Deposit Insurance: Reimbursement of Depositors

Aside from bank supervision, bank resolution schemes and the provision of emergency liquidity, deposit insurance constitutes a key element of the financial safety net in 113 jurisdictions worldwide (IMF 2013, IADI 2014). Deposit insurance aims to minimize the risk of bank runs and, thus, keep the financial system stable (Schich 2008). This was illustrated in the Fall of 2008 when the fear of bank runs led politicians around the world to increase the coverage level of their country's deposit insurance (Schich 2008).

According to Beck (2003), deposit insurance embodies a trade-off between financial stability and market discipline. On the one hand, a high coverage prevents destabilizing bank runs by depositors. On the other hand, monitoring efforts and the exertion of market discipline will be reduced by depositors if their deposits are fully covered. This may incentivize banks to engage in riskier activities. Thus, increased financial stability provided by deposit insurance comes at the cost of moral hazard.

An adequate coverage level and a credible reimbursement scheme solve this trade-off. Beck (2003) suggests that large depositors, who are most able to exert market discipline, are not covered under the insurance scheme and thus complement the supervisory part of the financial safety net. In addition to adequate coverage, credible reimbursement procedures are vital for the functioning of deposit insurance. If depositors do not perceive deposit insurance as credible, that is, they do not expect reimbursements, bank runs will happen in case of a bank failure, independent of the existence of deposit insurance. Similarly, if uninsured depositors expect to be reimbursed in the case of bank failure even without explicit deposit insurance, they will reduce their monitoring efforts.

Table 1 shows two aspects that influence the credibility of deposit insurance, namely the number of compensated depositors, as well as the legally allowed and actual timeframe for reimbursement (IMF 2013). The first two questions ask whether all insured depositors were fully compensated the last time a bank failed and whether, additionally, any uninsured depositors received compensation. The third and fourth question allow for the comparison of the legally required timeframe for the reimbursement of depositors, and the time taken to complete this process in practice. The results are excerpts from the World Bank Surveys on Bank Regulation and Supervision in 2007 and 2012.

The first question asked by the World Bank refers to the compensation of insured depositors. If not all insured depositors were compensated, depositors might be less trusting in future crises and the deposit insurance's credibility is likely to decrease. In the period 2008–2010 four of 32 countries (Ireland, Iceland, UK and Australia) did not wholly compensate all insured depositors. Six countries did not answer this question[1].

The second question deals with the reimbursement of uninsured depositors. Some countries compensated more depositors than were actually insured the last time a bank failed. The risk in compensating more depositors than are actually insured lies in the perception of the insurance system by uninsured depositors. The extension of the insurance coverage signals politicians' willingness to bail out large, uninsured depositors too, who originally should have exerted market discipline (Schich 2008). Consequently, these depositors reduce their efforts to monitor banks in the future (Beck 2003). For the period 2005–2006 this was the case in eight of 36 countries and between 2008 and 2010 in eight of 32 countries (eight and six countries respectively did not answer this question). Three countries – Germany, Lithuania and Norway – answered that they had compensated more depositors than were actually insured in both periods.

The two remaining questions make it possible to compare the period within which reimbursement had to take place according to legal obligations and the actual time it took for the depositors to get fully reimbursed. The European Union countries are legally obliged to compensate depositors within 20 days (IMF 2013). Denmark, the Netherlands, Norway, Spain, Turkey, and Norway fulfilled their obligation in less than the allowed time. By contrast, in Luxemburg, Switzerland, Slovenia, and Iceland it took longer to reimburse the depositors than legally allowed between 2008 and 2010. The shortest time allowed and needed in practice to reimburse depositors is one day in the USA.

In conclusion, deposit insurance constitutes a key element of the financial safety net of more than a hundred countries around the world. Aside from an adequate

[1] Although not yet included in the 2012 Survey, the rescue strategy of the Cypriot banking sector imposed in spring 2013 merits attention. For the first time all deposits, both uninsured and insured, were levied with a tax (6.75%-9.9%) to raise the money needed to stabilize the troubled banking sector (Sibert 2013).

coverage level, a credible reimbursement scheme determines the functioning of deposit insurance. Countries differ in terms of reimbursed depositors in the case of a bank failure and in the difference between the time allowed and needed until depositors are reimbursed. This might have implications for the functioning of deposit insurance schemes in the various countries in the future.

Dorothee Hillrichs

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Table 1

Deposit insurance: reimbursement of depositors, 2008–2010

Country	Were insured depo–sitors wholly compen–sated (to the extent of legal protection) the last time a bank failed?	Were any deposits not explicitly covered by deposit insurance at the time of the failure compensated when the bank failed (excluding funds later paid out in liquidation procedures)?		From the time of the event's trigger, within how many days is the deposit insurance scheme legally obligated to fully re-imburse insured depositors?	In general, how long (in days) does it take in practice to pay depositors in full?
	2008-2010	2005-2006	2008-2010	2008-2010	2008-2010
Austria	Yes	No	No	20	–
Belgium	Yes	No	No	20	–
Bulgaria	Yes	Yes	No	20	20
Croatia	Yes	Not available.	No	30	30
Cyprus	–	Not applicable.	–	20	–
Czech Republic	–	Yes	–	–	--
Denmark	Yes	No	No	20	14
Estonia	Yes	Not available.	Yes	20	–
Finland	Yes	No	No	20	–
France	–	No	–	20	–
Germany	Yes	Yes	Yes	20	–
Greece	Yes	No	No	20	–
Hungary	Yes	No	No	20	–
Ireland	No	No	No	20	20
Italy	Yes	No	Yes	20	–
Latvia	Yes	No	No	20	–
Lithuania	Yes	Yes	Yes	30	30
Luxembourg	Yes	No	No	30	180
Malta	–	Not available.	–	20	–
Netherlands	Yes	No	No	90	75
Poland	–	No	–	20	–
Portugal	Yes	No	No	20	20
Romania	Yes	No	No	20	–
Slovak Republic	Yes	Yes	No	30	20
Slovenia	Yes	Not available.	Yes	30	90
Spain	Yes	No	No	20	7
Sweden	–	No	–	–	–
United Kingdom	No	No	No	20	7
Iceland	No	–	No	90	365
Macedonia	–	No	–	–	–
Montenegro	–	–	–	45	–
Serbia	Yes	–	No	30	30
Norway	Yes	Yes	Yes	90	21
Switzerland	Yes	Yes	No	20	90
Turkey	Yes	–	Yes	360	45
Australia	No	Not available.	No	–	–
Canada	Yes	Yes	No	–	35
Japan	–	No	–	–	–
Korea	Yes	–	No	–	–
New Zealand	–	Not available.	–	–	–
United States	Yes	Not available.	Yes	1	1

Source: DICE Database (2013).