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CONCEPTUAL ISSUES IN DEPOSIT INSURANCE

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Introduction

Deposit Insurance is a specialised form of insurance. Although it has its own peculiarities, it nevertheless has the same basic principles of insurance, namely, the pooling of risks. It is the fear of disastrous financial losses that will be sustained when the "unexpected" happens that led to the development of insurance. Hansel (1978) notes that insurance cannot stop a misfortune or disaster from occurring but only helps soften the blow from a purely economic viewpoint. Countries that operate deposit insurance schemes include the United States of America, Cuba, Kenya, Trinidad and Tobago, Argentina, India and Spain, to mention but a few.

The basic purpose of deposit is to protect both the banking system and depositors from the unpleasant consequences of destructive runs on banks thereby ensuring the soundness of the banking system. Because of the unique position in the banking sector in the economy, bank deposits are often singled out for financial protection. This is to ensure that the banking system continues to play its catalytic role in economic development. This paper will review the basic models of deposit insurance as well as the inherent problems. Some issues of concern to the public regarding the operation of the Nigeria Deposit Insurance Corporation (NDIC) will also be discussed and suggestions made.

Forms of Deposit Insurance Schemes

Talley and Mas (1989) identified two major forms of deposit insurance, which are widely practised in developing countries – the implicit (or informal) and the explicit (or formal) systems.

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Implicit Deposit Protection

Talley and Mas (1989) stated that in most developing countries, governments typically do intervene to protect depositors in failing banks, a practice referred to as Implicit Deposit Protection Scheme (IDPS). Under this system, government protection of depositors is purely discretionary and is therefore non-obligatory. Government action in a failing bank situation is usually informed by a number of considerations among which are.

(i) The desire to achieve specific policy goals;

(ii) Cost-benefit considerations.

Another reason that has been advanced to justify government protection of depositors in a failed bank is anchored on a certain feeling of "guilt", being at least partly responsible for the failure of the bank through unfavourable government policies. In Nigeria, such policies include: mandatory credit allocation to otherwise unprofitable sectors; the rural banking programme that compelled banks to open branches in unviable locations; mandatory investments in stabilisation securities at rates unilaterally fixed by the Central Bank; relatively high reserve requirements on which little or no interest is paid and frequent changes in policies. This situation has remarkably changed for the better.

Under the implicit or informal systems of deposit protection, determination of the form and amount of protection is done on an **ad hoc** basis, as there may be no pre-existing rules, guides, or procedures. Any protection offered depositors would normally be financed out of government's current budget or through the Central Bank.

Five basic ways of extending protection to depositors under the IDPS are widely discussed in literature on deposit insurance namely:

(i) Direct payment to depositors of failed banks;

(ii) An arrangement for the failed bank's deposits to be assumed by another bank, which would be offered incentives by government;

(iii) Merger of a problem bank with a healthy and viable one with active government financial support;

(iv) Rehabilitation of a problem bank through direct equity capital injection;

(v) Direct extension of long-term loans to problem banks or government guarantee of loans provided by other parties.

In the years immediately preceding the introduction of deposit insurance in Nigeria, option (v) was often employed to assist problem banks.

However, some merger cases were also recorded in the early period of Nigeria's banking history. One of the

earliest cases was the merger in 1959 of Beirut-Riyad Bank with Standard Bank of West Africa (SBWA), now First Bank of Nigeria Plc, and also Chase Manhattan Bank with the International Bank for West Africa (IBWA), now Afribank Plc, in 1961. It is, however, doubtful whether there was any active government involvement in these two cases.

Formal or Explicit Insurance Scheme

An appropriate enabling legislation is usually required to bring a formal deposit protection scheme into operation and represents the system commonly referred to and understood as simply deposit insurance. The nature of the scheme varies from country to country with respect to participation, coverage, administration and funding. In most countries operating the formal scheme, membership is compulsory for banks, the coverage has an upper limit, administration is by a government agency and the scheme is funded through contributions (premiums) by insured institutions. In most cases, flat premium rates are used due to problems associated with the determination of appropriate weights to be assigned to various risk factors. Three basic variants have been identified and practised under a formal deposit insurance scheme based primarily on the extent of protection. First, there is the **limited coverage scheme** which is designed primarily to protect small depositors. When a bank fails, the insurer is authorised to pay off insured depositors up to a maximum predetermined amount or arrange for a failed bank's deposits to be transferred to another bank. With a limited coverage scheme, the insurer is not allowed to rehabilitate banks or arrange financially assisted mergers. The second variant involves **100% coverage** and is therefore at the other end of the continuum. All deposits are completely protected from loss subject, of course, to the ability of the insurer to honour her obligations. The insurer can therefore employ a wide range of devices in failure resolutions ***including*** pay off, transfers, financially assisted mergers and rehabilitations of failing banks. Although 100% deposit protection has been widely discussed in deposit insurance literature, it has rarely been used in practice. One may also wish to note that although depositors of one or two failed banks in Nigeria were paid in full when they were liquidated under the Abacha regime, this should not be confused with 100% insurance coverage since it was merely coincidental that the banks in question had enough assets to cover obligations to depositors who take priority over all other creditors in the event of liquidation of a bank.

