent, while the period 1968-1989 registered an annual growth of 10.9 percent (Table 9).

These suggest a boost in public confidence in banks after deposit insurance was established. However, in recent years, the number of deposit accounts in banks has shrunk, starting in 1984, as shown in Table 10 and Chart 3. The number of deposit accounts decreased by 7.1 percent in 1984, by 14.8 percent in 1985, by 3.8 percent in 1986, broken by a slight 0.6 percent increase in 1987, which again reverted to a 0.2 percent decrease in 1988 and 1.9 percent in 1989.

This development somehow dampens optimism about the build up of confidence in banks over the years as it implies a decrease in the number of people depositing in banks. However, this should be analyzed in the context of other developments during the period. It was at this time that high yielding government securities were introduced to mop up excess liquidity in the system. In 1984, total government securities outstanding rose by 43.2 percent, a considerable growth dwarfed only by the tremendous 215.3 percent increase in one of its components, namely, Treasury bills (Table 11). From 1984-1989, Treasury bills outstanding increased by an annual average of 83.4 percent. We could surmise then that some deposit accounts, particularly

Table 7
TOTAL DEPOSIT LIABILITIES OF ALL BANKS IN THE PHILIPPINES
(in Million Pesos)

Year	Amount	Growth	Year	Amount	Growth
1948	865.2	21.0	1969	7759.6	14.7
1949	771.0	(10.9)	1970	8886.0	14.5
1950	891.9	15.7	1971	10693.1	20.3
1951	778.7	(12.7)	1972	12633.7	18.1
1952	863.1	10.8	1973	17451.9	38.1
1953	941.4	9.1	1974	21487.7	23.1
1954	995.5	5.7	1975	27571.0	28.3
1955	1157.1	16.2	1976	34081.7	23.6
1956	1342.8	16.0	1977	42834.1	25.7
1957	1414.9	5.4	1978	54951.5	28.3
1958	1548.7	9.4	1979	70180.4	27.7
1959	1706.0	10.2	1980	90364.4	28.8
1960	1863.6	9.2	1981	100131.7	10.8
1961	2486.8	33.4	1982	116661.5	14.2
1962	3183.9	28.0	1983	140048.8	20.0
1963	3875.9	21.7	1984	152236.6	8.7
1964	3888.8	0.3	1985	167372.3	9.9
1965	4349.8	11.8	1986	165927.2	(0.9)
1966	5163.1	18.7	1987	179386.4	8.1
1967	6351.6	23.0	1988	226808.1	26.4
1968	6763.2	6.4	1989	286652.2	26.4

Source: Statistical Bulletin, Central Bank of the Philippines.

Table 8
AVERAGE GROWTH RATE OF BANK DEPOSITS IN THE PHILIPPINES, 1948-1989

Period	Growth Rate (Percent)
1948 - 1952	4.8
1953 - 1957	10.5
1958 - 1962	18.0
1963 - 1967	15.1
1968 - 1972	14.8
1973 - 1977	27.8
1978 - 1982	22.0
1983 - 1987	9.2
1988 - 1989	26.4
1948 - 1967	12.1
1968 - 1989	19.2

Source: Statistical Bulletin, Central Bank of the Philippines.

Table 9
AVERAGE SIZE OF BANK DEPOSITS IN THE PHILIPPINES, 1953 - 1989

Year	Amount (Pesos)	Growth
1953	3550.76	1.3
1954	2941.90	-17.2
1955	2973.87	1.1
1956	2852.45	4.1
1957	2550.48	-10.6
1958	1772.00	-30.5
1959	1754.66	-1.0
1960	1672.22	-4.7
1961	2005.17	19.9
1962	2073.70	3.4
1963	2209.04	6.5
1964	1725.98	-21.9
1965	1678.70	-2.7
1966	1605.08	-4.4
1967	1666.00	3.8
1968	1521.68	-8.7
1969	1576.91	3.6
1970	1582.82	0.4
1971	1699.56	7.4
1972	1690.22	-0.6
1973	1983.87	17.4
1974	2003.51	1.0
1975	2314.79	15.5
1976	2474.20	6.9
1977	2815.00	13.8
1978	3147.72	11.8
1979	3469.93	10.2
1980	4293.43	23.7
1981	4419.95	3.0
1982	4690.89	6.1
1983	5475.81	16.7
1984	6410.02	17.1
1985	8273.06	29.1
1986	8469.45	2.4
1987	9156.45	8.1
1988	11603.38	26.7
1989	14957.12	28.9

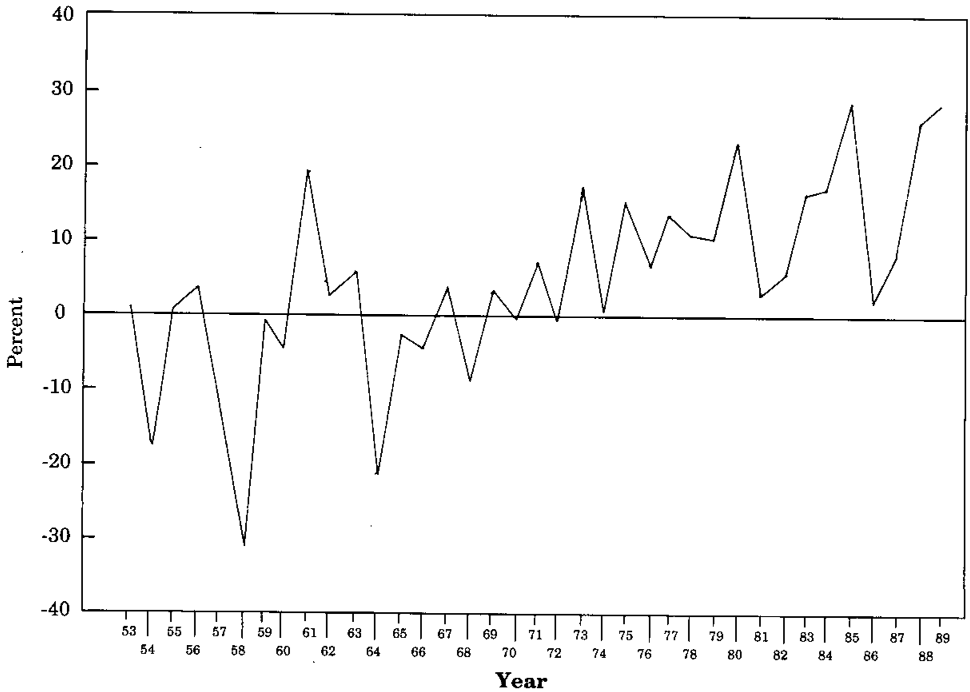
Source: Computed from Statistical Bulletin, Central Bank of the Philippines.

