SPECIAL CONSIDERATIONS WHEN TRANSITIONING FROM BLANKET GUARANTEES TO AN EFFECTIVE, LIMITED-COVERAGE DEPOSIT INSURANCE SYSTEM

Abstract

This paper addresses the experiences of countries that have sought to transition from a blanket guarantee to a limited-coverage deposit insurance system. The aim of the paper is to produce general guidelines on transition issues on the basis of the experiences of countries. The paper assumes that any country undergoing or considering a transition to an effective, limited-coverage deposit insurance system will establish clear public-policy objectives for the system and will conduct the appropriate situational analysis. The paper describes the main transition issues considered by the countries surveyed, emphasising their respective trade-offs.

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This paper addresses the experiences of countries that have sought to transition from a blanket guarantee to a limited-coverage deposit insurance system.[1] The aim of the paper is to produce general guidelines on transition issues on the basis of the experiences of countries.[2] The paper assumes that any country undergoing or considering a transition to an effective limited-coverage deposit insurance system will establish clear public-policy objectives for the system and will conduct the appropriate situational analysis.[3] The paper describes the main transition issues considered by the countries surveyed, emphasising their respective trade-offs.

Background

As a result of the frequency and magnitude of banking crises over the last two decades, attention has been focused on the role government should play in ensuring financial-system stability and in providing a safe savings mechanism for small depositors. For countries whose financial systems were in crisis, the adoption of a blanket guarantee of deposits and other liabilities prevented the financial and payments systems from collapsing. Complete coverage of deposit liabilities during a crisis can foster the confidence necessary for depositors to avoid runs and help restore and maintain the stability of the financial system. However, an unlimited guarantee can increase moral hazard and foster inadequate risk-management practices among depository institutions. As financial stability returns, policymakers must consider whether to continue unlimited coverage or to transition to a limited-coverage guarantee. If a transition to a limited-coverage system is chosen, the different policy options to achieve a smooth and effective transition become crucial.

For countries whose economies and financial systems had been centrally planned and managed, a transition from the unlimited guarantee provided by the state to a limited-coverage deposit insurance system occurred as part of fundamental restructuring of their economic and financial systems. As their financial systems become increasingly market-based, an unlimited state guarantee financed from public funds may become an expensive and unsustainable form of protection. In response, numerous countries have adopted, or are exploring the adoption of, an explicit, limited-coverage deposit insurance system. For all of

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[1] The Subgroup members were Mexico (coordinator), Hungary, Japan, and the International Monetary Fund.

[2] As part of its consultative process, the Financial Stability Forum's Working Group requested comment on transition issues and other topics included in its Research Plan on its official Web site. In response to this request, the experiences of several countries that had successfully transitioned from a blanket guarantee to a limited-coverage deposit insurance system were shared with the Subgroup. The experiences of other countries that are in the process of such a transition also were considered. The countries that responded included: Finland, Hungary, Japan, Korea, Mexico and Sweden.

[3] Public-policy objectives and situational analysis are the subjects of other papers by the FSF Working Group.

these countries, the process of transitioning from an unlimited guarantee to a limited-coverage system presents similar trade-offs.

The design and implementation of a deposit insurance system that is consistent with the European Union's directives on deposit protection schemes are among the issues of particular concern to Central and Eastern European countries.[4] Other countries facing similar regional policies should take them into account when designing their transition programs.

The trade-offs and considerations associated with a transition also are important for countries planning or involved in transferring public financial-service providers, whose obligations are under an implicit state guarantee, to private control. These providers may be development banks, state commercial banks or some other form of financial intermediary that offers an obligation that is subject to the provisions of the transition program.

For many countries, the use of a blanket guarantee has been a successful tool for avoiding the collapse of the financial system and for restoring or achieving stability. The use of a blanket guarantee in the majority of the countries surveyed was precipitated by sudden developments such as currency devaluations, the emergence of large speculative markets, or significant changes in the social and economic fundamentals of the country. As noted by the Working Group,

> "[e]xperience shows that depositor and creditor confidence can erode quickly, and this may have a severe effect even on relatively healthy institutions. To maintain confidence, depositors and creditors require immediate and widespread government assurance of the safety and availability of their deposits and claims. Another reason for adopting explicit blanket guarantees is the belief that they will provide the government the time and opportunity to restructure problem banks, thereby avoiding the need to deal with closure decisions."[5]

The transition to a limited-coverage deposit insurance system involves trade-offs. These trade-offs can be better understood in the context of the history of each country's financial system. An understanding of this history is crucial when a country is experiencing important social and economic reforms, has a tradition of recurrent economic or financial crises, or lacks public support for the transition.

