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ABSTRACT

Deposit insurance was first introduced into East Asia by the Philippines in 1963, followed by Japan in 1971, Taiwan in 1985 and Korea in 1996. However, it was the advent of the Asian financial crisis in 1997 which spurred the rapid development of new deposit insurance systems in the region. Since the crisis, new systems have emerged in Hong Kong, Indonesia, Malaysia, Singapore and Vietnam while pre-existing systems — such as those in the Philippines, Japan and Korea — have been enhanced from experiences gained during the crisis. Thailand and the People's Republic of China are planning to introduce their own deposit insurance systems shortly.

Although each of these systems was designed to meet specific country circumstances, their designers have also sought to adopt evolving good practices in developing their systems. As a result, deposit insurance systems share similarities in their objectives and design features such as governance, membership, funding and approaches to public awareness. The major differences arise in mandates and coverage limits. In addition, many of the new East Asian systems have had to deal with the challenge of transitioning from blanket deposit guarantees, initially adopted in the midst of the Asian financial crisis, to limited explicit deposit insurance while trying to maintain financial stability.

Finally, given that so many new deposit insurance systems are being set up at similar times the paper explores opportunities for greater information sharing and co-operation among all deposit insurers in East Asia.

1. Introduction

In most economies banks play the major role among financial institutions in intermediating between savers and investors, in the operation of the payment system and the execution of monetary policy.[1] The importance of banks in an economy, the potential for depositors to suffer losses when banks fail, and the need to mitigate "runs" and "contagion" risks, have led many countries to establish financial system safety nets.[2] These usually include prudential regulation and supervision, a lender of last resort facility[3] and, increasingly, some form of deposit insurance.

A deposit insurance system provides explicit — but limited — protection for eligible depositors in the event of a bank failure.[4] Deposit insurance can be designed to fulfill a variety of goals. However, the most common objectives are to contribute to financial system stability and to protect smaller and less financially

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[1] FSF Working Group (2001a).

[2] In this paper the term "bank" is used to denote all financial institutions which accept deposits from the general public. The term "run" is defined as a rapid loss of deposits precipitated by fear on the part of the public that a bank may fail and depositors may suffer losses. "Contagion" refers to the spread of individual bank runs to other institutions.

[3] In most economies, the monetary authority typically supplies lender of last resort (LOLR) facilities to troubled banks. LOLR loans are in principle provided to illiquid but solvent banks and at a penalty rate.

[4] Implicit deposit protection arrangements exist where depositors believe they will receive full protection in the event of a bank failure. However, most deposit protection arrangements are explicit and stipulate in legislation the rules governing the terms and conditions of protection. Explicit deposit insurance is viewed as being preferable to implicit protection because it reduces uncertainty and risk for depositors and can be helpful in reducing expectations on the part of the public of full government support in the event of a bank failure. Although some argue that a degree of uncertainty can lead depositors to exert greater effort in monitoring banks, in reality most depositors are not capable of doing so and/or do not have the necessary information or incentives to effectively monitor banks. For more information, see: FSF Working Group (2001a) and Garcia (2000).

sophisticated depositors from loss.[5] Without a credible deposit insurance system in place, the possibility exists that depositors might "run" by removing their deposits from a bank, and/or other banks, in response to difficulties at a single bank.[6]

Nevertheless, it is important to understand that the design of deposit insurance systems generally involves tradeoffs and the potential for introducing distortions into the financial system.[7] The most notable being moral hazard – or the incentive for excessive risk taking by banks or those receiving the benefit of a guarantee of protection. For example, full coverage for all deposits would effect the greatest protection for depositors but at the same time present the greatest challenge for controlling moral hazard. At the other end of the spectrum, very low coverage levels — that do not protect the majority of depositors in the system — would not be effective at curtailing runs and protecting the savings of most depositors. Therefore, designers of deposit insurance systems must choose coverage levels which provide adequate protection but which do not create excessive distortions such as moral hazard.[8]

Moreover, even a well-designed deposit insurance system needs to be supported externally by strong prudential regulation and supervision, an effective legal system, sound corporate governance and risk management in banks and appropriate accounting standards and disclosure regimes.

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[5] Other less common objectives for deposit insurance include: enhancing competition, providing a mechanism to close troubled banks, and ensuring resolution costs are absorbed by the banking industry. See also CDIC (2003) and Garcia (1999).

[6] See Diamond and Dybvig (1983).

[7] See Campbell, et al (2007) and Walker (2007).

[8] In addition to limiting coverage there are numerous other design features which can help minimize moral hazard including: the use of differential or "risk-adjusted" premiums; the introduction of certain forms of co-insurance; and minimising the risk of loss through early closure of troubled banks.

Although deposit insurance is effective at protecting depositors and contributing to stability in most situations, it cannot by itself deal with a systemic financial system crisis.[9] Systemic crises require the combined efforts of all safety net participants to effectively deal with them. Deposit insurance systems are most effective at dealing with single failures or a wave of small failures.[10]

The growth of deposit insurance systems have been particularly noticeable in East Asia, driven by such factors as rapid financial system development, the Asian financial crisis and a general desire to improve depositor protection and financial stability.[11] For example, prior to the mid-1990s, deposit insurance systems were initially introduced in Japan, Korea, the Philippines and Taiwan as a means to protect depositors and contribute to stability during the rapid development of their financial systems. Other economies in this period such as Hong Kong, Indonesia, Malaysia, Singapore and Thailand opted instead to protect their depositors through the use of implicit guarantees and other means.[12] Experience with the Asian financial crisis in 1997 and its aftermath, however, convinced these economies to develop their own explicit limited deposit insurance systems; and for countries with pre-existing systems to introduce enhancements as a result of experience gained from the crisis. The People's Republic of China intends to introduce a

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[9] A "systemic crisis" is defined as a crisis situation which affects and seriously threatens the viability of the entire financial system.

[10] See FSF Working Group (2001a).

[11] East Asia is defined to include: Japan, Korea, the People's Republic of China, Hong Kong (SAR), Macau (SAR), Taiwan, the Philippines, Vietnam, Cambodia, Laos, Thailand, Myanmar, Malaysia, Brunei, Singapore and Indonesia.

[12] In this period, Indonesia, Malaysia and Thailand generally relied on implicit guarantees while Hong Kong and Singapore emphasized the protection of depositors through prudential supervision and priority accorded to depositors over other creditors in insolvency law (i.e. depositor priority). The People's Republic of China relies primarily on state bank guarantees to protect depositors.

deposit insurance system in the near future as part of its financial system modernization plans.

This paper looks at the growth of deposit insurance systems in East Asia both before and after the Asian financial crisis. The first part of the paper starts with a survey of well-established systems in the region such as the Philippines, Japan, Taiwan and Korea. Section 3 examines the Asian financial crisis and its role in spurring the development of new deposit insurance systems and influencing changes in existing systems. The paper then describes the key characteristics of East Asian deposit insurance systems in Hong Kong, Indonesia, Malaysia, Singapore and Thailand. Section 4 reviews the similarities and differences of the East Asian systems and examines the extent to which they follow good practices in deposit insurance. Section 5 reviews work underway in the People's Republic of China on deposit insurance. The paper ends with a look at opportunities for greater regional cooperation on deposit insurance in East Asia.

2. Overview of Well-Established Systems in East Asia

Prior to the advent of the Asian financial crisis, explicit limited deposit insurance was introduced in a number of Asian countries including the Philippines (1963), Japan (1971), Taiwan (1985) and Korea (1996).[13] Vietnam began developing a system in the mid-1990s and introduced its formal scheme in 1999.[14] The following section provides an overview of the key features of these systems including information on their objectives, mandates, governance structures, membership, coverage and funding capabilities.[15]

Philippines

The Philippine Deposit Insurance Corporation (PDIC), established in 1963, was the first deposit insurance system in East Asia. PDIC is a separate legal entity and structured as a government corporation. Its objectives are to protect depositors, promote greater public confidence in banks and foster stability in the banking system. The PDIC's Board of Directors is chaired by the Secretary of Finance with the President and CEO of PDIC serving as the Board's Vice-Chairman. Members of the Board are the Governor of the Bangko Sentral ng Pilipinas (Central Bank) and two private sector representatives.

