II  Explicit and Implicit Deposit Insurance

The Choice between Explicit and Implicit Deposit Insurance

Sound Practice: Explicit deposit insurance has a number of important advantages compared with implicit insurance.

Policymakers have a variety of options concerning the protection of depositors. Countries can make explicit the protection of depositors in the case of a bank failure or they can leave the level of protection ambiguous, allowing the level and coverage of depositor protection implicit. Explicit protection lays out the level and the limits that depositors can expect in case of a bank failure, whereas implicit protection systems allow the conditions and limits to be negotiated during the failure process.

An explicit deposit insurance system is rules-based, clarifying the government’s obligations to protect depositors when a bank is unable to meet its repayment obligations. An explicit deposit insurance system is expressly laid down by statute or other legal instrument, and there are rules concerning compensation limits, the types of obligations covered, the methods for calculating obligations, funding arrangements, and other matters. An explicit deposit insurance system clarifies the financial obligations of the banking system and the public sector. For this reason, an explicit system restricts the extent of subjective or ad hoc decisions.

Some authorities have opted for a system of depositor preference instead of an explicit deposit insurance system. Under this arrangement depositors are given priority over other unsecured creditors in the distribution of proceeds from liquidation of a failed bank. Although this improves the depositors’ position in cases of bank insolvency, the bank’s assets may nonetheless still be insufficient to meet their claims in full, and depositors may also face long delays in receiving their funds.4

Where explicit deposit insurance systems do not exist, implicit deposit insurance is a pervasive feature of bank safety nets. The main characteristics of implicit deposit insurance include the absence of any rules regarding the coverage or compensation for losses and the absence of funds available for assistance. As a result, decisions on depositor protection are negotiated at the time of a bank failure. Possibilities exist for inconsistent treatment of depositors and other creditors, mixed market signals concerning the intentions of the authorities, and the reliance on discretionary government funding for bank failures (Kyei, 1995). Although implicit systems provide considerable flexibility for the authorities and allow “constructive ambiguity,” thus reducing the moral hazard that exists in any insurance system, the costs of such flexibility in terms of system efficiency and the resolution costs of crises must be carefully considered.

Some countries have tried to make an unambiguous commitment to offering neither explicit nor implicit deposit insurance. The clearest recent example is New Zealand, which takes a distinctive approach to banking supervision and does not offer deposit insurance. Such a policy may be feasible under some circumstances—for example, when the banking system is almost exclusively owned by strong foreign institutions (see discussion in Section IV). However, it is difficult to sustain over periods of economic and financial distress. A prominent example is Argentina, which between 1991 and 1995 abolished deposit insurance and announced a clear and unambiguous commitment to not protecting depositors. This policy was abandoned during the 1995 Tequila Crisis, when concerns about depositor reaction in the face of the deep financial difficulties led the authorities to reverse their stand and reinstate deposit insurance.

Moral Hazard

Sound Practice: When combined with other factors, such as effective regulation and supervision, specific design features of the deposit insurance system can reduce moral hazard.

A discussion of explicit deposit insurance must address moral hazard, which in this context is defined as “... the incentive for excessive risk taking by banks or those receiving the benefit of (deposit insurance) protection” (FSF, 2001). As in any insurance system, a deposit insurance system can lead to moral hazard in the form of excessive risk taking by institutions with insured liabilities. Although moral hazard cannot be

4This has been a factor in Hong Kong SAR’s decision to switch from a system of depositor priority to explicit limited deposit insurance.
eliminated, the safety net can be designed to reduce the distortions introduced by moral hazard considerations. Clarity on the responsibilities of bank shareholders and strong supervision with early intervention capacity are good examples. In addition, specific design features of the deposit insurance system can be introduced to limit moral hazard, including coinsurance, risk-based insurance premiums, and mandatory subordinated debt issuance, among others. The appropriate system will depend on the specific institutional environment within which the deposit insurance system operates. Section V provides a detailed discussion on this issue.

Recent Academic Literature on Explicit Deposit Insurance

In recent years a number of econometric studies have attempted to evaluate the economic consequences of introducing explicit deposit insurance. Some of these studies suggest a statistical correlation between an explicit deposit insurance scheme and the increased risk of a systemic crisis. The paper by Demirgüç-Kunt and Kane (2002) may be taken as representative of this literature. Building on the results of Demirgüç-Kunt and Detragiache (2002), Demirgüç-Kunt and Kane (2002) argue that increased risk taking owing to an explicit deposit insurance system manifests itself in an increased probability of experiencing a systemic crisis.

Although a strong institutional environment—indicated by measures of bureaucratic quality, lack of corruption, contract enforcement, and legal efficiency interacted with deposit insurance variables—mitigates the effects to a certain degree (interaction terms are negative and significant), explicit deposit insurance still significantly increases banking fragility. Thus Demirgüç-Kunt and Kane (2002) question the desirability of an explicit deposit insurance system and claim that “officials in many countries should close their ears to the siren call of explicit deposit insurance” (p. 192). Even though the authors point out that the research summarized in their paper “by no means implies that all countries with explicit systems should close them down at the first opportunity,” several of their findings (for example, concerning the desirability of ex post systems) stand in sharp contrast to earlier assessments of good practice and deposit insurance design (see Garcia, 2000).

A number of econometric studies have raised questions about the robustness of the Demirgüç-Kunt and Kane (2002) conclusions. Although Demirgüç-Kunt and Kane (2002) perform various robustness tests, the conclusion that explicit deposit insurance increases the risk of systemic crisis is not replicated in other binary models of banking crises. For instance, Eichengreen and Arteta (2000), in an attempt to consolidate recent work on the determinants of banking crises, find that the effect of explicit systems is highly sensitive to the use of different crisis lists and deposit insurance series, and to the exclusion of several types of countries. A particularly striking feature is that the exclusion of Organization for Economic Cooperation and Development (OECD) countries weakens the effect of deposit insurance on crisis probability, since OECD countries are expected to have a contract environment favorable to a deposit insurance system. The authors conclude that “there is at least as much evidence that deposit insurance has favorable effects . . . as that it destabilizes banking systems . . . .” (p. 25).