Table 10
NUMBER OF DEPOSIT ACCOUNTS IN BANKS IN THE PHILIPPINES, 1953 - 1989

Year	Number	Growth
1953	265126	19.3
1954	338387	27.6
1955	389089	15.0
1956	470754	21.0
1957	554758	17.8
1958	873982	57.5
1959	972267	11.2
1960	1114446	14.6
1961	1240196	11.3
1962	1535373	23.8
1963	1754562	14.3
1964	2253097	28.4
1965	2591168	15.0
1966	3216723	80.0
1967	3812491	18.5
1968	4444562	16.6
1969	4920763	10.7
1970	5614032	4.9
1971	6291700	12.0
1972	7474600	18.8
1973	8796898	18.0
1974	10725034	21.9
1975	11910784	11.0
1976	13774841	15.6
1977	15216318	10.5
1978	17457566	14.7
1979	20225335	15.8
1980	21047133	4.0
1981	22654497	7.6
1982	24869790	9.8
1983	25575893	2.8
1984	23749779	-7.1
1985	20230995	-14.8
1986	19465502	-3.8
1987	19591252	0.6
1988	19546724	-0.2
1989	19164934	-1.9

Source: Statistical Bulletin, Central Bank of the Philippines.

Chart 3
GROWTH IN SIZE OF DEPOSITS ACCOUNTS
IN THE PHILIPPINES, 1953-1989



Source: Table 9

Table 11
GOVERNMENT SECURITIES OUTSTANDING IN THE PHILIPPINES, 1984 - 1989

Year	Total Govt. Securities (Mil. Pesos)	Growth (Percent)	Treasury Bills (Mil. Pesos)	Growth (Percent)
1984	69590.3	43.2	19377.0	215.3
1985	94889.8	36.4	31162.6	60.8
1986	123711.1	30.4	55419.6	77.8
1987	150299.6	21.5	105908.1	91.1
1988	197296.4	31.3	141436.5	33.5
1989	227199.6	15.2	172542.6	22.0
Average (1984-89)		29.7		83.4

Source: Statistical Bulletin, Central Bank of the Philippines.

time deposits, which showed an annual average decrease of 14.6 percent from 1984-1989 (Table 12), were shifted into the higher yielding Treasury bills.

This shift could be attributed to the considerable interest rate differentials in favor of Treasury bills which prevailed during the period.

Table 13 shows that, in 1984, T-bill rates for all maturities was 36.98 percent compared to 17.38 percent for time deposits with maturities of 181 days to one year or a rate differential of almost 20.0 percent. This contrasts with the immediately preceding years when rate differentials were less than 1.0 percent. In the succeeding years, T-bill rates continued to outpace time deposit rates, although by smaller margins, ranging from 2.90 percent in 1987 to 7.46 percent in 1990.

It has also been the practice of some people to maintain multiple accounts in amounts within the insurance coverage, which was P 15,000.00 prior to its increase to P 40,000.00 in 1985. Therefore, as the insurance coverage increased, there was less motivation for the people to hold multiple bank accounts in small amounts. This is borne out by the increase in the average size of deposits which accompanied the decrease in the number of deposit accounts. The shrinkage in the number of deposit accounts does not necessarily mean that deposit insurance has failed in its objective of fostering depositor confidence, but only that other factors such as interest rates are considered by depositors in choosing where to place their funds. Since government securities are de facto insured by the government, their higher interest rates motivated this shift.

It may also be mentioned that in 1981, a businessman absconded with millions in clean bank loans which caused some bank failures, but a system-wide run was averted. The fact that depositors of the closed banks were paid off may well have had a calming effect on depositors of other banks who therefore refrained from causing a run on said banks.

The arguments against deposit insurance include: increase in bank intermediation cost, uneven insurance burden, undue advantage of bank deposits over other investment outlets, too much regulation, moral hazard and adverse selection.

1. Increase in Bank Intermediation Cost

Insurance premia are paid by member banks. However, this and other expenses form the bank's intermediation cost which it passes on to depositors and borrowers in the form of interest rates and other

Table 12
NUMBER OF TIME DEPOSIT ACCOUNT
IN THE PHILIPPINES, 1984 - 1989

Year	No. of Accounts	Growth
1984	2814379	(31)
1985	1176344	(58)
1986	1057875	(10)
1987	953994	(10)
1988	1296126	36
1989	1110318	(14)
Average (1984-89)		(14.6)

Source: Statistical Bulletin, Central Bank of the Philippines.

Table 13
INTEREST RATES FOR TREASURY BILLS AND TIME DEPOSITS IN THE PHILIPPINES, 1970 - 1990

(in Percent)

Year	(1) Treasury Bill Rates (All maturities)	(2) Time Deposit Rates (181 days-1 year)	(1-2) Difference
1970	13.372	7.000	6.372
1971	12.038	7.000	5.038
1972	12.154	7.000	5.154
1973	9.664	7.000	2.664
1974	10.260	7.000	3.260
1975	10.475	7.000	3.475
1976	10.406	10.000	0.460
1977	11.161	10.000	1.161
1978	10.950	10.000	0.950
1979	12.178	12.000	0.178
1980	12.316	14.000	1.684
1981	12.914	13.001	0.087
1982	14.415	13.919	0.496
1983	14.544	14.162	0.382
1984	36.985	17.380	19.605
1985	27.048	19.818	7.23
1986	16.040	11.490	4.550
1987	12.887	9.990	2.897
1988	15.510	11.955	3.555
1989	9.678	14.475	5.203
1990	24.742	17.283	7.459

Source: Central Bank of the Philippines, Center for Statistical Information.

bank charges. Without this added burden on banks, interest rates paid on deposits would be higher, while lending rates and other charges on loans will be lower.