In comparing a blanket guarantee to a limited-coverage deposit insurance system, the first trade-off involves moral hazard, which potentially is greater under a blanket guarantee.[6] Maintaining a blanket guarantee can prove costly, particularly when depository institutions and others view the blanket guarantee as a license for excessive risk-taking. A second

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[4] This issue is addressed in the paper on cross-border issues.

[5] Financial Stability Forum Working Group on Deposit Insurance, *A Consultative Process and Background Paper*, June 2000, p. 11.

[6] Moral hazard is the subject of a separate paper.

trade-off is the potential for destabilisation if the limited-coverage system is not implemented correctly. Given that a blanket guarantee can provide a false sense of security, it is important that officers of depository institutions, depositors, creditors, supervisors and regulators are provided during the transition with the correct incentives to address and correct existing gaps and problems.

Considerations for Transitioning to an Effective, Limited-Coverage Deposit Insurance System

Institutional arrangements

When considering how the transition will be implemented it is important to make sure that the institution(s) designated as responsible for the transition have the necessary expertise, tools and powers. The experience of the countries surveyed as to which institution should lead the transition was mixed. In some countries, the institution chosen to lead the transition was affected by a negative public perception of the previously existing institution. As a result, it was deemed more prudent to create a new entity to be lead the transition.

Another important consideration indicated by the countries surveyed was whether the limited-coverage deposit insurance system should be managed as a separate entity. The alternative would be an “umbrella” approach, whereby regulation, supervision and deposit insurance are handled in one institution. There is no clear-cut answer to this question; however, most of the countries surveyed decided to assign the transition mandate to a separate institution.

Regardless of the institutional setting, a crucial issue to ensure the credibility and long-term viability of a new or modified deposit insurance system is the presence of effective corporate governance principles. Such principles can help to ensure a qualified, independent and accountable decision-making process.

Coverage limits

One of the first questions policymakers have to answer when transitioning from unlimited to limited coverage is how to set the limits of coverage. After analysing numerous cases around the world, the following conclusion was reached: there is no rule of thumb. Countries have followed different approaches to fit domestic circumstances.

An important consideration, however, is that, regardless of the specific figure chosen, the level of coverage should be sufficient to ensure that the deposit insurance system is credible—that it has the confidence of the public. Geographic factors also should be taken into consideration. For example, if there is a high level of capital flows between two countries, different coverage levels could foster unwanted capital flight.

Regarding the type of deposits to be insured, the experiences of the countries were driven by their public-policy objectives. In all circumstances, however, there should be a well-structured transition mechanism based on accurate and timely databases. Issues to be considered include whether to maintain an unlimited blanket guarantee for a period of time or to eliminate certain types of deposits gradually from the list of guaranteed liabilities.

Funding

Contrary to the cost of a blanket guarantee, which is ultimately bourne by taxpayers, the cost of a limited-coverage deposit insurance system is usually paid by, or shared with, depository institutions through insurance fees.[7] The transition to a limited-coverage deposit insurance system usually involves the imposition of new or revised premiums or levies on insured institutions. If those funds are insufficient to pay for the cost of the blanket guarantee—especially if it stems from a systemic crisis—the cost usually is shared between depository institutions and the government. The latter can resort to higher taxes, asset sales, or debt issues. In any case, it is important to have a clear mechanism in place to ensure that the deposit insurance system will have access to adequate funding during and after the transition.

Insurance premiums

Given that the transition to a limited-coverage deposit insurance system often proceeds when depository institutions may be in a weakened condition, the determination of insurance premiums should reflect this fact. The imposition of deposit insurance premiums or levies should not undermine the competitiveness of depository institutions or destabilise them. In some countries, the initial premiums imposed on depository institutions after a crisis are relatively high, because they include the cost of the crisis as well as the cost of deposit insurance. As stability returns, the level of premiums can be reexamined.

During the transition period countries need to consider whether they will levy flat or differential premiums. Some deposit insurance systems differentiate the fees paid by banks depending on the risk posed by the institution to the deposit insurer. However, in all of the countries surveyed, premiums initially were set on a flat-rate basis after the consideration of the availability and quality of information, the risk-management culture, the degree of stability of the financial system, and the availability of expertise, among other factors.

