Protecting Your Deposits

Deposit Protection Scheme

Highlights

Moral Hazard in Deposit Protection

- 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 protection programs exclude interbank deposits from protection, and a few countries limit deposit protection 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 on a pro-rata basis.
- 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.

For more information on the Deposit Protection Scheme contact:

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