Role of deposit protection in crisis

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The role of deposit protection is undergoing various changes in light of the global financial crisis and the need to maintain financial stability. Some argue that deficiencies in financial safety nets contributed to the financial crisis.

A widely accepted definition of a financial safety net includes at least three elements, deposit protection, lender-of-last-resort function and the prudential regulatory and supervisory framework.

Some suggest that there are four key elements if failure resolution mechanisms for financial institutions are taken into account.
The elements are designed to reduce the disruptions in the financial system stemming from bank failures.

Role of deposit protection during financial crisis

The evolution of the global financial crisis of 2008 /09 showed the importance of maintaining depositor confidence in the financial system and the central role that deposit protection serves in maintaining that confidence and supporting financial stability.

Internationally, the deposit insurer joined other safety net players in co-ordinated efforts to identify financial risks and develop co-ordinated policies to confront financial distress and respond to financial fragility.

The contemporary mandates of deposit protection schemes have evolved, with more of them assuming responsibilities beyond a “pay box function” such as risk minimisation that involves risk assessment and problem bank resolution.

Greater awareness and emphasis has been placed on the importance of ensuring that the deposit insurer has the operational and institutional independence needed to interact on an equal basis with other safety net players.

Higher Coverage Levels

The financial crises of 1970s, 1980s and most recently the global financial crisis of 2007 /8 resulted in the insolvency of many financial institutions, and ultimately set in motion fundamental changes in the role of deposit protection.

The first major developments were on the coverage limit.

The developed world mainly European countries and the United States increased their coverage limit by 4,8 and 5,6 times of Gross Domestic Product (GDP) per capita respectively.

In Asia, the increase was around 26 times of GDP per capita. The overall increases in coverage limit were different across countries ranging from 75 to 400 percent.

European coverage limit currently stands at 100 000 euros per individual while it is US$250 000 in the United States.
These developments were mainly done to move away from the notion of protecting unsophisticated depositors to that of achieving financial stability taking into account the magnitude of the financial crisis.

Hoelscher (2011) indicated that the 100 000 euros and US$250 000 coverage limit for European countries and US will cover 98 and 99,8 percent of depositors respectively by number and covers 60 and 78 percent respectively in terms of value, against an 80 /20 percent scenario before the crisis.

In theory a higher coverage level reduces the incentive for arbitrary depositor runs but it should be done not at the expense of market discipline.

The objective of only protecting small depositors is not effective during financial crisis as low coverage limit levels are normally inadequate to stabilise depositor expectations.

Bank resolution and intervention

The financial crisis underscored the importance of rapid resolution to arrest contagion and restore stability.
This therefore means that during crisis deposit insurers' role is to ensure a resolution

process where banks can be wound down in an orderly fashion, removing the unsafe or unsound elements but preserving the vital financial activities.

In order to fully discharge this role, deposit insurers as highlighted by International financial standard setting bodies like the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) there is need for appropriate tools to deal with all types of financial institutions in difficulty.

In the event of a bank closure, deposit insurers are responsible for the process of actually securing and inventorying a bank's assets and preparing a final set of financial statements.

The decisive action to solve the problems of the bank might take the form of private solutions (recapitalisation, sale of bank shares or merger), purchase and assumptions or liquidated payout.

Securing assets of the failed bank helps to minimise asset stripping and preserve the value of the bank.
In the event of liquidation, creditors and depositors will be paid from proceeds from asset sales and recoveries from debtors.

Compensate depositors in the event of collapse of deposit taking institution.

During the financial crisis some banks collapsed and deposit insurer's role was to reimburse depositors of the failed institutions up to the cover limit.

This ensures that depositors have prompt access to their funds and is done to protect and minimise losses on the part of depositors and investors from crisis in the bank's balance sheet.

Deposit protection prevents or reduces losses associated with the bank failure to less informed depositors and may be viewed as part of a broader consumer protection program.

By carrying out this function deposit protection promotes public confidence in the financial system as it protects depositors against the loss of their deposits.

Minimise a run on banks

Deposit protection is a mechanism to prevent panic by assuring depositors in other banks of the integrity of the system as a whole.
During the financial crisis this role of protection or assuring depositors safety of their money reduces the likelihood of a bank run and the on-set of a banking panic.

This enhances financial system stability through minimising chances of small depositors to cause bank runs, and thereby contributing to an orderly payment system.

Public awareness

Deposit insurers throughout the whole world intensified their literacy and public campaign awareness programmes helping depositors to make better informed investment decisions.

Complementary financial safety nets and regulatory discipline

A wide set of different institutions are involved in the provision of the various elements of the financial safety net.
Besides the deposit insurer, prudential authorities (regulators and supervisors), monetary and fiscal authorities play an important role in a crisis situation, including in relation to bank failure resolution.

Collaborations among safety net players may lead to elimination of a single point of failure (vulnerability to one point of weakness), enhanced regulatory objectivity, accountability and transparency and reduced opportunities for regulatory arbitrage, failure or capture in future.

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