2. Uneven Insurance Burden

The assessment base for large banks contains a big proportion of uninsured deposits, meaning those with balances above the limited coverage, while the assessment base for smaller banks usually contains only a small proportion of uninsured deposits. Therefore, the premiums paid by larger banks are for deposits that are not covered by insurance which result in these banks assuming most of the cost burden.

While it is true that larger banks bear the bulk of the insurance burden, they also derive considerable gains in a climate of confidence inspired by deposit insurance. Continued operation of the smaller and weaker banks which pay less premium and are nevertheless afforded security is beneficial to the larger banks as the risk of contagious bank runs is minimized. Furthermore, as a general practice, governments are unlikely to allow large banks to fail. Thus, these banks "get their money's worth" so to speak.

Additionally, the practice of returning part of assessment income (in the case of the U.S. and the Philippines) on a pro-rata basis also benefits the banks which previously paid larger premiums.

3. Undue Advantage of Banks Over Other Investment Outlets

Since bank deposits are covered by insurance, people are more likely to choose to deposit in banks rather than in alternative investment opportunities. This seeming lopsidedness is due to the fact that deposit insurance is for the benefit of small depositors who in the first place may not directly participate in investment ventures involving large amounts of money. The decision on where to place one's money rests not only on insurance coverage, but also on the amount of money one has in the first place and the ease or difficulty of access thereto, after it has been deposited or invested. Thus with or without deposit insurance, most people with modest incomes will still choose bank deposits over other investment opportunities.

4. Too Much Regulation

It is felt that setting up of a deposit insurance system, which entails the examination by the insuring entity of banks over and above the existing supervisory and regulatory controls by the monetary authorities, may run counter to the currents of financial deregulation sweeping the globe. Some economists (Flannery, 1982) even raise the point of whether deposit insurance creates a need for more bank regulation, because of the issue of moral hazard which will be discussed in the following section.

5. Moral Hazard

Moral hazard pertains to the incentive for banks to undertake excessive risk taking because: (a) the bank stands to gain higher profits on riskier ventures if successful, while in the event of failure, the losses are shared with the insuring institutions which pay off the insured deposits; and, (b) depositors no longer monitor the risk profiles of their banks and so do not impose any depositor or market discipline on these institutions because their deposits are insured.

In the absence of deposit insurance, depositors are liable to withdraw their funds upon learning that a bank's management has undertaken a risky and imprudent investment strategy, thereby imposing market discipline. With deposit insurance, however depositors are assured of getting back their losses even if their bank collapses. Hence, the element of market discipline disappears and bank managers are allowed some leeway to embark on risky ventures. When a bank is insolvent and is allowed to operate, managers undertake risky investments with high returns in the hopes of recouping past losses. Under these circumstances, even a small probability of a large gain can yield large residual profits which may restore solvency. On the other hand, any losses stemming from such a strategy are shared with the insuring institutions which pay off depositors in the event of closure.

Kuprianov and Mengle (1989) state that with deposit insurance, "the incentive for excessive risk taking exists because bank shareholders do not bear the full costs of the risks assumed by the bank. If the bank fails, shareholders bear only part of the cost. The rest is borne by the deposit insurance funds. But if the outcome is favorable, shareholders collect all the profits. Because a substantial portion of the risk can be shifted to the deposit insurance funds in such a manner, bank managers have incentives to engage in excessively risk behavior. And this incentive is most pronounced among institutions that are either approaching insolvency or are already insolvent. Under the current system, such institutions have little to lose and everything to gain from taking on large risks in a desperate attempt to restore financial solvency before they are taken over by regulators".[48]

The issue of moral hazard was evident in the SLA crisis in the U.S. where insolvent thrifts continued deposit-taking activities backed by deposit insurance and, in a bid to recoup losses from previously failed investments, took on even riskier activities with hopes of higher returns. This was compounded with depositor apathy because of the high deposit insurance coverage. In fact, the so-called brokered deposits, which were in fact pooled small deposits which aggregated US$ 100,000, were moved around the country in search of high returns offered by insured banks regardless of whether they were in good financial condition or not.

The problem of moral hazard was exacerbated by virtually full coverage in the U.S. (which covers up to US$ 100,000) and the perception that some banks are "too big to fail". Hence, depositor discipline is lacking as there would be virtually no uninsured depositor to impose such discipline.

It may be mentioned, however, that in Germany where there is also a virtually limitless insurance coverage administered by private banking organizations, officials interviewed felt that the problem of moral hazard, though theoretically part and parcel of deposit insurance, did not manifest itself in any considerable manner in their country.

6. Adverse Selection

Adverse selection takes place when insurance is voluntary and hence, encourages only the worst risks to participate. Stable banks which stand to gain the least, opt out, thereby the average riskiness of insured banks rises. This problem would therefore arise in insurance systems with voluntary membership. In the U.S., this has been tempered by the fact that the big banks and other nationally chartered institutions are required by their licensing authorities to participate in the deposit insurance scheme. In Germany, where the private banks' deposit insurance system is also voluntary, respondents felt that there was no adverse selection because the strongest banks are members of the association and membership prequalification requires stable financial condition. These same requirements need to be fulfilled in order for a bank to remain as a member in good standing.

48. Antoli Kuprianov and David L. Mengle, "The Future of Deposit Insurance: An Analysis of the Alternatives", The Federal Reserve Bank of Richmond *Economic Review*, May/June 1989, p. 5.