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[13] See Republic of the Philippines (1963), Deposit Insurance Law of Japan (1971), Republic of China (1985) and Republic of Korea (1996).

[14] See Socialist Republic of Vietnam (1999).

[15] See Campbell, et al (2007) and Walker (2007).

PDIC is a "risk minimizing"[16] deposit insurer provided with a critical role in failure resolution and as the mandatory receiver and liquidator of banks ordered closed by the Monetary Board of the Central Bank.[17] Partly in response to the Asian financial crisis, the PDIC Charter was amended in 2004 in order to restore the Corporation's examination powers and provide it with investigative powers as well. This allows PDIC to examine its member institutions, in close coordination with the Central Bank and with the approval of the Monetary Board of the Central Bank; and investigate complaints related to unsafe and unsound banking practices.

Membership in PDIC is compulsory for all banks including domestic branches of foreign banks. Referring to Table 1, all deposits (including foreign currencies) up to a limit of P250,000, or about US$5,300 are covered, with 95.06% fully insured. Banks are assessed a flat-rate premium of 0.2% of total deposits per annum. PDIC has established a deposit insurance fund, which is the capital account of the Corporation. It principally consists of: a Permanent Insurance Fund (PIF); Assessment Collections; Reserves for Insurance and Financial Assistance Losses; and Retained Earnings.[18]

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[16] There are many different types of mandates available for deposit insurance systems. These typically range from so-called pure "paybox" type of structures to "risk minimizers". A "paybox" insurer mandate is generally focused on paying out the claims of protected depositors after a bank has been closed. Paybox insurers typically do not have intervention and examination powers. Some paybox systems have been given the added responsibility to minimize costs associated with the closure of banks. That is, while they are mainly reactive they may have some proactive features such as access to risk assessment information and they may play a role in decisions on failure resolution. These have been referred to as "paybox-plus" or "least cost resolution" systems. Deposit insurers with a full "risk minimization" mandate are usually required to minimize their exposure to loss and therefore, be proactive in terms of on-going risk identification, assessment and management.

[17] The Monetary Board of the Philippines is the policy-making body of the Central Bank. The Board has the exclusive right and final authority over the closure of banking institutions.

[18] See Republic of the Philippines (1963) and PDIC Annual Report (2004).

Japan

The Deposit Insurance Corporation of Japan (DICJ) was established in 1971 with a mandate to protect depositors, contribute to financial stability and assist in the orderly resolution of problem banks. Coverage at that time was limited to ¥1 million (US$8,800) per depositor. The Deposit Insurance Law was amended in 1986 to expand the insurer's function to provide financial assistance for mergers and acquisitions of failed financial institutions. In 1996, the Law was amended again to incorporate a blanket guarantee (to deal with Japan's financial crisis) for a limited period; extend financial assistance beyond payout costs; and, to allow for the collection of a special premium to help finance the blanket guarantee.

In 1998, legislation was enhanced further to allow the DICJ nationalization powers, borrowing authority from the market with a government guarantee and the ability to recover non-performing loans through a newly established subsidiary — the Resolution and Collection Corporation (RCC). The DICJ was allowed to pursue civil and criminal liability of executives of failed banks and discover hidden assets of debtors in cooperation with the RCC. Special measures to deal with intervention in a systemic crisis were added to the legislation in 2000. The DICJ's powers also include: financial administration, operation of bridge bank assistance and on-site inspection of financial institutions. As of April 1, 2005, demand and time deposits are under a limited guarantee of ¥10 million (US$86,000). Unlike demand deposits, deposits for settlement and payment purposes continue to receive a full blanket guarantee.[19]

Table 1 highlights the fact that membership in the DICJ is compulsory for all banks, building societies and credit cooperatives. The system

[19] See Deposit Insurance Law of Japan (1971) and DICJ Annual Report (2004).

excludes foreign bank branches and postal savings banks. However, after the planned privatization of the postal savings system in 2007, postal savings banks will be included as members of the DICJ.

The DICJ is funded by premiums on insured deposits and may borrow from the private financial markets and issue bonds guaranteed by the government. Premium rates are currently 0.083% for general deposits and 0.115% for payment and settlement deposits. A differential (risk-adjusted) premium system is under consideration.

Taiwan

The Taiwan Ministry of Finance and the Central Bank jointly established the Central Deposit Insurance Corporation (CDIC) in 1985. CDIC is responsible for protecting depositors, promoting savings, maintaining an orderly credit system and enhancing the safety and soundness of the financial system. CDIC is governed by a seven-member Board of Directors and has been provided authority to conduct risk assessment. It has been granted a broad range of failure resolution powers and a least cost resolution mandate.[20] In January 2007, the CDIC's Act was amended to increase the size of the deposit insurance reserve, strengthen risk management for underwriting operations; introduce a special premium surcharge under prescribed circumstances; and the establishment of bridge banking powers.[21]

Membership is compulsory for all deposit-taking institutions but excludes institutions already covered by foreign insurers. Maximum coverage per depositor per bank is NT$1 million (US$30,000) and excludes foreign currency deposits. Premiums are assessed on

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[20] See Republic of China (1985) and Central Deposit Insurance Corporation (2004).

[21] See Financial Outlook Monthly (February 2007).

insured deposits and a differential premium system is employed. Premium assessments currently range from 0.05–0.06% of insured deposits.

Korea

The Korea Deposit Insurance Corporation (KDIC) was established in 1996 to formally protect depositors of insured financial institutions and to maintain public confidence in the financial system. The system protects deposits at banks, securities companies, insurance companies, merchant banking corporations, mutual savings banks, and credit unions. KDIC has been provided with a wide range of powers to minimize its exposure to losses including risk assessment, joint examinations of high risk (insolvency-threatened) institutions, on-site inspection and investigation of failed financial institutions and failure resolution.

During the Asian financial crisis, Korea introduced a blanket guarantee. This began to be withdrawn in 2001 as financial system stability returned and comprehensive economic and financial system restructuring was implemented. It has now been replaced by a limited guarantee of 50 million Won (US$53,000) per depositor per member institution. The system is funded by premiums collected from member institutions at a flat rate, but differentiated according to the type of institution protected. Premium assessments range from 0.1% of insured deposits for banks to 0.3% for mutual savings banks.[22] A differentiated (risk-adjusted) premium system is being planned for the future.

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[22] See Republic of Korea (1996) and KDIC (2004).

Vietnam

Vietnam began developing a deposit insurance system in the mid-1990s and established Deposit Insurance of Vietnam (DIV) in 1999. DIV is charged with protecting depositors; contributing to the stability of insured institutions; conducting supervision; and, ensuring the safe and sound development of the banking sector. The DIV was given the power to inspect its member institutions and a major role in failure resolutions. Membership in the system is compulsory and banks must pay an annual premium equivalent to 0.15% of the average balance of all insured deposits. If a bank becomes insolvent, individual depositors are entitled to receive up to VND 50 million (US$3,125) from the DIV. Individual account holders over this limit must recover any deficiency through the liquidation proceedings as other creditors of the bank. Deposit insurance is not applicable to foreign currency deposits.

Since its inception, the DIV has made insurance payments (up to the coverage limit) to nearly 3,000 depositors at 33 insured institutions. This has worked to reduce the risk of contagion in the system, maintained stability and kept the banking sector under control. According to the DIV, all payments have been funded by the industry so little or no public funds have been used in these resolutions. In order to deal quickly with insolvent banks, the DIV recently instituted a policy of early closure of troubled institutions.[23]

Other Established Systems in East Asia

As of writing, Brunei, Macau (SAR), Cambodia, Laos and Myanmar do not have formal explicit limited deposit insurance systems. Laos protects depositors with a special fund created by the central

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[23] See Socialist Republic of Vietnam (1999) and Hai (2005).

bank.[24] Cambodia and Myanmar provide an explicit 100% guarantee from the central bank for all deposits. Macau utilizes depositor priority and supervisory oversight to protect depositors, although it is contemplating a limited explicit deposit insurance system.