The **discretionary coverage** scheme lies midway between the other two systems and involves the coverage of deposit liabilities up to a maximum amount just like a limited coverage scheme. The main distinguishing feature,

however, is that the insurer is authorised, when conditions so permit, to extend **de facto** coverage to uninsured deposits like the example cited under the limited coverage scheme. The operation of the Nigerian Deposit Insurance Corporation fits perfectly into this mould.

Mandatory versus Optional Schemes

A formal deposit insurance scheme may be voluntary, in which case individual banks would be allowed to decide on their own whether to insure their deposits or not based on the perceived advantages. Under a mandatory scheme, all banks are legally compelled to join. Ebodaghe (1990) maintains "a compulsory scheme allows for cross-subsidy by the larger and more secure banks". He argues further that a voluntary scheme would tend to negate the efforts of monetary authorities geared towards achieving a safe and sound banking system. This is because the failure of an insured bank, no matter its size, would create panic and loss of confidence in the entire gamut of the banking system. It is worthy of note that a voluntary system is inherently unstable as banks may frequently move in and out of the scheme, making planning difficult.

Uniform Versus Variable Premium Assessment Policy

As stated earlier, most formal deposit insurance schemes operate a uniform premium assessment as against a variable premium assessment policy. Barnet (1976) believes that the main advantage of the variable rate premium model is that premiums are geared to risk. The conservatively run bank whose operations pose very little risk to the insurance fund is rewarded with lower premium rates and vice versa. However, it should be acknowledge that the difficulties associated with risk measurement renders this model unattractive to deposit insurance managers. Giddy (1982) reports that Argentina practices a risk-based premium assessment scheme.

In addition to measurement problems, the use of risk based variable rates in premium determination tends to exacerbate the problems of troubled banks through increased premium payments leading to higher costs and lower profits. It can also precipitate a run on a bank by sending unfavourable signals to the banking public about the health condition of banks especially in sophisticated and well-informed societies.

Funding a Deposit Insurance Scheme

A crucial element in the design of a deposit insurance scheme is the question of funding. This is important because it affects public confidence in the banking system and determines who bears the losses arising from the failure of a bank. In most countries that operate formal deposit insurance schemes, premium charged on deposits is a major source

of funds and may be complemented by equity contributions from government and other stakeholders.

To function effectively, a deposit insurance scheme must be adequately funded. However, the assessment of the adequacy of a deposit insurance fund is usually very problematic, being dependent on both actual and potential losses inherent in the banking system. Since the incidence of bank failures could be mitigated through effective banking supervision, the adequacy of the insurance fund must, of necessity, be assessed with reference to the efficiency of the regulatory system as a critical qualitative factor.

Policy makers frequently use the ratio of capital and reserves to insured deposits as a rough measure of funds adequacy. For NDIC, the ratio increased from 2.01% in 1990 to 3.03% in 2000. Care must, however, be taken to ensure that the interpretation of such ratios are made in the context of certain critical qualitative factors such as the quality of the insured banks' assets, management, the overall efficiency of the supervisory system and ease of access to "standby" credits by the fund administrators.

Deposit Insurance in Nigeria

The Nigerian Deposit Insurance Corporation (NDIC) which was established under Decree No. 22 of 1988 is the body statutorily charged with the administration of deposit insurance in Nigeria. The corporation is empowered under the decree to insure all deposit liabilities of licensed banks and other financial institutions operating in Nigeria, and it guarantees payments to depositors of a failed bank or financial institution up to a maximum of ₦50,000.00. Some aspects of the corporation's operations that have continued to be of concern to the general public include:

i. the insured limit of ₦50,000.00 which is perceived as being too low;

ii. the coverage of interbank deposits;

iii. the level of premium charged on deposits;

iv. the mandatory participation by all banks;

We shall briefly discuss each of them.