Legal and regulatory frameworks

A limited-coverage deposit insurance system must be well-defined, whether by voluntary agreements or by law. To be effective, voluntary agreements underlying deposit insurance arrangements must be enforceable. For example, the failure to adhere to the terms of the voluntary agreement may lead to the withdrawal of deposit insurance and/or revocation of the banking license. In either case, if the limited-coverage system is to be effective, the participation of depository institutions, especially strong institutions, must be ensured. This is accomplished in many countries by making participation in the deposit protection scheme mandatory.

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[7] The topic of funding a limited-coverage deposit insurance system is addressed in the paper of funding.

In most of the countries surveyed, changes that accompanied the transition have taken the form of a decree, a parliamentary resolution, or a law “protecting” the deposit insurer against later institutional or governmental changes. Similarly, the establishment of a clear and adequate regulatory and supervisory framework was noted as being crucial for the effective transition to a limited-coverage deposit insurance system. In countries with pre-existing limited-coverage systems, the regulatory framework has to be adapted to accommodate first a blanket guarantee and then, the transition to limited coverage. Countries with no experience in limited-coverage deposit insurance may require a more comprehensive regulatory change. Moreover, transparency in regulation and its enforcement, are integral to an effective transition.

Condition of the banking system

The condition of the banking system is a key factor in the determination of when and how to transition to limited coverage. If implemented while the financial system is weak or unstable, the transition can be a destabilising element that will increase the overall cost to the system:

> “After a country has suffered a financial crisis, it is best to ensure that most of the major problems relating to the financial crisis have been adequately addressed before transitioning to limited-coverage deposit insurance. However, if governments wait for all deficiencies in an economy or financial system to be addressed or the system to be reformed, blanket guarantees could become entrenched.”[8]

Thus, it is important to ensure that during the transition all the necessary issues are addressed to prepare the financial system for limited coverage. The ability to ensure that failed depository institutions are dealt with adequately, whether by the deposit insurer or another entity, is among these issues.

In the countries surveyed, some degree of stability was achieved before initiating the transition. The elements that usually were present during the transition included tighter banking regulations in line with international practices, including accounting, regulatory, supervisory and auditing standards. In addition, a more-open disclosure regime to improve the flow of information and more-stringent risk-management regulations were important elements.

The quality and quantity of information are crucial to an effective transition; adequate information will facilitate a correct assessment of the state of the financial system and its strengthening process. In this sense, the information requirements of a limited-coverage system might be viewed as much higher than under a blanket guarantee. Some of the countries surveyed still have a blanket guarantee or very high coverage levels in place until the health of the financial system is adequate and reliable information is available.

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[8] Financial Stability Forum Working Group on Deposit Insurance, *A Consultative Process and Background Paper*, June 2000, p. 12.

Timing

The issue of timing was most frequently mentioned as crucial for an effective transition, from inception to completion. The first decision relates to the desirability of a "fast track" approach *versus* a more gradual process. The advantages and disadvantages of a gradual approach are shown in table 1, below. Experience shows that in most cases, a financial system is not ready for a fast-track transition when coming out of a crisis. Thus, gradualism is a more appropriate policy choice. It allows the transition to start, avoids an entrenchment of the blanket guarantee, and provides depository institutions, regulators, and supervisors with adequate time to prepare for limited coverage and all its implications.

Most of the transitions analysed for this paper included a specific goal regarding when the ultimate level of coverage would be reached and a detailed timeline that described how the system would reach that goal. In some cases, deposits guaranteed under the blanket guarantee were grandfathered and coverage on new liabilities was reduced gradually. In other cases, a fixed schedule included in the law specified the qualitative and quantitative reduction of coverage over a number of years. For example, every year coverage on certain deposits is to be reduced or eliminated, or the amount of the guarantee per individual or institution is to be reduced further.

In most cases, specific deliverables were included in the transition plan. These included the desired coverage goal, as well as the institutional arrangements and advances needed to strengthen the banking system. Integral to an effective transition is a clear "tracking mechanism" designed to monitor whether all the necessary financial, regulatory, institutional, and legal changes are occurring on time. Policymakers should specify the factors on which to base progress as clearly as possible.

Some countries underscored the importance of providing for "correction mechanisms" during the transition process to allow changes to be made as necessary. However, such corrections need to be well understood by the market. Otherwise, they may negatively affect incentives for market discipline, or call into question the credibility of the government's commitment to the transition.

