Dubai International Financial Centre
DIFC

DIFC Economics Workshop: Deposit Insurance Briefing Note 3

A Deposit Insurance (DI) scheme protects bank depositors in the event a bank is unable to meet its obligations.

The workshop reviewed the motivations behind the institution of a DI schemes

- Strengthen banking & financial system stability
- Prevent bank runs and panic
- Protect bank retail depositors from incurring large losses in the event of bank failures.
- Promote banking & financial sector development

As often happens in insurance contracts, a DI provides an incentive for additional risk taking, because parties to the contract are protected against loss. So the design of a DI needs to balance the objective of protecting depositors with the need to avoid reckless behavior and increased risk taking.

Many DI schemes establish insurance funds, and most of the payments into the fund come from banks, or jointly from banks and the government. A DI scheme however cannot prevent the occurrence of crises, it may merely lower the costs of the crises to depositors and co-exist with the central bank lender of last resort function so it provides an additional protection as part of a financial safety net.

The moral hazard introduced by DI is mitigated if the country has a strong institutional environment measured by indicators such as bureaucratic quality, bureaucratic delay, lack of corruption, the quality of contract enforcement and legal efficiency). Countries with poor contracting environments are likely to suffer adverse consequences from deposit insurance. In designing a DI scheme three elements are crucial:

1. Clear understanding and statement of Public Policy Objectives
2. Undertake a comprehensive situational analysis of local conditions:
   - I. Legal & Regulatory framework
   - II. Enforcement of laws
3. Specify clear Mandate, Powers and Structure
   - I. Transparency, Accountability & Predictability
   - II. How does DI fit into the prudential regulatory and supervisory framework

Some takeaways:

- Explicit Deposit Insurance schemes are now offered by some 98 countries across the globe, though they differ in coverage, funding, co-insurance features, pricing of insurance premia and voluntary / mandatory membership.
- Many countries, both advance and emerging market economies have increased the scope and coverage limits of their DI in response to the financial crisis and in order to restore public confidence in their banks.
- DI is not prevalent in the GCC or the wider MENA region.
- DI can be an important element in strengthen banking & financial system stability, preventing bank runs and panic, protecting bank retail depositors from incurring large losses in the event of bank failures and in promoting banking & financial sector development.
- DI should be designed as an element of a Financial Safety Net: a financial stability mechanism that usually comprises the deposit insurance function, prudential regulation and supervision, and the lender-of-last-resort function
- DI should be designed to maintain market discipline and minimize incentives that induce an increase in risk taking by covered institutions (moral hasard and adverse selection issues).
- In essence providing strong **incentives for private parties to remain vigilant** is critically important in weak contracting environments where private monitoring must overcome weaknesses in official supervision