[24] See Campbell, et al (2007) and Walker (2007).

TABLE 1: ESTABLISHED DEPOSIT INSURANCE SYSTEMS IN EAST ASIA

Country	Governance and Structure	Membership	Coverage	Funding
Japan (1971)	• DICJ is a separate legal entity • Began life as a "Paybox" but has acquired many elements of a "Risk Minimizer" such as a failure resolution mandate and specific examination powers	• Compulsory for all banks, building societies and credit cooperatives • Excludes foreign bank branches and postal savings banks • After privatization in 2007, postal savings banks to be members	• ¥10 million (US$86,000) for general (demand and time) deposits • Settlement deposits unlimited • Per depositor, per institution • Excludes foreign currency deposits	• Industry funded by premiums on insured deposits • Combined ex-ante/ ex-post • Flat rate of 0.083% for general deposits and 0.115% for payment and settlement deposits • Differential premiums planned
Korea (1997)	• KDIC is a separate legal entity • "Risk Minimizer" with examination powers and a requirement for least cost resolution	• Compulsory for all domestic banks, foreign bank branches, securities, insurance, credit unions and most other financial institutions	• KRW 50,000,000 (US$53,000) • Per depositor per institution • Excludes foreign currency deposits • Depositor priority in place	• Industry funded by premiums on deposits • Combined ex-ante/ ex-post • Flat rate of 0.1% on bank deposits • Differential premiums planned

TABLE 1 (Continuation)

Country	Governance and Structure	Membership	Coverage	Funding
Philippines (1963)	• PDIC is a separate legal entity • "Risk Minimizer" with regulatory/ examination powers and a requirement for least cost resolutions	• Compulsory for all deposit taking institutions including foreign bank branches	• P250,000 (US$5,300) • Per depositor, per institution • Includes foreign currency deposits	• Industry funded by premiums on total deposits • Ex-ante with a P3 billion initial capital provided by the government • Flat rate premium of 0.2%
Taiwan (1999)	• CDIC is a separate legal entity • Provided with elements of a risk minimizer including a requirement to use a "least payout cost" method for failure resolutions	• Compulsory for all deposit taking institutions • Excludes institutions already insured by foreign insurers	• NT$1,000,000 (US$30,000) • Per depositor, per institution • Excludes foreign currency deposits	• Industry funded by premiums on insured deposits • Primarily ex-ante • Differential premiums (0.05–0.06% of insured deposits)
Vietnam (1999)	• DIV is a separate legal entity • "Risk Minimizing" deposit insurer	• Compulsory for all banks and credit unions • Excludes foreign bank branches	• VND50,000,000 (US$3,125) • Per depositor per institution • Excludes foreign currency deposits	• Industry funded by premiums of 0.15% on the average balance of personal insured deposits • Primarily ex-ante • Flat rate premiums (differential system planned)

3. Asian Financial Crisis and the Development of New Deposit Insurance Systems

Before the onset of the Asian financial crisis in 1997, no explicit deposit insurance systems were in place in Indonesia, Malaysia and Thailand. Instead, they relied heavily on implicit protection whereby troubled institutions were generally rescued by the authorities and depositors and most creditors were fully protected. The crisis showed that these arrangements were not only inadequate but that the pervasiveness of these implicit guarantees, combined with deficiencies in supervisory and regulatory framework, exacerbated the crisis. As a result, explicit 100% blanket guarantees, and major financial sector reforms were required, to help stabilize their financial system.

Although the use of blanket guarantees helped provide stability to the countries most affected by the crisis, blanket guarantees can be detrimental if retained too long. This is because they reduce market discipline and introduce significant moral hazard into the financial system.[25] Thus, the IMF and World Bank, as part of a broad package of financial sector reforms, urged Indonesia, Malaysia and Thailand to withdraw their blanket guarantees as soon as financial stability returned and replace them with an explicit — but limited — deposit insurance systems.[26]

Due to the severity of the financial crisis in Japan and Korea, these countries were also forced to adopt blanket guarantees in 1996 and 1997, respectively. However, as financial sector stability returned to their economies they have now withdrawn their full guarantees and

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[25] See FSF Working Group (2001a).

[26] See Lane, et al (1999).

transitioned back to their limited explicit deposit insurance systems in place before the financial crisis.[27]

The crisis had a less direct impact on Hong Kong, the Philippines, Taiwan and Singapore, where no blanket guarantees were introduced as a result of this crisis.[28] The aftermath of the crisis, however, was a period where officials in Hong Kong and Singapore began to review the adequacy of their own financial stability arrangements and look at ways to improve their competitiveness as international financial centers. As a result, both countries undertook a series of financial sector reforms beginning in 1998 which included the development of explicit limited deposit insurance arrangements to bolster stability and add an additional layer of protection for their depositors.[29] In the Philippines, the period after the financial crisis provided an opportunity for the authorities to enhance their deposit insurance system (e.g. in 2004, the PDIC Charter was amended to restore the Corporation's examination powers and provide it with investigative powers).

Indonesia

Prior to the Asian financial crisis, failed private banks in Indonesia were generally allowed to remain in the system in recapitalized form or otherwise supported by the Bank of Indonesia (BOI). Some banks were closed but all depositors were generally compensated. As an example, Bank Summa was closed and its depositors compensated in the early 1990s.[30]

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[27] See Nanto (1998) and the IMF (2000).

[28] In Taiwan, an implied blanket guarantee was avoided in 1997. However, the emergence of serious problems with a number of financial institutions in 2001 led to the eventual introduction of a *de facto* blanket guarantee.

[29] See HKMA (2002), MAS (2002) and the IMF (2003,2004).

[30] See Akhtar (2004).

In November 1997, 16 insolvent small banks were closed as an initial result of the financial crisis. At the same time, the Government announced it would guarantee only small deposits (up to IDR20 million – then equivalent to US$6,000). This, however, failed to prevent large-scale runs and in January 1998 the Government issued a blanket guarantee covering all Rupiah and foreign exchange liabilities for all creditors. With the assistance of the IMF, the Indonesian Bank Restructuring Agency (IBRA) was introduced in 1998 and given responsibility for bank resolution and restructuring of insolvent banks.[31] Initially, the administration of the blanket guarantee was shared between the BOI and IBRA. However, from June 2000 onwards, IBRA was given full responsibility.

In addition to the use of blanket guarantees, the BOI continued to provide liquidity support to facilitate the resolution process for troubled banks during the succeeding years. As stability gradually returned to the financial system, the Indonesian authorities (under the auspices of the IMF and World Bank) began developing a plan for the eventual transition from blanket guarantees to a limited explicit deposit insurance system.[32]

Following a number of years of development, the deposit insurance system was introduced on September 22, 2005.[33] The Indonesian Deposit Insurance Corporation (IDIC) was established with an initial capital of IDR4 trillion (US$400 million). It is governed by a six-person Board of Commissioners with three persons from the industry or IDIC employees and one representative each from the MOF, Indonesian Financial Supervisory Authority (FSA) and BOI. The organization's

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[31] See Ingves (2001).

[32] See IMF (2005).

[33] The year 2005 also saw the winding down of IBRA after the agency recovered approximately 28% of the US$60 billion in distressed assets it had managed since 1998. The Ministry of Finance set up a temporary unit to deal with remaining failure resolutions until the IDIC becomes fully operational.

objectives are to protect depositors and promote financial system stability and confidence. The IDIC is deemed an operationally independent institution which is accountable to the President of Indonesia.

