Role of Deposit Protection Systems

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Almost 95 percent of depositors are unaware of their rights in terms of the Deposit Protection Corporation Act (Chapter 24:29). The new biweekly series christened “Deposit Protection at Your Service” will enable the Deposit Protection Corporation “the Corporation” or “DPC” to charge its statutory mandate as provided in Section 5 (1)(f) of the said Act “to keep the public informed of (i) the corporation’s role in contributing towards the stability of Zimbabwe’s financial system; and (ii) the rights of depositors in the event of a contributory institution becoming insolvent. This inaugural article focuses on the concept and role of deposit protection systems in the financial system and the historical background of the development of deposit protection systems.

Why governments regulate the banking sector

Regulatory intervention attempts to maintain financial stability and at the same time, induce greater efficiency of financial markets. Banks play a critical role in the economy by acting as intermediaries between savers and borrowers, facilitating the payments system and by also acting as agents of monetary policy implementation. Banks are generally highly leveraged institutions, susceptible to liquidity and solvency challenges.

As such, they are therefore exposed to the risk of runs either because of loss of confidence in the bank itself or from a loss of confidence in the banking system as a whole (Garcia:2000). Widespread failures of banking institutions can have negative repercussions on a country’s payments system and the economy at large.

The critical role played by banks in the economy, the potential for depositors to suffer losses when banks fail and the need to mitigate contagion risks, lead countries to establish financial safety nets. A financial safety net normally includes prudential regulation and supervision, a lender of last resort and deposit protection.

What is Deposit Protection?

In general terms, deposit protection is a bank deposit guarantee scheme which ensures that depositors are reimbursed part or all of their deposits in the event of a bank failure. A deposit protection scheme can also be defined as an institutional arrangement designed to protect banking deposits in the event of a bank failure, (Diz & Lagos 2003).

According to Talley & Mas (1990) DPS are typically created to prevent contagious bank runs, to provide a formal national mechanism for handling failing banks, and to protect small depositors from losses when banks fail. Because banks are highly leveraged institutions, depositors have a strong incentive to show up at the bank first, to withdraw their funds in case they doubt the financial health of a particular bank. Those at the end of the line may get nothing. In short, deposit protection is designed to prevent depositors from overreacting to bad news about banks. (Kurizkes, Schuermann & Weiner: 2002).

In some countries deposit protection has been broadened to cover customers of financial institutions which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services without the conventional interest charges, for example Asset Management Companies.

On one hand, the existence of a deposit protection scheme will to a certain extent moderate the impact of bank runs since customers are unlikely to withdraw all their funds, yet on the other hand, evidence suggests that the fact that deposits are partially protected may not be enough to prevent a bank run. It should be pointed out at the outset that deposit protection will only be effective if it's complementary to the efforts of the other safety net players, i.e. strong regulatory and prudential supervision regimes and lender of last resort function.

A Brief History of Deposit Protection

The first country to establish a deposit protection scheme was the Republic of Czechoslovakia in 1924 in order to rebuild its financial sector after the turmoil caused by the First World War. The United States established the Federal Deposit Protection Corporation in 1933 in response to bank runs and bank collapses which occurred in the US between 1930 and 1933. Norway established its deposit protection scheme in 1961 and four other schemes were set up in Germany, Canada, Finland and Japan between 1966 and 1971.

Deposit Protection Systems Worldwide

There are now over 100 deposit protection schemes in operation all over the world and about 41 countries are studying and contemplating adopting deposit protection systems (www.iadi.org). Most of the deposit protection schemes are mainly concentrated in Europe and Asia. Africa has nine explicit deposit protection schemes, namely Algeria, Kenya, Tanzania, Zimbabwe, Nigeria, Morocco, Uganda, Libya and Sudan (www.iadi.org). Other countries like Malawi, Lesotho, Zambia and Mozambique are also working towards establishing deposit protection systems in their jurisdictions.

Rationale for Establishing a Deposit Protection Scheme in Zimbabwe

Since independence in 1980, the Zimbabwean banking sector was relatively stable and highly regulated. Deregulation of the sector in the early 1990s exposed the banking sector to structural vulnerabilities and risk management cum corporate governance challenges. The need for deposit protection was underscored by bank failures in the market between 1995-2001, mainly Universal Merchant Bank, United Merchant Bank, Zimbabwe Building Society and First National Building Society.

It is in the light of these bank failures in the market that the Government saw it fit to set up an explicit deposit protection scheme to protect vulnerable depositors in the event of bank failures. Thus on July 1 2003, the Government established the Deposit Protection Fund in terms of Section 66 of the Banking Act [Chapter:24:20]. The Fund is vested in and administered by the Deposit Protection Corporation, in terms of the Deposit Protection Corporation Act [Chapter 24:29].

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