Moreover, the theoretical basis for the proposition that explicit deposit insurance increases banking fragility needs to be carefully reviewed. Demirgüç-Kunt and Kane (2002) argue that an explicit scheme will be detrimental to private monitoring efforts, thus weakening market discipline. However, the proposition that in the absence of deposit insurance, small-scale depositors will effectively monitor banks is less than obvious. Specifically, as argued by Dewatripont and Tirole (1994), small-scale depositors are often uninformed and suffer from a coordination problem, thus lacking the incentives to acquire the necessary information to discipline banks effectively. A solution to the coordination problem is for them to be represented by an agent that intervenes contingent on the bank’s performance. According to this theory, the additional effect of making depositor claims less secure should be marginal. Hence, it would be far more important to involve large creditors in efforts to effectively control risk taking, one of the central objectives of an explicit limited deposit insurance system.

Critics of deposit insurance contend that the introduction of an explicit deposit insurance system will hamper market discipline, because covered depositors will lose their incentives to discipline banks. Most of the studies cited to underpin this line of reasoning use data from the United States (Flannery, 1998, provides an extensive survey of the relevant literature), a country with a relatively high coverage level relative to GDP and with a highly developed financial system. As a consequence, it is not clear whether the results carry over to other environments, although the work by Demirgüç-Kunt and Huizinga (2004) suggests that similar effects may be found elsewhere. These authors use a sample of up to 2,500 banks in 43 countries to examine how bank characteristics influence the interest cost and the growth rate of deposits for banks operating in countries with or without

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3Robustness tests include a two-stage procedure to control for the possibility that countries with weak banking systems are more likely to introduce a deposit insurance system, the use of a principal component measure of moral hazard instead of the deposit insurance characteristics, and the inclusion of other variables characterizing the banking system.

6Note that this result depends on the way explanatory variables are weighted to account for measurement errors.
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An explicit deposit insurance system. They find that an explicit scheme indeed lowers the sensitivity of banks’ interest rate expenses to changes in risk profiles.

Nonetheless, other econometric studies reach the opposite conclusion. Martinez Peria and Schmukler (2001) find that depositors in Argentina, Chile, and Mexico intensively disciplined banks during the 1980s and 1990s, and that deposit insurance did not significantly diminish the extent of market discipline. Gropp and Vesala (2004) conclude on the basis of a sample of 128 banks in 15 European countries that introducing explicit deposit insurance actually reduced risk taking. The authors argue that, by introducing explicit limits on coverage, European authorities were able to effectively reduce the expected public subsidy in case of failures. The authors also find that certain bank characteristics produce different effects on risk-taking behavior when a deposit insurance system is introduced. Institutions having lower charter values and a higher share of subordinated debt reinforce the risk-mitigating effect of explicitly reducing coverage, whereas very large banks do not change their policies in reaction to deposit insurance. This latter result points to the importance of an integrated approach to the safety net and the way it shapes incentives.

In summary, recent econometric studies do not point to a firm conclusion regarding the effectiveness of private monitoring and the consequences of explicit deposit insurance systems on banks’ risk-taking incentives. Depositors seem to respond rationally to bank performance in most circumstances, in particular when they are not covered by a deposit insurance system, but explicit systems do not have an impact on banks’ risk taking that can be universally observed. In addition, an explicit deposit insurance scheme is only one component in a comprehensive bank safety net. Although the existence of a safety net will, on average, influence agents’ risk-taking incentives, it is less clear that explicit deposit insurance will do so in a well-defined way that permits its influence to be distinguished from that of other financial safety elements.

Policy Implications

The primary contrast between implicit and explicit deposit insurance systems is between discretion and rules. An implicit guarantee will allow the government to employ a strategy of constructive ambiguity and flexibility—for example, the extent to which depositors and shareholders receive a haircut can be made dependent on the availability of funds and/or the economic—and political—importance of the groups being affected by a bank failure. Thus, constructive ambiguity has the potential to increase private monitoring efforts but entails the danger of excessively discretionary policies, favoring those groups that are best organized to defend their interests. An implicit system may thus subject depositors to unplanned decisions under crisis conditions and result in unequal treatment of deposits, while at the same time maximizing the government’s potential liability. To the extent that both large and small depositors and other classes of creditors may believe themselves to be protected by implicit insurance, market discipline will be reduced and moral hazard will be increased.

The introduction of an explicit scheme does not completely eliminate the potential for ad hoc decision making, but it does reduce its scope, provided that the scheme is credible. The potential for explicit deposit insurance to give rise to a problem of dynamic inconsistency is nonetheless real, and governments may still be tempted to override a rules-based system on political grounds or on the belief that institutions are either “too big” or “too many” to fail. In these situations, constructive ambiguity can be a positive thing, because although some banks may be “too big to fail,” they are not given a competitive advantage by being explicitly designated as such.

Nonetheless, these issues potentially arise in all rules-based systems. The primary advantage of explicit deposit insurance is that it provides a mechanism to deal with depositors’ claims equitably and transparently while limiting the government’s potential liability. It is important to note that proponents of making the safety net explicit do not claim that depositors’ incentives will be unaffected. They rather argue that the benefits of preventing bank runs outweigh the costs in terms of weaker market discipline, if and only if the loss of some market discipline can be augmented by appropriate regulation and supervision.