The insurer is responsible for failure resolution and payouts and settlement of what are considered non-systemic banks. It can act as a liquidator or nominate a liquidator. All decisions are made by a coordination committee made up of representatives from the IDIC, MOF, FSA, and BOI. A notable feature of the IDIC is that the decision on the type of resolution undertaken will be based on a lowest or least cost to the deposit insurer criteria. Membership is compulsory for all licensed banks and includes foreign bank branches.

Box 1

Transitioning from Blanket to Limited Guarantees

According to the Financial Stability Forum Working Group on Deposit Insurance (2001), any country considering transitioning from a blanket guarantee to a limited explicit deposit insurance system should do so as quickly as circumstances permit. Nevertheless, special care must be taken to ensure that some measure of stability has returned to the financial system before transitioning; and, that all necessary structural reforms have been initiated.

Hoontrakul and Walker (2001) caution that the full implementation of a deposit insurance system should only be undertaken when the banking system returns to normalcy and the financial and economic environment is conducive. Otherwise, transitioning could be counterproductive and even lead to increased fragility, capital flight and further exacerbate moral hazard problems. The key questions for policymakers are how to manage the transition process in a timely, orderly and constructive manner and how to design an incentive-compatible deposit insurance system.

Of particular concern is that protection for depositors and other creditors is being reduced during the transition process. Therefore, policy makers should pay attention to public attitudes and expectations. In addition, economies with a high level of capital mobility, and/or regional integration, should consider the effects of different protection levels and other related policies. Policy makers need also to consider the capacity of the banking system to fund deposit insurance.

In some transitioning cases, various countries (e.g. Indonesia, Japan, Mexico and Hungary) have opted for a gradual removal of blanket guarantees, allowing banks time to adjust to new prudential standards and other reforms. In addition, a gradual transition permits bank managers to be trained in a risk-management culture and gives depositors time to become accustomed to the new arrangements. A major disadvantage, however, is that the transition period might be too long, raising doubts among depositors and creditors about the government's commitment to withdraw the blanket guarantee.[34]

[34] See Campbell, et al (2007).

With respect to coverage, the IDIC will replace the existing blanket guarantee with a limited guarantee of IDR5 billion (US$500,000). The plan is to reduce this gradually to IDR1 billion and then to IDR100 million (US$11,000) per depositor per institution by the end of 2007. This coverage limit is expected to protect roughly 98.5% of all individual deposit accounts. Islamic deposits (savings based on Sharia principles) will be covered by the deposit insurance system.[35]

Indonesia's high share of state banks and large number of small domestic banks has caused concerns that the removal of the blanket guarantee may cause abrupt shifts in deposits to state and foreign banks, if not properly managed.[36] Thus, the government decided to provide high levels of coverage for insured depositors in the deposit insurance system and stipulated that systemic banks will continue to receive full blanket protection. Coverage limits will apply on a per depositor per institution basis and will cover demand and savings deposits as well as foreign currency deposits.

Premiums will initially be set at a minimum 0.1% of banks' insured deposit balances per six-month periods (with a provision to increase it to a maximum of 0.5% per six month period in accordance with risk-based premium scale which will be fully implemented at a latter date). In practice, the initial rate charged to most banks is expected to be around 0.2% per year and the objective of the IDIC will be to eventually reach a fund target ratio of 2.5% of insured deposits. If

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[35] "Indonesian banking law defines a Sharia principle as an agreement between a bank and other parties to maintain funds or financing for business activities based on Islamic laws, such as mudharabah (financing pursuant to profit sharing), *musharakah* (financing pursuant to capital participation), *murabahah* (sale and purchase of goods for profit), *ijarah* (financing of capital goods pursuant to the leasing principle) or *ijarah wa iqtina* (transfer of ownership over leased goods from a bank to other parties)" – from the International Financial Law Review (2006).

[36] See Indonesia Ministry of Finance (2004).

additional funds are required, the deposit insurer will be allowed to borrow funds for liquidity purposes from the government.

Malaysia

Bank Negara Malaysia's (BNM) practice prior to the Asian financial crisis was to take over failed commercial banks and market the assets of the failed banks to healthy institutions. In many cases, due to the poor quality of the assets, the acquiring banking institutions reimbursed all depositors of the failed banks with the full assistance of BNM.[37] This created an implicit guarantee among depositors that all their deposits would be fully covered. However, this guarantee covered only commercial banks and finance companies. Other failed institutions, such as deposit-taking cooperatives, were normally liquidated without any compensation to depositors.

Unlike Indonesia and Thailand, systemic bank runs did not occur in Malaysia during the crisis. However, during the latter part of 1997 there was a flight to quality for depositors, which adversely affected several of the weaker banks and finance companies, necessitating BNM liquidity support.[38] The government announced a comprehensive blanket guarantee on deposits in January 1998 to prevent a further shift in deposits and possible bank runs.

In the period 1998-2004, the implementation of bank restructuring and the 2001 Financial Sector Master Plan further strengthened the financial system. It was also in this period that the planning and development of a deposit insurance system was initiated.[39] Since then, the banking system has been restructured and the supervisory

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[37] This happened in the mid-1980s during the failure of 36 deposit-taking cooperatives which were not under the supervision of BNM.

[38] See Akhtar (2004).

[39] Malaysia Ministry of Finance (2001).

and regulatory system updated. Danaharta, Malaysia's bank restructuring agency which played a leading role in the disposal of distressed assets in the financial crisis, completed the bulk of its work and is now being wound down.

The Malaysia Deposit Insurance Corporation (MDIC) was established in August 2005 and became operational on the 1st of September 2005. Its primary objectives are the protection of depositors and contributing to financial system stability. The MDIC is provided with the additional objectives of reinforcing and complementing the existing regulatory and supervisory system by promoting sound risk management practices; the minimization of regulatory costs; and complying with Sharia Law for Islamic deposits. MDIC is governed by a Board of Directors made up of public and private representatives and managed by a President.[40] The MDIC reports directly to the Minister of Finance.

The deposit insurer's mandate stresses that its function is to minimize resolution costs to the financial system. The MDIC is charged with resolving banks deemed non-viable by Bank Negara (the supervisory authority) and has been granted powers to recapitalize institutions, conduct non-performing loan carve outs, undertake purchase and assumption agreements, and liquidations and payouts to insured depositors. Regular examinations, other than preparatory exams, will likewise be conducted by Bank Negara.[41] The MDIC has the power to terminate membership in the deposit insurance system.

Membership is mandatory for all commercial banks (including locally incorporated foreign bank subsidiaries but not foreign bank

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[40] See Bank Negara Malaysia (2005) and MDIC Act (2005).

[41] A preparatory exam is usually undertaken prior to depositor reimbursement (payout). It is an examination of the books, records and accounts of the bank relating to its deposit liabilities.

branches) and finance companies. In response to the significant role played by Islamic finance in Malaysia, these institutions are included in Malaysia's deposit insurance system. The maximum coverage level is RM60,000 (US$17,000) per depositor per institution. Separate protection is provided for joint accounts and trust accounts. Foreign currency deposits are not covered. Islamic and conventional deposits will receive separate but equivalent protection and two separate funds will be created for each sub-scheme.

The system is funded by premiums on insured deposits with the MDIC granted the authority to borrow from the government for liquidity purposes. Premium rates have not yet been determined but the maximum premium rate will be capped at 0.5% of insured deposit liabilities. However, the actual rates imposed are expected to be relatively low given that most problem banks have been resolved and their costs absorbed by the financial system. A differential (risk-adjusted) premium system is expected to be introduced within the first few years of operation. Deposit insurance premiums will be a tax-deductible business expense.

Malaysia's system allows depositor liability to a bank to be offset against insured deposit liabilities and depositors receive priority over all other unsecured creditors in insolvency. Employees of the MDIC receive legal protection against civil and criminal liability for their decisions, actions or omissions taken in "good faith" while discharging their mandates.