Issues Confronting Deposit Insurance

The recent S&L crisis in the U.S. has brought to the fore certain issues confronting deposit insurance. These will be discussed in the following sections:

1. Determining the Level of Insurance

Most existing deposit insurance schemes set ceilings for insurance coverage. However, even this limited coverage could at times be in effect, unlimited. For instance, in the U.S. which has a US$ 100,000 ceiling, the average savings deposit balance is far less than the amount. There have even been cases when deposit balances over and above US$ 100,000 are effectively insured because of the "too big to fail" policy.

In Germany, the coverage is also virtually limitless, because it is based on 30 percent of the insured banks capital. In the Philippines, there is a P 40,000 limit on coverage, accounts with balances not exceeding P 40,000 made up 96.69 percent of the total number of bank accounts as of 31 December 1987.

Complete insurance coverage could give bank deposits an even greater competitive advantage over other investment channels. Additionally, it would weaken bank management incentives to pursue policies conducive to the protection of depositors.

There is therefore a need to limit deposit insurance coverage, given that the main objective of deposit insurance is the protection of small depositors. Various things are considered in determining coverage. First is the number of accounts covered as a percentage of the total, prevailing consumer price index, level of total deposit liabilities of the banking system, and bank closure experiences.

2. Pricing of Insurance

Most deposit insurance systems price insurance on a flat rate basis. Some other schemes do not operate on a fixed rate. For instance, the French system is priced on an ex-post basis which is anchored on a regressive ratio to deposits.

A major criticism against the flat rate system is that it does not price insurance equitably. The price is the same for a stable bank with very little possibility of ever calling on the insurance fund for pay-off as well as for a troubled bank which is on the brink of making a call on the system. Hence, the riskiness of the banks are not factored into the price as is the case in other forms of insurance, for instance, life insurance.

There are three major aspects of deposit insurance pricing. First is determination of a price sufficient to keep the level of the insurance fund at an adequate level. This is because an under-funded insurer will not be able to discharge its functions effectively. As seen in the U.S. S&L crisis, the FSLIC which itself was insolvent, was unable to close insolvent thrifts in time to prevent further damages.

Second is the basis of the premium, whether based on the riskiness of the insured institution or on an across the board level. Risk-based premiums would enhance equity and efficiency by placing costs on banks engaging in activities perceived to increase risk exposure. Flat rate premiums are perceived to motivate risk-taking.

Third is the base for assessing premiums. This could be based solely on the insured deposit level or on the aggregate deposit liabilities of a bank.

Role of Deposit Insurance in Additional Savings Mobilization

By making banking safer for depositors, deposit insurance encourages depositors to save in banks. This increases savings mobilization. With deposit insurance safeguarding insured deposits, people will be more likely to save in banks and thus assist banks in financial intermediation.

Relationship of Deposit Insurance to Bank Supervision

Some authors contend that deposit insurance creates a need for regulation (Flannery, 1982). This is indeed true as the moral hazard engendered by deposit insurance would require more vigilance from the regulators. As banks' management has an incentive to undertake riskier ventures given the deposit insurance safety net, bank regulators should be more assiduous in the discharge of their supervisory functions. This seems to be a counterpoint to the earlier argument cited that deposit insurance enables monetary authorities to adopt a more liberal stance towards bank regulation and licensing of institutions. However, there is no real conflict between the two statements if we take them to mean that while deposit insurance, by providing a safety net would allow a more liberal stance towards bank regulation, the regulations in place have to be assiduously enforced and proper supervision of the banks operating under more relaxed rules should continue to be undertaken.

It is also mentioned in some quarters that if bank regulators are doing their jobs satisfactorily, there would be no need for deposit insurance as there would then be no bank failures. However, some bank failures are caused by frauds which even the most diligent of bank examiners would be hard-pressed to get wind of in a timely manner. Therefore, even if there is an efficient supervisory authority, there is still a place for deposit insurance in the protection of bank depositors in the event of closure.

Relationship Between Deposit Insurance and Monetary Management

With deposit insurance in place, even marginally performing banks would more or less have more room for maneuver and would not be as vulnerable to bank runs. It is said that deposit insurance allows monetary authorities to impose regulations as needed, without constantly fearing about how the weaker institutions will fare and how this will affect their depositors.

Chapter 4

REFORMING DEPOSIT INSURANCE: THE CASE OF THE U.S.

One of the major financial crises in U.S. in the 1980s involved deposit insurance, in the form of the collapse of the FSLIC following the crisis in the savings and loans industry, which saw numerous S&L bankruptcies. This is a case of a bankrupt insurer and its insolvent insured institutions, whose combined losses are estimated at over US$ 100 billion and necessitated a bail-out involving tax-payers' money. Several views on the root of the crisis have been advanced, ranging from deregulation without an accompanying reform of the deposit insurance system (Kareken, 1990) to the other extreme, that of overly stringent limitations on the investment powers of S&Ls coupled with the presence of deposit insurance (Dotsey and Kuprianov, 1990). The following sections will briefly discuss the antecedents to the debacle as well as proposed reforms, together with the feasibility of implementing such reforms.

Dotsey and Kuprianov (1990) advance that as early as the 1950s, the stage has been set for the current S&L crisis owing to several factors. Foremost is the grant to the FSLIC of authority to borrow from the U.S. Treasury to offset legislated reductions in deposit premia and increases in insurance coverage. It may be mentioned that upon inception in 1934, the FSLIC was tasked with establishing a reserve fund equal to 5 percent of all insured accounts and creditor obligations within 20 years. It was given the power to assess an annual premium of 0.25 percent as needed. At that time, deposit insurance was up to US$ 5,000 per depositor.

A year later, in 1935, however, the premium was halved to 1/8 of 1 percent of deposits. The emergency assessment was likewise cut to 1/8 of 1 percent. Presently, premiums are at 0.6 per mill. of total deposits. This scaling back was based on the belief that improved regulation and supervision would keep future losses in check and thus below historical averages. Even as the assessment levels were lowered, insurance coverage increased through the years, to: US$ 15,000 in 1966; US$ 20,000 in 1969; US$ 40,000 in 1974; and, US$ 100,000 in 1980. With these developments and the escalation in deposits, insurance liabilities outstripped by far the accumulation in

FSLIC permanent fund. The 5 percent reserve fund target was never fully satisfied. According to Barth, et.al. (1989), the FSLIC's primary reserve fund never exceeded 2 percent of insured deposits.[49] Hence, based on historical data, the FSLIC has not had the necessary reserves to deal with widespread bank failures (Dotsey and Kuprianov, 1990).