Countries that initially set up a blanket guarantee system, but had to extend its duration, suggested that rather than specifying a time-frame for the removal of the guarantee, it may be more appropriate to specify the conditions that first need to be satisfied. For example, such conditions would include specific regulatory changes and/or the capitalisation levels of depository institutions. Under this approach, the government can signal its commitment to the transition process and the cost of the crisis may be reduced. In the case of one country, the timing of the transition was contingent on the financial condition and stability of the banking sector.

Table 1: Some advantages and disadvantages of a gradual approach

Advantages	Disadvantages
• Depository institutions can adjust smoothly toward the new standards, especially when fresh capital is scarce. • Managers of depository institutions can be trained in a risk-management culture. • Depositors need time to adjust to the new scheme, especially after years of a blanket guarantee.	• The transition period might be perceived as too long, thus raising doubts among depositors, regulators and/or policymakers about the government's commitment. • The potential for moral hazard may decrease more slowly than in a more rapid transition to limited coverage.

Public awareness

Given that public confidence is a critical element of any deposit insurance system, it is important that the transition plan be communicated clearly to all affected parties. A transition to limited coverage can be perceived as "taking away something from the public." However, it is in the interest of depositors, creditors, and supervisors to increase market discipline through a limited guarantee. A transition should be accompanied by a widespread public-awareness campaign to inform the public about the details of the coverage reduction in order to avoid misconceptions.

Lessons Learned

Lessons learned by countries that have undergone or begun a transition to a limited-coverage deposit insurance system include the need to build the right incentives for the parties involved during the different stages of the transition process. In particular, the timing of the transition, the need to provide for corrections along the way, and the need for close coordination among the regulatory/supervisory agencies and the deposit insurer were mentioned as key to an effective transition to limited coverage. The transition process should emphasise the appropriate sequencing of events. For example, the introduction of a limited-coverage scheme is more feasible after the banking sector begins to consolidate and the economy shows evidence of stabilisation.

To enhance credibility, the reforms should reflect a consensus among representatives of the owners of depository institutions, depositors, debtors, public policymakers and government officials. Equally important, the limited-coverage deposit insurance system should be clearly defined, whether by voluntary agreements or law. Depositors might be particularly concerned about the strength of the banking sector at the time the new scheme enters into effect. Therefore, close tracking of the performance of depository institutions is highly important.

The countries surveyed indicated that it is advisable to transition to a limited-coverage deposit insurance system gradually. A gradual approach gives the owners of depository institutions and other stakeholders sufficient time to make the changes necessary for a successful transition.

The principal roadblock perceived by countries was insufficient coordination among financial authorities and difficulties in negotiations with public policymakers. Other limitations noted were a lack of resources to handle insolvent depository institutions. These problems were overcome through actions such as lobbying legislators and the granting of special powers to the deposit insurance system to issue government-backed debt.

Conclusions

Even though many of the topics in this paper are the subject of other Working Group papers, it is important to note that, when considering a transition from a blanket guarantee to an effective, limited-coverage deposit insurance system, certain factors need to be addressed. The experience of different countries suggests that it is desirable to have some degree of stability in the banking sector before initiating a transition to limited coverage. However, many of the changes necessary for a system to function effectively with a limited guarantee can be implemented during the transition period. Realistic timing, clear deliverables and an adequate tracking process are essential elements for an effective transition, regardless of the structure of a deposit insurance system. Table 2 below depicts various changes that can increase the potential for a successful transition.

Table 2: Examples of changes recommended by countries to increase the potential for a successful transition

Legal	• Enactment of a law or voluntary agreements to establish the deposit insurance system. • The deposit insurance system should have autonomy, but should be accountable for its actions. • Provisions should be made to fund the deposit insurance system. • The deposit insurance system or another entity should be empowered to sell assets of failed institutions and to refinance its debt, if necessary.
Regulatory	• Depository institutions should be required to comply with internationally accepted standards.
Supervisory	• Adequate compliance and disclosure regulation should be enacted.
Institutional	• Transparency in the operation of the institution managing the transition and insured institutions should exist.
Financial	• Adequate funding to restructure the banking system and to start-up the deposit insurance system should be provided *via* private capital markets and/or the public sector.
Political	• The enactment of the law or voluntary agreements that established the deposit insurance system should be discussed thoroughly with public policymakers in order to gain consensus.