Thailand

Although Thailand experienced a number of financial institution failures prior to 1997, no explicit limited deposit insurance system was created. Instead, authorities dealt with failure resolutions on a case-by-case basis. However, following a series of high profile finance companies failures in the early 1980s, Thailand established the Financial Institutions Development Fund (FIDF) in 1985. The FIDF is administered by the Fund Management Committee, chaired by the Governor of the Bank of Thailand, and funded through bank contributions and interbank and repurchase market borrowings. The FIDF is empowered to provide financial assistance to depositors and creditors. It is viewed as an implicit insurance system since it does not announce ex-ante the terms and conditions of coverage.[42]

When institutional failures occurred in the 1997 crisis, the financial system was provided with liquidity support by the FIDF but eventually 56 finance firms were permanently closed and most depositors compensated. Nevertheless, by August 1997 blanket guarantees were provided to all creditors in financial institutions in the event of failure. Comprehensive financial restructuring measures were initiated shortly thereafter affecting the legal, supervisory and regulatory systems.

The Financial Restructuring Agency (FRA) was created to provide advice to the MOF on how best to deal with resolving the failed finance companies. As part of these initiatives, a number of private asset management companies were also created to deal with non-performing loans. Eventually, a state asset management company was created (i.e. Thailand Asset Management Company or TAMC) to deal with the non-performing loan problems and to help viable debtors continue to service their loans. In addition, the Thai government, under advice provided by the IMF and World Bank, initiated the development of an explicit deposit insurance program to eventually replace the guarantee provided by the FIDF.[43] Further reforms to the system were contained in the 2004 Financial Sector Master Plan which sought to improve financial system stability,

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[42] See Wesaratchakit (2002).

[43] See IMF (October 2005).

efficiency, competitiveness and broaden the accessibility of the financial system for all users.[44]

Thailand has taken steps to establish a deposit insurance system with plans to gradually remove its blanket guarantee over time. For instance, in November 2003, the blanket guarantee for all non-deposit creditors was withdrawn although depositors remained fully protected. On November 30th, 2004, the Cabinet approved a draft law to establish a deposit insurance agency. The law is currently being moved through the legislative process and is expected to be finalized and implemented by 2008, provided the economic and financial sector environment is conducive.

When this occurs, the deposit insurance agency will be established and the process of replacing the existing blanket deposit guarantee with a limited coverage deposit insurance system will commence. At present, it is proposed that the blanket guarantee should be gradually reduced from 50 million Baht (US$1.5 million) per depositor as a first step and then be gradually reduced further to 1 million Baht (US$30,000) by the end of the process. The final coverage limit is expected to cover an estimated 98% of individual depositors and approximately 40% of the value of deposits in the system.[45]

The deposit insurance agency will be provided with a mandate to protect depositors, contribute to financial system stability, assume the task of the liquidator of failed institutions, and minimize costs associated with depositor payouts. It will be a separate legal entity reporting to the Minister of Finance (MOF) and governed by a committee made up of seven persons including representation from the Bank of Thailand (BOT) and MOF.[46] Membership in the

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[44] See Thailand Ministry of Finance (2004).

[45] See Yuthamanop and Sirithiveeporn (2002).

[46] See Pattaya Mail (2004).

system will be compulsory for all banks and finance companies and will include foreign bank branches. However, credit unions will not be included in the scheme.

The government is considering granting the insurer the right to demand confidential information from financial institutions in cooperation with the BOT and other financial regulatory agencies. For budgetary purposes, it is envisioned that the agency will not have the classification of a state agency or state enterprise. In keeping with the established practices for supervisory personnel in Thailand, legal indemnification for employees of the agency is expected to be limited.

With respect to funding, the agency would be provided with initial capital of up to 1 billion Baht (US$30 million).[47] The deposit insurer will be allowed to issue bonds but will not be able to borrow from the MOF. Premiums are expected to be set initially at 0.4% of insured deposits, although the deposit insurer will have the authority to raise premiums to a ceiling of 1% of insured deposits. This relatively high premium rate is similar to what the FIDF is currently charging institutions in order to help recover its resolution costs associated with the Asian financial crisis. A differential premium system may eventually be adopted after experience has been gained running the deposit insurance system. The full netting of obligations in an insolvency is expected to be exercised.

Hong Kong

Prior to passing the Hong Kong Deposit Protection Scheme Ordinance in May 2004, depositors were protected primarily

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[47] See Siam Global Associates Law Bulletin (2004).

through a depositor priority system.[48] As Hong Kong increasingly developed into a major financial centre and most developed economies began adopting deposit insurance systems, it decided to introduce explicit deposit insurance.

Hong Kong's Deposit Protection Board (DPB) is a corporate body with a seven-member board composed of a mix of government ex-officio and private board members. Its mandate is that of a paybox insurer with responsibilities for the contribution (premium) assessment and collection, fund management, depositor compensation (payout) and the recovery of compensation payments from the assets of failed banks. In order to economize on its limited supervisory resources, the DPB performs its functions through the Hong Kong Monetary Authority (HKMA) and reports to the Financial Secretary of the Government of the Hong Kong Special Administrative Region (SAR).

Membership is compulsory for all licensed banks and includes foreign bank branches. This reflects the position of Hong Kong as an international financial centre and the importance of foreign banks in their financial system. Foreign bank branches are exempted if there is an equivalent scheme which covers depositors in the home country. Members of the DPB may be subject to requirements for maintaining assets in Hong Kong.

The coverage limit is set at HKD100,000 (US$12,800) and is estimated to fully cover 84% of individual depositor accounts.[49] Coverage is

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[48] Depositor priority is the granting of preferential treatment to depositors in an insolvency such that their claims (typically unsecured) must be paid in full before remaining (unsecured) creditors can collect on their claims. However, a drawback with depositor priority is that the assets available to depositors are dependent on the liquidation process and there is no certainty that depositors will receive all of their claims. In addition, because of the complexity of the liquidation process, depositors have no clear indication of the speed of repayment of their priority claims. For more information, see FSF Working Group (2001b).

[49] See Arthur Andersen (2000).

per depositor per institution with savings, chequing, time deposits and foreign currency deposits booked in Hong Kong being covered. There is separate coverage for special accounts such as joint accounts and trust accounts.

The DPB is funded by contributions collected on protected (insured) deposits. A differential premium system is in place with a range of 0.05–0.14% of protected deposits. The target fund for the DPB is 0.3% of total protected deposits.[50]

A depositor's liabilities to a failed bank will be fully netted or set off against their protected deposits. The board members and those acting on behalf of the DPB will be indemnified and receive legal protection against civil liability when discharging the DPB's mandate in good faith.

Singapore

Singapore began studying explicit limited deposit insurance in 2001 and introduced a system in 2005 to provide an extra element of protection for depositors and dispel public expectations of 100% implicit coverage. Due to the small size of its jurisdiction in Singapore, the Monetary Authority of Singapore (MAS) decided to minimize administrative costs as much as possible when designing its deposit insurance system. Thus, the Singapore Deposit Insurance Corporation (SDIC) has been given a paybox mandate with no intervention or resolution powers.[51] The SDIC is a separate legal entity and reports directly to the Minister.[52] Its Board of Directors is made up of both public and private sector officials.

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[50] Deposit Protection Scheme Ordinance (2005)

[51] The system become operational in April 2006.

[52] See Singapore Deposit Insurance Act (2005) and MAS (2004).