In the mid-1960s, rising inflation and interest rates led to funding problems for the S&Ls. They were prohibited from diversifying their portfolios and thus concentrated only in long-term fixed rate mortgages. Consequently, the industry's profitability declined as deposit rates increased above the rates of return S&Ls derived from their portfolio of home mortgage loans. Congress attempts to assist the industry through legislated deposit rate ceilings, which authorized thrifts to pay 0.25 percent higher than banks, did not markedly ease the problem either, and instead the interest rate ceilings led to disintermediation.[50]

Nevertheless, thrifts as a whole, from 1965-1979, registered asset increases at an annual rate of 10.6 percent. They were consistently profitable, with return on assets averaging 0.61 percent. In particular, the late 1970s were profitable years, with ROA averaging 0.70 percent. Even during those years however, the industry went through periods of disintermediation when rising interest rates caused deposit outflows, cost increases and sluggish growth in quality earning assets. From 1965-1979, deposits and capital growth lagged behind assets, leading to the industry's increased dependence on borrowed funds.[51]

From 1980-1982, thrifts sustained losses due to the increase in deposit rates which they could not recoup in the short run through increased lending rates because most of their assets were in fixed rate mortgages. These losses were accompanied by a deterioration in the industry's capital position and shrinkage of deposit base. Although profitability somewhat improved from 1983-1985, due to lower interest rates, the industry's capital position remained inadequate.[52]

The industry suffered the aforesaid losses despite deregulation of the industry in 1980 with the passage of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) which provided

49. Ibid., pp. 10-11.

50. Ibid., p. 11.

51. J.A. Cacey, "Thrifts in the Troubled 1980s: In the Nation and the District", Federal Reserve Bank of Kansas City *Economic Review*, December 1989, FRB Kansas, p. 5.

52. Ibid., p. 7 (for a discussion on capital measurement).

for a phase-out of interest rate regulations and permitted thrifts to diversify their asset portfolios to include consumer loans other than mortgage loans, loans based on commercial real estate, commercial paper and corporate debt securities. Dotsey and Kuprianov (1990) assert that the deregulation came too late to help thrifts cope with the steep rise in interest rates.

Massive losses overwhelmed the FSLIC's resources. There were even hundreds of cases when insolvent thrifts were not closed because the FSLIC lacked the resources to deal with them. Continued deterioration in a number of thrifts compelled the FSLIC to act. In 1980, 32 thrift insolvencies were resolved, 82 in 1981 and 247 the following year. A total of 493 thrifts voluntarily merged with other institutions during the same period. Nevertheless, Kane (1989) estimates that 237 insured thrifts were insolvent under Generally Approved Accounting Principles at end-1982.[53]

This crisis was exacerbated by policies of regulatory forbearance, which allowed insolvent institutions to remain open with the hope that they will eventually stage a turnaround. These included lenient net worth requirements and permissive regulatory accounting principles followed by the Federal Home Loan Bank Board (FHLBB), the agency which chartered S&Ls up to its dissolution in 1989 and under whose auspices the FSLIC operated. This policy of regulatory forbearance allowed the merger of troubled thrifts with those whose finances were only slightly better, making the FSLIC the residual risk bearer for inadequately capitalized institutions. It also had the effect of consolidating losses into larger organizations which continued to operate despite under-capitalization.[54]

Even as these troubled thrifts were allowed to operate, the FHLBB lacked the resources to satisfactorily monitor their operations. Thus, armed with the safety net of deposit insurance, these troubled thrifts continued to attract deposits and operate without sufficient capital.

The Garn-St. Germain Act of 1982 was aimed at solving the industry's problems through a program of regulatory forbearance and further deregulation. It introduced the net worth certificate program which was aimed at minimizing forced mergers or other regulatory actions against thrifts. Investment powers of thrifts were also liberalized.

Unfortunately, even as interest rates started declining by 1982, the thrift industry did not fully recover its losses. Since the FHLBB

53. Op. Cit., p. 12.
54. Ibid., p. 9.

lacked the necessary resources for examination and closure of troubled S&Ls, the situation deteriorated. Given regulatory forbearance and more investment powers, these thrifts embarked in a number of risky and imprudent schemes in an effort to recoup past losses.

Therefore, after 1982, S&L losses were largely attributable to credit quality problems in contrast to earlier losses which stemmed from rising interest rates and fixed returns on long-term home mortgage portfolio.

The Management Consignment Program (MCP) of 1985 was an attempt to gain control over problem thrifts. It involved placing troubled institutions under the management of a conservator selected by the FHLBB, until they could be sold or liquidated by the FSLIC. Two years later, however, many institutions placed under MCP were still losing.

As the crisis dragged on, it became apparent that the FSLIC lacked the resources to deal with the massive losses accumulated by the S&L industry. The FHLBB chairman acknowledged in late 1985 that the FSLIC needed more funds and proposed a one-time assessment of 1 percent on all FSLIC insured thrifts, which was opposed by the industry. Instead, a special deposit insurance assessment of 1/8 of 1 percent was levied. Although it raised US$ 1.0 billion, the amount was insufficient.

U.S. Treasury officials with the FHLBB commenced meeting in 1985 to draw up a recapitalization plan for the FSLIC. They proposed a transfer of resources from FHLBB and continued levy of special deposit insurance assessment. This met with objections from the S&L industry. Debate on the merits of the proposal continued up to 1987 when the GAO announced that the FSLIC had become insolvent with a deficit estimated at over US$ 3.0 billion by end-1986.[55]

The Competitive Equality Banking Act (CEBA) of 1987 provided for the issuance of US$ 10.8 billion in bonds to recapitalize the FSLIC. This was not sufficient to recapitalize the fund as project costs of dealing with insolvent thrifts continued to mount.