1. Insured Limit & Coverage of Inter-bank Deposits

Right from inception, the maximum amount (the insured limit) that is guaranteed for payment by NDIC in case of a bank failure has remained at ₦50,000.00 per depositor. This implies that a depositor is insured only up to this amount in the aggregate "with respect to deposits held in the same right and capacity in each insured bank including all domestic branches of the same bank." Thus, if a person maintains multiple accounts in different branches of the same bank, all the deposits are aggregated and treated as if they were all held in only one account. It therefore

follows that the only way a depositor can insure "comprehensive coverage" is to limit his deposit in any bank to a maximum of ₦50,000 (A scenario that is not only cumbersome but impracticable for big time depositors). It should be stated here that although the insured limit is ₦50,000, depositors are entitled to "dividends" from the proceeds of sale of fixed assets and recovery of debts on *pro rata* basis.

Closely related to this is the criticism that although premium is charged on interbank and other term deposits, such deposits, for all practical purposes, are not "covered" since the amounts involved usually far exceed the insured limit. However, to the extent that the corporation in collaboration with CBN strives to maintain a sound financial system which will ultimately minimise the incidence of bank failures, an indirect protection may be implied.

There is no doubt that the insured limit of ₦50,000 per depositor is no longer adequate, fourteen years after the scheme came into operation. Although the corporation's board approved an upward review of this limit to ₦100,000, this is yet to be implemented as the NDIC Decree is yet to be amended to reflect this development.

Whatever the insured limit may be, it should always be borne in mind that small depositors constitute the target group for protection since it is assumed that big time depositors have adequate information on the risk profile of banks which would guide them in their choice. The corporation may, however, consider giving holders of large deposits the option of taking up additional cover on such deposits while the premium would be borne by the depositors themselves. A convenient premium should be carefully worked out after taking into account all relevant factors.

2. *The Level of Premium Charged on Deposits*

The corporation charges a premium of 15/16 of one per cent per annum on the total deposit liabilities standing in the books of the insured bank as at 31st December of the preceeding year. Premiums payable are not chargeable to depositors' accounts in any form. In other words, the banks are expected to absorb them as part of their operational expenses. Although this could be viewed as additional cost to banks, it may be justified on the strength of the need to build up the deposit insurance fund which is the financial backbone of any insurance scheme. There is, however, a provision in the NDIC decree for a downward review of the premium as the size of the insurance fund increases.

3. *The Mandatory Participation by All Banks*

The advantages of a mandatory scheme have already been articulated in the earlier part of this article. One contentious issue relating to this

however, is the power of the corporation to voluntarily terminate the insurance contract. Sec. 22(1) states as follows:

> Where it appears to the corporation that an insured bank or its directors or trustees have committed a grievous violation of its obligation or have continued to conduct the business of the bank,
>
> (a) in an unsound manner
>
> (b) intentionally or negligently permit any of the officers or agents of the insured bank to violate any provision of any law or regulation to which an insured bank is subject, the corporation shall serve on the board of the insured banks a warning notice stating that where the unsound practice continues, the name of the bank shall be removed from the register of the insured banks...

This provision, in my opinion, raises serious questions of morals and equity. Why should the corporation reserve the right to unilaterally terminate the contract without conceding the same right to the insured bank? How can it be guaranteed that the actions of the corporation in this respect will always be guided by utmost good faith and national interest and that it will not be used as a cover to discharge itself of liabilities that may arise when there is an impending threat of bank failure?

Concluding Observations

In this paper, we have attempted to x-ray the general concept of deposit insurance with special emphasis on its operation in Nigeria. It was shown that deposit insurance shares the same basic principle of insurance, namely, the pooling of risks to mitigate possible financial losses. Certain issues of concern to the banking public with respect to some aspects of NDIC operations were also discussed.

As a way of addressing the contentious issue of the insurance limit of ₦50,000 which is considered by many as being inadequate, efforts should be made to accelerate the amendment NDIC decree to reflect the enhanced limit of ₦100,000 approved by the corporations board since 2000. In addition, holders of large deposits could be given the option of taking up additional cover at a premium to be borne by the depositors themselves. The power conferred to NDIC to unilaterally terminate insurance contracts with banks should also be reviewed in the interest of equity.

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