TABLE 2: NEW SYSTEMS BEING INTRODUCED

Country	Governance and Structure	Membership	Coverage	Funding
Hong Kong (2005-06)	• DPB is a separate legal entity • "Paybox" model	• Compulsory for licensed banks • Includes foreign bank branches	• HKD100,000 (US$12,800) • Per depositor, per institution • Includes foreign currency deposits • Depositor priority	• Industry funded by premiums on insured deposits • Combined ex-ante/ex-post funding and ability to borrow for liquidity • Target fund (0.3%) • Differential premiums (0.05-0.14% of insured deposits)
Indonesia (2005)	• IDIC is a separate legal entity. • "Paybox plus" with a lower cost resolution mandate and liquidation responsibilities	• Compulsory for all banks • Includes foreign bank branches	• Unlimited, to be reduced to IDR5 bn, then IDR1 bn, and finally to IDR100 million (US$11,000) • per depositor, per institution • includes foreign currency and Islamic deposits	• Industry funded by premiums on total deposits • Combined ex-ante/ex-post with govt. borrowing authority • Target fund (2.5%) • Differential premiums (0.1-0.6%)
Malaysia (2005)	• MDIC is a separate legal entity • "Paybox plus" model with a least cost resolution mandate	• Compulsory for all banks, discount houses • Excludes foreign bank branches	• RM60,000 (US$17,000) • Per depositor, per institution, excludes foreign currency deposits • Includes Islamic deposits • Depositor priority in place	• Industry funded with separate assessments for Islamic/ ordinary insured deposits • Primarily ex-ante; power to impose levies and borrow from central bank • Flat rate premiums initially (max rate of 0.5%) • Differential premiums planned

TABLE 2 (Continuation)

Country	Governance and Structure	Membership	Coverage	Funding
Singapore (2006)	• DIA is a separate legal entity • "Paybox" model	• Compulsory for all "full" banks and finance companies • includes foreign bank branches	• S$20,000 (US$13,000) • Per depositor, per institution • Excludes foreign currency • Depositor priority in place	• Industry funded by premiums on insured deposits • Primarily ex-ante (target of 0.3% of insured deposits) with power to borrow from the government • Differential premiums (0.03-0.08% of insured deposits envisioned)
Thailand (2007)	• DIA is a separate legal entity • "Paybox" model with liquidation powers and consideration of a least cost method of depositor payout	• Compulsory for all banks & finance companies • Excludes credit unions and includes foreign bank branches	• Blanket deposit guarantee proposed to be reduced over time to 1 million Baht (US$30,000) • Per depositor per institution • Excludes foreign currency • Depositor priority in place	• Industry funded by premiums on insured deposits • Primarily ex-ante but agency may issue bonds for liquidity purposes • Flat rate premium up to a limit of 1% of insured deposits • May be replaced by differential system

SDIC membership is compulsory for all full banks (i.e. banks allowed to take retail deposits from Singapore residents) and finance companies. Membership includes full foreign bank branches.[53] In terms of coverage, the maximum limit is S$20,000 (US$13,000). Coverage will be per depositor per institution, excluding interbank, foreign currency, and small business deposits. Designated provident funds placed as bank deposits will receive separate protection of up to S$20,000.[54]

Funding of the system is based on the collection of premiums on insured deposits with a differential premium system planned. The differential premium system considered would initially rely on asset maintenance levels and have a range of 0.03–0.08% of insured deposits. It is expected that the differential premium system will in time encompass supervisory ratings as well as asset maintenance levels. A target fund of 0.3% of insured deposits has been set. The deposit insurer may seek access to government funds for emergency liquidity. Presently, Singapore utilizes automatic set-off of mutual obligations in a bank insolvency. As in Hong Kong and Malaysia, employees of the SDIC will receive legal protection from liability while discharging their mandates. According to the governing legislation, depositors (and the insurer) will receive depositor priority in an insolvency.[55]

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[53] Singapore intends to require foreign bank branches to meet asset maintenance requirements (e.g. the minimum requirement is 100% of the insured deposit base) to ensure that there will be sufficient assets in Singapore to meet the insured deposit liabilities of the branch.

[54] A provident fund is a fund in which an individual contributes a defined percentage of their salary over the course of their working life in order to receive a lump sum or other form of payment for retirement or other purposes. Provident funds can be administered privately or by governments.

[55] Depending on the specific arrangements, depositor priority systems have the potential to lower costs for a deposit insurer. However, this can be mitigated to some degree by the ability of lower ranked creditors to collateralize obligations, initiate early withdrawal of funds and other measures at their disposal. For more information, refer to the FSF Working Group Discussion Paper on Depositor Priority (2001).

4. Common Features, Differences and Good Practices

The following section reviews some of the common features and differences of East Asian deposit insurance systems and the extent to which these systems have embraced evolving good practices in deposit insurance developed by organizations such as the International Association of Deposit Insurers (IADI), the organization for Asia-Pacific Economic Cooperation (APEC), the Financial Stability Forum (FSF), and the International Monetary Fund (IMF).[56]

Public Policy Objectives

All of the previously established deposit insurance systems and new systems introduced after the Asian financial crisis formally specify their objectives in legislation with the most common being the protection of depositors and to contribute to financial system stability. Some of the new systems, such as Malaysia, include additional objects such as the promotion of sound risk management practices and minimizing regulatory costs. Singapore has the objectives of providing extra depositor protection and limiting public expectations of blanket coverage in bank failures.[57]

Mandates and Powers

Deposit insurer mandates range from relatively narrow "paybox" mandates (concentrating on reimbursing depositors of failed institutions) to those encompassing risk assessment and management, failure resolution and direct regulation and supervision. The FSF Working Group (2001a) stresses that there is no single mandate suitable for all deposit insurers. But, whatever mandate is chosen should be formally specified and the powers accorded to the de-

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[56] See FSF Working Group (2001a), Garcia (1999, 2000) and IADI (2005).

[57] See Campbell, et al (2007).

posit insurer should be consistent with its mandate. Garcia (2000) also stresses the need to clearly specify mandates.

All the systems reviewed specified their mandates in legislation and contain a core paybox component. Singapore and Hong Kong have the most limited systems in terms of mandates and powers, driven by their focus on minimizing administrative costs. Malaysia and Indonesia have provided more extensive failure resolution powers (and a least cost resolution mandate) to their insurers in an effort to minimize future resolution costs as much as possible. Meanwhile, some established systems - such as Japan and the Philippines - saw their mandates expanded with the addition of new powers in the aftermath of the Asian financial crisis.

Box 2

Summary of Key IADI Endorsed Good Practices on Building Effective Deposit Insurance Systems

- **Mandate and Powers.** There is no single mandate suitable for all deposit insurers but mandates need to be formally specified and consistent with powers.

- **Governance.** The sound governance of deposit insurers strengthens the financial system's architecture and contributes directly to financial system stability. An operationally independent and accountable deposit insurance system, with a clear mandate and which is insulated from undue political and industry influence, provides greater integrity, credibility and legitimacy than entities lacking such independence. The governance framework should also reflect the mandate of the deposit insurer and the governing body should have knowledgeable people.

- **Membership.** Membership should be compulsory and the deposit insurer should have control over entry and exit.

- **Funding.** Member banks should pay for the cost of deposit insurance. There should be ex-ante and ex-post arrangements. Deposit insurers should consider the use of differential premiums when they can ensure that the necessary resources are in place to administer the system appropriately.

Box 2 (Continuation)

- **Failure Resolution.** Ensuring that a framework exists for prompt corrective action and resolution of troubled banks can reduce the costs to depositors and the deposit insurer, contribute to financial system stability and help reduce the likelihood of an isolated bank failure turning into a financial crisis. Cooperation and information sharing between deposit insurers and supervisory authorities need to be in place before and after a failure.

- **Reimbursing Depositors.** It is important to reimburse depositors as quickly and accurately as possible. Preparatory reviews prior to failure are critical.

- **Public Awareness.** The public must be informed of the benefits and limitations of deposit insurance on a regular basis.

- **Interrelationships.** Information sharing and coordination mechanisms need to be in place for all safety net participants and unproductive overlap and duplication should be minimized. Formal information sharing arrangements either through legislation, memoranda of understanding, legal agreements or a combination of these techniques are necessary.