In 1989, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) was enacted. It aims to re-regulate the S&L industry by limiting thrifts' investment powers and requiring them to specialize in mortgage lending. It also required thrifts to meet capital requirements as stringent as those imposed on commercial banks, thus ending the previous capital forbearance policies. This involved enhanced supervision and regulatory controls along with stricter penalties for fraudulent and criminal activities.

55. Ibid., p. 16.

The FIRREA also reorganized the federal savings and loan regulatory agencies. It abolished the FSLIC and created a new deposit insurance fund, the Savings Association Insurance Fund (SAIF) under the FDIC. It also established the Resolution Trust Corporation (RTC) to take over the FSLIC's caseload of insolvent thrifts. The FHLBB was also dissolved and replaced with a new federal chartering agency, the Office of Thrift Supervision (OTS), under the direction of the Secretary of the Treasury. Government regulators inherited a backlog of almost 600 insolvent S&Ls.[56]

This restructuring was aimed at eliminating the conflict of interest perceived to be inherent in the old system where the chartering agency also administered deposit insurance. Under such a set-up, the chartering agency had both the incentive and means to delay resolution of problem thrifts. This was evident in the crisis under discussion.

The FIRREA allocated funds to pay off the obligations incurred by the FSLIC before its abolition. The RTC will also receive US$ 50 billion additional funding to meet the costs of resolving cash involving insolvent thrifts.

The total cost of the bail-out is projected at US$ 166 billion, spread out till 1999. It includes US$ 40 billion for 1988 rescues, the aforementioned US$ 50 billion to close currently insolvent institutions, US$ 33 billion for future costs and US$ 43 billion of interest costs.[57]

Higher insurance premia will be paid by thrifts as well as by commercial banks to fund the costs of the bail-out. Thrifts will have to pay 23 cents per US$ 100 from 20.8 cents, while banks will pay 15 cents per US$ 100 of deposits from 8 cents. Despite these, U.S. taxpayers are expected to pay around 75 percent of the program's total costs.[58]

Other Suggestions for Reforms

In addition to the reforms introduced under the FIRREA, some economists also point to the need for further reform, such as using risk-based insurance premium, optional deposit insurance, replacing government insurance with privately administered deposit insurance or providing deposit insurance only to narrow banks.

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56. Ibid., p. 19.
57. Dwight M. Jaffee, "Symposium on Federal Deposit Insurance for S&L Institutions", *Journal of Economic Perspectives*, vol. 3, no. 4, Fall 1989, p. 6.
58. Ibid., p. 6.

1. *Risk-Based Insurance Premium*

Deposit insurance brings with it the risk of moral hazard, or excessive risk-taking by insured institutions, as previously discussed. This excessive risk-taking of insured and insolvent S&Ls was largely responsible for massive losses sustained by the industry from 1982 onwards. Together with regulatory forbearance, this risk-taking attitude was fostered by the flat rate premium imposed on insured institutions regardless of their financial stability and risk-taking profile. Hence, there is no linkage between an institution's riskiness and the price it had to pay for deposit insurance. Thus, a stable and conservative institution had to pay at the same rate as an insolvent and risky institution, furthering the incentives for moral hazard.

Some quarters now feel that pricing deposit insurance in relation to a bank's riskiness would somewhat obviate excessive risk-taking and thereby enhance the safety of deposits. Merton (1977) and Sharpe (1981) show that under a fixed rate deposit insurance premium scheme, shareholders are prone to take additional risks as they stand to reap all the profits from such risks but share part of the losses with the insuring agency should such be sustained.

In contrast, in the absence of deposit insurance, the more risky banks would have to pay higher interest rates on deposits to attract depositors, thus serving as a market discipline. With deposit insurance in place, this discipline is gone. Pricing deposit insurance based on risks would somewhat provide a basis for linking the bank's risk profile with its cost of funds and thereby serve to deter excessive risk-taking.

The central question here would be that of properly pricing deposit insurance and setting appropriate risk measures. Merton (1977) posits that the price of deposit insurance is related to the banks deposit to assets ratio, and to the volatility and term maturity of assets. Goodman and Santomero (1986) discuss a variable rate deposit insurance under which asset composition is considered in pricing insurance. It would impose a higher rate on loans than on securities. Ronn and Verma (1986) propose arriving at empirical estimates of premia from market data by using isomorphic relationships between equity and a call option, and insurance and a put option. They used the market value of equity to solve for the asset value and its volatility.

While the merits of risk-based premia vis-a-vis discouraging excessive risk-taking are evident, there are some misgivings about its implementation. Kareken (1983) points out that there are different kinds of risks faced by a bank, such as riskiness of loan portfolio, various asset and liability maturities, as well as kinds of non-banking activities the banks engage in. Hence, some pitfalls in risk measurement may exist. And because a bank's risk profile changes over time, then there are considerable costs involved in monitoring banks to ensure that their risk assessments are up-to-date. This would necessitate an increase in the number of bank supervision activities and examinations currently taking place.

Kuprianov and Mengle (1989) opined that "unfortunately, efforts to develop variable prices have not been encouraging. The practical effect of pricing schemes advanced thus far would be to penalize losses after they have been incurred rather than to discourage beforehand the behavior that leads to the losses. In other words, pricing proposals have been based on after the fact observations when their stated purpose should be to modify behavior before the fact".[59]

Risk measurement problems dominate the downside of a risk-based insurance scheme. The following are some difficulties associated with risk-adjusted premia:

(1) The magnitude of risks in a bank's operations includes numerous considerations such as quality of loan portfolio, bank management, prevailing economic conditions and the like. It would therefore be difficult to quantify in terms of determining an accurate premium rate. Assessors' judgments can sometimes be open to question.

(2) Risks may vary from bank to bank and from time to time. Hence, uniformity of treatment of risks among similarly situated banks can become subject of "negotiated assessments" to enable banks to cut down on insurance costs.

(3) Variance in bank risks would be difficult to monitor and likely to result in a hodge-podge of rates if assessors were to assess "real" risks in operations of banks.

