Deposit Protection Corporation

Protecting Your Deposits

Deposit Protection Scheme

Highlights

Moral Hazard in Deposit Insurance

In the context of deposit protection, the term moral hazard refers to the incentive for insured banks to engage in riskier behavior than would be feasible in the absence of protection. It can also be defined as the incentive created by insurance that induces those insured to undertake greater risk than if they were uninsured because the negative consequences are passed through to the insurer.

Mitigating Moral Hazard

Deposit protection, like any insurance system, must be designed to mitigate the impact of moral hazard and some of the ways are as follows;

a) Risk-Based Protection Premiums

- Risk adjusted premium rate is levied on an institution assessed on the basis of that institution's risk to the deposit insurer.
- It helps to foster discipline among contributory institutions as it is designed to raise the explicit cost of funding risky activity hence discourages engaging in risky activities/behaviour.

b) Restriction of Coverage to Particular Types of Depositors

- Insurance coverage could be confined to certain classes of deposits and excluding from protection the accounts owned by depositors who may be presumed capable of assessing the risk characteristics of banks.
- A considerable number of the countries that have explicit deposit insurance programs exclude interbank deposits from protection, and a few countries limit deposit insurance to households and non-profit organizations.

c) Coverage Limit and Scope

- This refers to a guarantee that the principal amount and interest accrued on protected accounts will be paid up to a specified limit which varies from time to time.
- This means that, depositors with deposits less than the coverage limit will be paid in full and those with amounts above the limit will receive the insured amount only and the difference will be paid through the liquidation process.
- The cover level under normal circumstances should compensate at least 90% to 95% of insured depositors in full in the event of a bank failure.
- Reducing the maximum amount of insurance available to an individual depositor has been suggested as a means not only of giving more depositors incentives to monitor the risk behavior of banks but also of reducing failure-resolution costs while still providing protection for truly small savers.

d) Increased Capital Requirements

- Higher capital requirements are perhaps the strongest restraint on moral hazard because they force stockholders to put more of their own money at risk and provide a larger deductible for the insurer.
- Higher capital requirements also tend to reduce returns on equity because banks must substitute equity for lower-cost deposits, and this substitution increases their average cost of funds.

e) Insured-Depositor Preference in Receivership Claims

- Under insured-depositor preference uninsured depositors and unsecured, nondeposit creditors would not receive any funds until the insurer had been made whole for meeting its obligation to insured depositors.
- As a result, uninsured depositors would have increased incentives to protect themselves whether by increasing their risk-monitoring activities or by moving funds out of deposits and into collateralized and other relatively low-risk obligations.

f) Regulatory Discipline

- Market discipline alone is not sufficient to mitigate moral hazard. It is best used in concert with regulatory discipline from prudential supervision and an effective failure resolution regime.
- Safety net participants should have coordinated regimes for early detection and timely intervention and resolution of troubled institutions.

g) Holding Parties at Fault to losses

- In the event of a bank failure parties at fault such as management, directors and shareholders if found at fault should be prosecuted or suffer losses for their actions. This helps to foster discipline and reduce appetite for risk behaviour.

For more information on the Deposit Protection Scheme contact:

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