- **Legal Protection.** Individuals working for deposit insurers and other safety net participants should be protected against legal liability, except in cases of misconduct, for their decisions, actions or omissions taken in "good faith" while discharging their mandates.

- **Transitioning.** In transitioning from a blanket guarantee to limited coverage, care must be taken to ensure that financial stability has returned. Policy makers need to understand public attitudes and expectations.

Governance

The IMF, World Bank, APEC and IADI (2005) all stress that sound governance of organizations comprising the safety net strengthens the financial system's architecture and contributes to system stability. Furthermore, operationally independent and accountable safety net organizations, with clear mandates and which are insulated from undue political and industry influence, provide greater integrity, credibility and legitimacy than entities lacking such independence.

Independence is helpful for all deposit insurance systems whether they have a simple paybox mandate or more extensive mandates. This guidance emphasizes that the governance structure should reflect the public policy objectives and mandate of the insurer.[58]

In this regard, all the systems studied have adopted a publicly administered model incorporating a Board of Directors structure with both public and private sector representation.[59]

Although the East Asian systems are all legally separate organizations, the level of *de facto* or operational independence varies. For example, in the Philippines, Taiwan and Malaysia, the deposit insurer enjoys a relatively high degree of operational independence.

In Singapore, the deposit insurer is accountable to the Minister in charge of the Monetary Authority of Singapore. In Malaysia, the MDIC reports to the Minister of Finance. In Indonesia, the IDIC is accountable to the President. Hong Kong's deposit insurer is accountable to the Financial Secretary and depends heavily on the administrative resources of their monetary authorities.

Information Sharing and Coordination

According to the FSF Working Group (2001a) and IADI Guidance (2005), information sharing and coordination of the activities of the deposit insurer and other safety-net players is extremely important regardless of the insurer's mandate. It is also critical that formal

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[58] See IADI (2005).

[59] By far, the most common deposit insurance systems are those administered by governments. Their main advantages are that they provide the full faith and credit of the government and are part of the financial safety net. As a result, they are able to maintain depositor confidence even in times of great financial stress. Government-backed systems also tend to have the advantage of offering a clear legal obligation to pay depositors. Many private systems do not provide this degree of legal certainty.

agreements (ideally supported by legislation) be in place between the deposit insurer and other safety-net participants to facilitate information exchange and cooperation. Consideration is given in most of the systems to the use of formal mechanisms to exchange information and coordinate activities. For example, Hong Kong, Indonesia and Malaysia have these provisions incorporated into their legislation and appear to be developing standard operating procedures in these areas. In the Philippines, an agreement has been executed between PDIC and the Bangko Sentral ng Pilipinas in sharing information on banks.

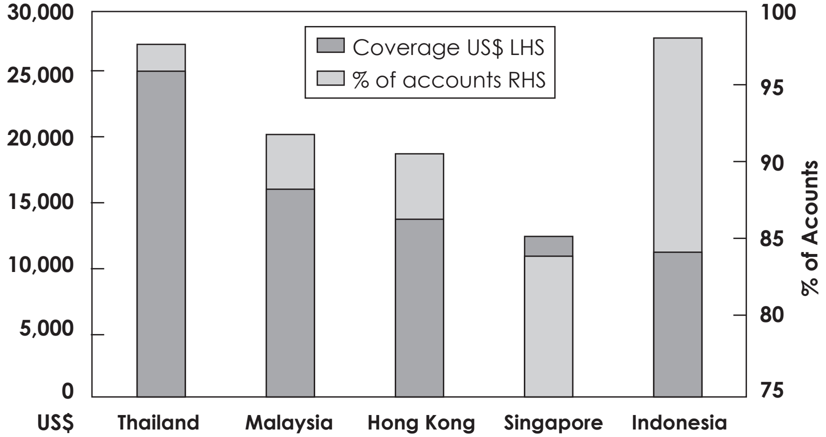
Membership

Compulsory membership has become increasingly common in the world and is recommended by the FSF Working Group (2001a) and Garcia (2000). All the East Asian systems require their major deposit-taking institutions to be members. Reflecting the importance of foreign banking institutions in their economies, Hong Kong, Indonesia, Singapore and Thailand extend or plan to extend membership to foreign bank branches. The risks of insuring foreign bank branches are generally dealt with in these economies through the use of asset maintenance requirements.

Coverage

Each of the new East Asian systems cover core demand and saving deposit products. Hong Kong, Indonesia, Malaysia, Singapore and Thailand exclude coverage of non-deposit products and sophisticated depositors. Hong Kong and Indonesia (along with the well established system in the Philippines) are the only systems covering foreign currency deposits. Provident funds placed in bank deposits are covered in Singapore. Islamic deposits receive separate protection in Indonesia and Malaysia.

New System Coverage Limits



The maximum coverage limits in all the East Asian systems appear to fully protect the majority of their small depositors. The highest proposed coverage level, in terms of the proportion of individual deposit accounts covered, is in Indonesia at 98.5%, followed closely by Thailand.[60] Indonesia's law also stipulates that in the failure of a systemic bank, depositors in these institutions will receive full 100% protection.

[60] Despite the high levels of individual deposit accounts coverage, the actual value of deposits protected is relatively low (i.e. estimated to be around 40% for Thailand and 38% for Indonesia).

Box 3

Summary of Sound Deposit Insurance Practices Suggested by IMF: Hoelscher, Taylor and Klueh (2006), and Garcia (2000)

In general, the infrastructure:

1. Have realistic objectives.
2. Chose carefully between a public or private deposit insurance system (DIS).
3. Define the DIS' mandate accordingly, ensure powers and resources provided are consistent with objectives and mandate.
4. Have a good legal, judicial, accounting, financial, and political infrastructure.

To avoid moral hazard:

5. Define the system explicitly in law and regulation. Conduct a public awareness campaign.
6. Give the supervisor a system of prompt remedial actions.
7. Resolve failed depository institutions promptly.
8. Provide low coverage.
9. Net (offset) loans in default against deposits.

To avoid adverse selection:

10. Make membership compulsory.
11. Risk-adjust premiums, once the DIS has sufficient experience.

To reduce agency problems:

12. Create an independent but accountable DIS agency.
13. Have bankers on an advisory board, not the main board of a DIS with access to financial support from government.
14. Ensure close relations with the LOLR and the supervisor supported well defined formal agreements.

To ensure financial integrity and credibility:

15. Start when banks are sound.
16. Ensure adequate sources of funding (ex ante or ex post) to avoid insolvency.
17. Invest funds wisely.
18. Pay out or transfer deposits quickly.
19. Organize good information on the condition of individual institutions and the distribution of deposits by size.
20. Make appropriate disclosure to maintain confidence while enabling depositors to protect their interests.

Although criticized by McLeod (2005) for allowing moral hazard problems to persist, this approach illustrates the overriding concern of Indonesian authorities with ensuring financial stability during the transitioning process. The lowest coverage level (as a proportion of accounts covered) is in Singapore, which covers around 84% of depositors.

Depositors (and the deposit insurer through subrogation) will receive additional protection in Hong Kong, Malaysia and Singapore from the existence of depositor priority in an insolvency.[61]

Funding

According to the FSF Working Group (2001a), member banks should pay for the cost of deposit insurance; there should be ex-ante and ex-post arrangements; and deposit insurers should consider the use of differential premiums when they can ensure that the necessary resources are in place to administer the system appropriately. All the new systems meet these good practices. In addition, a number of the systems have introduced target fund ratios. Indonesia has established a target fund ratio of 2.5% of deposits, and both Singapore and Hong Kong envision a ratio of 0.3% of insured deposits as being sufficient for their systems. It should be mentioned that it may take a considerable amount of time for most of these systems to build up the necessary funds to reach these targets.

Singapore and Hong Kong either have or aim to introduce differential premiums and expect to rely heavily on their supervisory system assessments as the basis for the scoring systems. Although the other economies have flat-rate premium systems in use or planned, Indonesia, Malaysia and Thailand have indicated plans

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[61] See Campbell, et al (2007) and Walker (2007).

to eventually introduce differential systems once they believe they have sufficient experience to implement them effectively.