(4) Different premiums based on risks if made public will send signals to depositors about the riskiness of banks and thus may precipitate runs of banks perceived to be risky. This runs counter to the objective of deposit insurance which is to safeguard the system from destructive runs.

(5) This may be prejudicial to small banks which may be considered more risky and thus would be paying a higher premium. This would in turn reduce its available funds which it could otherwise have used in income-generating activities. Consequently, the risk-based insurance would prove to be a burden.

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59. Anatoli Kuprianov and David Mengle, "The Future of Deposit Insurance: An Analysis of the Alternatives", Federal Reserve Bank of Richmond *Economic Review*, May/June 1989, p. 12.

Finally, Goodman and Santomero (1986) in a paper reexamining variable rate insurance and relating the financial to the real sector, conclude that a variable rate system raises the cost of funds made available to the real sector by financial firms. This, in turn, reduces the overall availability of funds, and imposes an increased probability of bankruptcy on firms that obtain such loans. When such bankruptcies occur, society experiences a dead-weight loss, as assets of the ill-fated firm must be transferred to their next-best use.

Appropriate financial institution insurance pricing must be conducted to weigh the social costs connected with both financial firm failure and real sector bankruptcy. Limiting the analysis to the financial sector and actuarially fair insurance pricing misses an important part of the effect of insurance: the risk absorption feature by which real sector losses are mitigated. Considering these, one concludes that an optimal insurance scheme must incorporate social considerations into any proposal. Interestingly, the result may be that the current system emerges as a reasonable second-best solution.[60]

Optional Deposit Insurance Over and Above A Strictly Followed Limit

It is generally accepted that while there is a US$ 100,000 limit in insurance coverage in the U.S., there is in fact de facto 100 percent coverage. Recent experiences with big bank problems such as Continental Illinois in 1984, wherein federal regulators rescued holding company creditors along with the bank itself, point to de facto 100 percent coverage. This destroys market discipline and abets excessive risk-taking. One remedy for this would be to protect depositors only up to a certain limit and to adhere to that limit strictly. Should depositors feel the need for insuring their deposits which are over and above the insured amount, then optional insurance could be made available to them upon payment of a corresponding premium. Under such a set-up, the small depositors who are the targets of deposit insurance would continue to be protected against bank failures. The more sophisticated, big depositors can also at their own option increase the amount protected through optional insurance. This will enable depositor or market discipline to still work as the big depositors will see it in their best interests to monitor their banks.

60. Laurie S. Goodman and Anthony M. Santomero, "Variable Rate Deposit Insurance: A Re-examination", *Journal of Banking & Finance,* 10 (1986), p. 217.

However, optional insurance could be counter-productive as depositors would likely choose to deposit in banks which offer optional insurance at minimal additional costs. Since these banks are most likely the big ones, the smaller banks which cannot offer the same option will be handicapped. This competitive edge of the big banks arising from optional insurance would run counter to one of the rationale for deposit insurance, which is to foster competitive efficiency among banks.

Replacing Government Insurance with Privately Administered Deposit Insurance

This proposal stems from the perception that there is a conflict of interest if the chartering agency which has the power to open and close banks is also the insurer. It also arose from the fact that because of government involvement in the S&L crisis, U.S. tax-payers will have to shoulder the major portion of the bail-out expenses. One argument against this proposal is that it is doubtful if any private insurer would have sufficient resources to underwrite an account as vast as depositor insurance. It may be mentioned however, that in Germany, the three insurance funds are privately administered, though not by private insurance companies but by the various banking associations. France is also similarly situated.

A variation of this proposal is one advanced by Benston (1983) which called for the setting up of several public insuring agencies (Office of the Comptroller of the Currency, Federal Reserve's Division of Supervision and Regulation, FDIC, etc.) which depository institutions could choose from, aside from private entities. While this may remedy the ills which Benston associates with the present monopoly position of deposit insurers including lack of competition, lack of incentive to adopt more efficient procedures, etc., it may be administratively difficult to implement.

Providing Deposit Insurance Only to Narrow Banks

This is also called the safe banking proposal. In essence, it separates banks' deposit-taking and payment operations from risky lending activities. Under this system, banks could only invest in safe liquid assets, such as short-term Treasury debt, non-interest bearing reserves and highly rated securities. Commercial lending would be carried out by separate entities funded by commercial paper.

It would appear that this proposal solves the question of moral hazard and depositor instability. Due to restrictions on investments by narrow banks, moral hazard would be eliminated. This being the case, depositors are protected and hence would not be motivated to run on a bank. However, there are some arguments against this proposal. First, depositors would be required to sacrifice the economic gains made possible by the existence of banks which effectively intermediate by combining the functions of offering both payment services and lending facilities.[61]

Then, since intermediation services would still be demanded, market forces will work such that other institutions would offer such services, thereby operating like the old wide banks. Consequently, these new institutions would be vulnerable to depositor instability if they are uninsured and to moral hazard if they are insured. The net effect would be just to shift the problems of depositor instability and moral hazard to another segment of the financial sector.[62]

Regulatory Reforms

The S&L crisis pointed to the weaknesses in the regulatory and supervisory structure responsible for overseeing the industry. In hindsight, a number of proposals for regulatory reforms have been forwarded. They are summarized by Kuprianov and Mengle (1989) as follows:

(1) "Regulators should have the means to deal promptly and firmly with insolvencies before they threaten the soundness of the deposit insurance funds.
(2) No institution should be considered too big to fail.
(3) No depositors or creditors except those insured under the law should be treated as insured.
(4) The flow of information to the market should be as accurate as possible.
(5) Explicit and credible policies should be in place for handling future failures."[63]

The first proposal is seen as an answer to the difficulty posed by the fact that even when a large number of thrifts were failing, the FSLIC lacked the resources to resolve such failures and the federal chartering agency (FHLBB), instead of promptly closing the ailing banks, simply adopted a policy of regulatory forbearance. This

