Case for integrated protection schemes

November 14, 2013

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The on-going evolution of the financial sector through deregulation, globalisation, financial innovation, information and technological advances has led to the conglomeration of the sector.

As such, the operational design of financial institutions has moved away from the era of distinct banking, insurance and securities business entities to a more consolidated functional structure offering integrated financial services and complicated financial products.

These changes have necessitated a review of the scope and functional role of deposit insurance/protection schemes in an attempt to improve their responses to crisis.

It has also enhanced the protection of financial consumers and contributed to the stability of the financial system.

In some continents such as in Europe and Asia, Integrated Protection Schemes were introduced in response to changes in the financial landscapes.

This resulted in deposit insurers being given broader mandates to provide protection to insurance policyholders, banks and non-bank financial institutions like asset management and stockbrokers.

In Malaysia, the Deposit Insurance Scheme has been extended to protect insurance policyholders and depositors effective December 31, 2010.

Following the Asian financial crisis in 1997, the Korea Deposit Insurance Corporation was transformed into an integrated deposit insurer covering almost all the compensation schemes.

In Zimbabwe, there are different protection systems with the Deposit Protection Fund established in 2003 being administered by the Deposit Protection Corporation and an Investor Protection Fund which is separately administered by the Securities and Exchange Commission of Zimbabwe.

Integrated Protection Schemes

An Integrated Protection Scheme is one where a single integrated insurer e.g. deposit insurer provides guarantee or protection to investors in security firms (Investor Compensation Scheme), policyholders of insurance companies (Insurance Compensation Scheme) and depositors in deposit taking financial institutions (Deposit Protection Scheme) for the loss of insured funds in the event of a member institution’s failure.

In some cases, the funds for the three schemes are administered separately and expenses are charged to the respective funds.

Rationale of Establishing an Integrated Protection Scheme
The insurance and securities industries are integral components of a financial system.
It is important from a policyholder and investors' perspective that their savings be protected in the unlikely event of a failure of an insurance or asset management/stock broking company.

Protection and assurance of payment in the event of a failure of a member institution will enhance public confidence as well as promote consumer demand for insurance and investment products.

An IPS can benefit the insurance and securities sectors as it will level the playing field for the banking, securities and insurance industries.

This will further promote public confidence. Most IPS have broader functions, including complementing the central bank's efforts to promote sound risk management of insurance, securities and deposit taking institutions.

IPS acts as a proxy for policy holders, securities investors and depositors in monitoring the health and soundness of insurance, asset management and banking institutions.

Guiding Principle for the Design of IPS
The design and features of an IPS should include a coverage to protect at least 90 percent by volume or number of all insurance policyholders, security holders and depositors in the market; equitable protection for conventional insurance companies, securities firms and deposit taking institutions, that is, similar protection for financial consumers in different sectors; and should be cost efficient, contribute to the stability of and confidence in the financial system.

Benefits of Integrated Protection Schemes
(a) Economies of scale and scope in the following areas; expertise, knowledge and experience from one sector can be applied across the scheme.

An IPS is cost effective as operational costs can be shared that is; direct expenses accrue to each respective fund while non-attributable expenses are allocated based on proportion of premiums collected in previous assessment year.

Efficient resource allocation: With one scheme, infrastructure and supervisory resources can be leveraged more efficiently.
The IPS enables efficient use of resources, cross fertilisation of expertise and more accessible dispute resolution processes.

Harmonised Legal Structure for Various Protection Schemes
(b) Co-ordinated policy decisions with other safety net participants
It helps to minimise or reduce inconsistencies and inter-agency conflicts in policy decisions and approaches as there will be one institution co-ordinating the various funds.

(c) Integration gives both a critical mass for investment and continuous activity of some level enhancing the overall state of readiness.

(d) Enhanced resolution and crisis response capabilities.
Single point of contact when intervention and failure resolution are needed

(a) Addresses key gaps in consumer protection
Independent dispute resolution services for banking, insurance and investment disputes will be available under one roof.

Generic design features of IPS Compulsory membership
Membership is compulsory for general and life insurance companies, asset managers and deposit taking institutions.
Reinsurance and insurance brokers are excluded because they do not conduct business for members of the public. Insurance brokers/adjusters/agents — these are intermediaries with no financial commitment to pay claims to policy owners.

Separation of funds
An IPS normally operates with different types of funds for example Deposit Protection Fund, Investor Protection Fund, General Insurance Compensation Fund and Life Insurance Compensation Fund.

This is done for purposes of equity, transparency and accountability.
Each fund is built from annual levies received from the respective contributories either as ex ante or ex post. In other jurisdictions, IPS has powers to raise or borrow money from the central bank or market.

Governance
The IPS is funded from the various participants in the financial services sector through premiums paid periodically either annually or quarterly.

It is operated by an independent body representing both consumers and the industry and is insulated from undue political and industry influence.

Issues and challenges for adopting
A well-developed legal framework is a pre-requisite for adopting an IPS.
Public policy objectives, governance, operational and organisational matters, mandates and powers should be clearly defined and formally specified through legislation or documents accompanying legislation.

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