61. Op. Cit, p. 15.
62. Federal Reserve Bank of Minneapolis, *A Case for Reforming Deposit Insurance,* FRB Minneapolis, U.S.A., 1988, p. 9.
63. Op. Cit., p. 15.

exacerbated the crisis. Proposals now call for placing of an institution under receivership or conservatorship as soon as its capital were to fall below 1.5 percent of total assets.[64]

This capital level would be sufficient grounds for closure without requiring that proof be shown for unsafe and unsound practices. The FDIC also suggested that it be authorized to terminate insurance coverage on six months notice if the institution is apparently operating in a manner that threatens the deposit insurance fund.[65] The Comptroller of the Currency also suggested that a national bank be declared insolvent when its equity capital drops down to zero.[66]

Regarding proposals (3) to (5), when institutions are considered too big to fail, it has been noted that the de facto 100 percent coverage given even to uninsured depositors and creditors of Continental Illinois worsened the problem of moral hazard. When banks and depositors anticipate a bail-out, risk-taking is enhanced and depositor discipline is wiped out. If depositors are made to shoulder part of the losses, depositor discipline will come into play to reduce moral hazard.

The fifth proposal is related to the first. In the S&L crisis, discretionary powers plus the lack of explicit directives on the handling of troubled thrifts allowed insolvent entities to continue operating and incurring ever increasing losses. With straightforward procedures in place, prompt resolution of problem cases is envisioned.

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64. Proposal by the FHLBB at end-1988.

65. FDIC, *Deposit Insurance for the Nineties: Meeting the Challenge,* Draft Executive Summary, January 1989, p. 18.

66. "Comptrollers Plan to Change Equity Capital Calculations", *American Banker,* 3 March 1989, p. 10.

Chapter 5

CONCLUDING OBSERVATIONS

The collapse of the FSLIC amid the S&L crisis in the U.S. may have dampened the enthusiasm of countries contemplating the establishment of deposit insurance. Although deposit insurance is widely credited as providing banking stability by protecting deposits and minimizing bank runs, it is also seen as fostering moral hazard and excessive risk-taking. The banking stability enjoyed by the U.S. in the half decade immediately following the establishment of deposit insurance is due in most part to the curtailment of depositor runs on banks. On the other hand, the excessive risk-taking rampant in the S&L industry and seeming depositor apathy regarding the risk profile of banks are also attributed by some quarters to the presence of deposit insurance.

While deposit insurance indeed brings with it the reality of moral hazard and lack of depositor discipline, the system in itself cannot be wholly blamed for the S&L industry debacle. Other exogenous factors such as the narrow scope of thrift activities and the advent of floating and high interest rates also contributed to the difficulties of thrift banks. Even when the industry was deregulated to allow them more investment activities, it is believed that the deregulation came too late to remedy the difficulties created by a mismatch in maturity and interest rates paid on assets and liabilities of thrifts. The continued deregulation, which saw thrifts engaging in activities they did not have expertise on, made their conditions worse. The policy of regulatory forbearance exacerbated tendencies toward moral hazard as bank management saw fit to engage in increasingly risky activities in hopes of recouping previous losses. De facto 100 percent insurance coverage also worsened the lack of depositor or market discipline. Depositors aware of the deposit insurance safety net continued to place their funds in risky banks which paid handsome interest rates.

Thus, in sum, deposit insurance coupled with interest rate fluctuations, deregulation, regulatory forbearance or outright fraud as well as plain economic downturn in some states, led to the downfall of the S&L industry. It may also be mentioned that the FSLIC was itself under-capitalized in the first place, and later declared insolvent, hence it did not have the resources nor the will to expeditiously resolve cases of failing thrifts. Still with regard to regulatory bodies, it has been mentioned that there is an apparent conflict of interest when the insurer is also the chartering agency.

It must be remembered that chastening as the U.S. case has been, it should not necessarily mean that deposit insurance does not work. The U.S. case is simply one example of how deposit insurance is administered. There are other means of practising deposit insurance, which do not have all the shortcomings of the U.S. system, but on the other hand, many have their own unique weaknesses.

For example, in Germany, the insurance funds are privately administered by the various banking associations. Their funds have always been fully paid up and any costs relative to pay-outs are promptly replenished. Thus, the insolvency of the insurer which was the case in FSLIC is quite remote. Perhaps one feature of the German system which also sets it apart from the U.S. system is the close monitoring made by the Banking Associations of their members. Although bankers feel that government supervisors are doing their jobs satisfactorily, audits under the auspices of the associations are conducted and aimed at identifying weaknesses even before they are spotted by government examiners. Thus, regulatory forbearance is not a problem.

Hence, it can be said that for deposit insurance to work effectively, all other supervisory controls must also be in good working conditions. In fact, the role of proper bank supervision in fostering a stable financial system could never be overstated. The presence of a deposit insurance system should never lull supervisory bodies into complacency at their jobs of monitoring the banks activities. Changing scenarios in the financial community such as deregulation also impinge on deposit insurance, and its successful implementation should take account of the changes wrought by deregulation and necessary adjustments have likewise to be made.

In sum, deposit insurance is not the only method of insuring the safety of deposits, but it is one method which a number of countries so far find effective. Based on experiences of countries with deposit insurance systems, an effective system should be well funded. A bankrupt insurer will only worsen the difficulties being faced by banks. An efficient system of bank supervision must also be in place to monitor member banks and to ensure that they are operating satisfactorily.

The other alternative is an implicit deposit insurance system, similar to that currently being practised in some SEACEN countries where the monetary authorities, although under no legal obligation to protect deposits, do so in effect under their lender-of-last-resort facility.

Whether a country adopts deposit insurance or not depends on the circumstances faced by its banking system and its economy. For instance, in a country where the banking system is small and is dominated by government banks, the establishment of a formal deposit insurance system may not be very imperative.

There should be a careful weighing of the trade-offs between depositor protection, avoidance of runs and financial stability on the one hand, and the costs of deposit insurance including the threat of moral hazard on the other. In the SEACEN countries, these trade-offs should be weighed taking into consideration the degree of maturity and stability of their respective financial systems.

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