Failure Resolution

Another area where differences have emerged is in failure resolution approaches. Malaysia's MDIC and Indonesia's IDIC have been given a range of powers over failure resolution and accompanying least cost resolution mandates. Malaysia has been provided with the power to conduct preparatory reviews in payout situations. Indonesia's IDIC is subject to a memorandum of understanding with the BOI so that it may conduct preparatory reviews of deposit liabilities or obtain the necessary information from the BOI.

The Philippines' PDIC has a comprehensive role in failure resolution, liquidation and receivership. Hong Kong's and Singapore's systems are not expected to have any resolution responsibilities as these are expected to remain the responsibility of their respective supervisory authorities. Thailand is considering providing its deposit insurance system with liquidation and receivership roles.

Public Awareness

Growing recognition of the importance of public awareness to promote the benefits and limitations of deposit insurance — particularly with respect to facilitating transitioning from blanket guarantees to limited explicit systems — has made this a strong feature of these new systems facing transitioning challenges. Significant resources are being devoted to programs underway in Malaysia and Indonesia. Public awareness is explicitly noted in deposit insurance statutes in these countries. Thailand plans to implement an extensive public awareness program to assist in transitioning to its limited explicit deposit insurance system.

5. China and Deposit Insurance

Presently, depositors in the People's Republic of China rely on a 100% implicit state guarantee for all deposits.[62] While China has experienced closures of banks and other deposit-taking institutions over the years, depositors in these institutions have generally been fully protected. This is typically accomplished by transferring their deposits to an acquiring institution or through direct reimbursement to depositors by the government. Problems with the "big four" banks have usually been dealt with by using public funds to recapitalize them and by purchasing their problem assets and disposing of them through state-controlled assets management companies (e.g. the Huarong, Orient, Cinda, and Great Wall companies).[63]

In its drive to reform its financial sector, China has announced its intention to introduce an explicit deposit insurance system in 2007. In fact, a special division of the People's Bank of China is now responsible for design and implementation of a scheme. Key objectives so far announced are to introduce fairer treatment among creditors; clarify the management responsibilities for failed banks; protect and compensate depositors in failed banks; and promote nationwide financial reforms.[64]

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[62] According to the BIS (2006), four large state banks dominate the Chinese financial system and control 60% of total assets in the banking system. The so-called "big four" are the Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and the Agricultural Bank of China. The remaining domestic banking institutions include three development banks, 112 commercial city banks, 211 foreign bank branches, 220 foreign bank representative offices and about 28,000 rural co-operative banks. Many of the newly emerging banks in China are private and have an implicit government guarantee but are not viewed as being as safe as the large state owned banks.

[63] Ibid.

[64] See Hatano (2005).

As development of the scheme progresses, designers of the deposit insurance system will also need to deal with some major financial restructuring issues. For instance, China is in the process of privatizing many of its state banks and this is expected to be a long and involved process. In addition to dealing with the very large state banks, there are approximately 28,000 rural cooperative banks which need to be consolidated in an orderly fashion.[65] Difficult issues will need to be decided such as, will deposit insurance be extended to all remaining state banks or only private banks?

So far, the supervisory, legal and accounting regimes in China are being restructured in an effort to improve the governance and risk management of the financial system. As an example, China has established a separate supervisor – the China Banking Regulatory Commission (CBRC) in April 2003. The CBRC has introduced a risk-based supervisory system and tightened governance and risk management standards for the banking sector and is developing a new corporate bankruptcy law. China has already set up a securities investor protection fund and an insurance policy holder protection fund. The deposit insurance system will need to be consistent with this framework to be effective.

Other questions which need to be addressed are whether the new deposit insurance system will have a limited or extensive risk minimizing mandate; what will be its membership requirements and coverage limits and how it will be funded. And, very importantly, how will transitioning from blanket guarantees to a limited explicit system work. Will it be immediate or occur in stages spread out over time? Early indications are that it will occur slowly in tune with other financial sector reforms.

[65] See Bekier, Huang and Wilson (2005).

The last issue to consider is whether the authorities will actually use the deposit insurance system they create to close banks and reimburse insured depositors. In their history, state authorities in China have been very reticent about imposing losses on creditors in bank failures.

6. Regional Cooperation

Another issue with deposit insurance in East Asia is regional cooperation. Given that these new deposit insurance systems are being set up at similar times one could ask how all the region's insurers could work together more effectively to build their capabilities and deal better with the failure of a bank operating in multiple jurisdictions.

With respect to information sharing and capacity building, a good example of regional cooperation has been made by IADI in setting up an Asia Regional Committee (ARC) of Deposit Insurers. The Committee has a mandate to reflect regional interests and common issues through the sharing and exchange of information and ideas. Committee members hold regular meetings and conferences throughout the region and have undertaken research into issues such as: transitioning from blanket guarantees to limited coverage systems; developing guidance on failure resolution; and, examining liquidity issues for deposit insurers. Nevertheless, there may be other opportunities to cooperate in the future such as pooling regional information management resources and partnering with other international organizations such as the IMF and Asian Development Bank (ADB) in the further development of their respective deposit insurance systems.[66]

Finally, with the increasing growth in international banking activities, future failures may well occur in entities with more extensive business throughout the region. And, since many of these institutions' foreign branches are increasingly covered by host country deposit insurance systems, this may become a major issue with the new schemes. Thus, pursuing opportunities for more formal cooperation

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[66] See IADI (2004).

and information sharing between deposit insurers and supervisory authorities in the region will also contribute to dealing more effectively with bank failures. An example of this could be the development of formal agreements such as Memoranda of Understanding (MOU) between various deposit insurers and between deposit insurers and supervisory authorities. Areas which could be addressed include: exchange of information on the financial condition and performance of problem banks; coordinating intervention and closure activities; sharing information on deposit liabilities and the dispositions of assets of failed banks.

7. Conclusions

Deposit insurance was first introduced into East Asia by the Philippines in 1963, followed by Japan in 1971, Taiwan in 1985 and Korea in 1996. However, it was the advent of the Asian financial crisis in 1997 which spurred the rapid development of new deposit insurance systems in the region. Since the crisis, new systems have emerged in Hong Kong, Indonesia, Malaysia, Singapore and Vietnam while pre-existing systems — such as those in the Philippines, Japan and Korea – have been enhanced from experiences gained during the crisis. Thailand and the People's Republic of China are planning to introduce their own deposit insurance systems shortly.

Although each of these systems was designed to meet specific country circumstances, their designers have sought to adopt evolving good practices in developing their deposit insurance systems. As a result, the systems share similarities in their objectives and design features such as governance, membership, funding and approaches to public awareness. For instance, all the new systems require compulsory membership and will be pre-funded to a large extent from insurance premiums charged to their member banks. Public awareness of the terms and conditions of deposit insurance has been recognized as important and included in the responsibilities of many of the insurers. And, all the systems are now set up as separate legal entities with varying degrees of operational independence.

The major differences arise in the areas of mandates and coverage levels. To a large extent, this reflects differing country circumstances. For example, Hong Kong and Singapore opted to restrict their deposit insurers to very narrow mandates focused on making payouts to insured depositors in the event of bank liquidation — reflecting concerns with making the most efficient use of their limited supervisory resources.

Meanwhile, Indonesia and Malaysia have provided their insurers with broader failure resolution powers and requirements to seek least-cost resolutions. The Philippines provided its insurer with a crucial role in failure resolution, liquidations and examination. This flows from experience in having to resolve a large number of banking failures and to do everything possible to minimize losses in the resolution process.[67]

In addition to the challenges of building new deposit insurance systems, Indonesia, Malaysia and Thailand are dealing with the special challenge of transitioning from explicit blanket guarantees to limited coverage deposit insurance. In some cases, the development of deposit insurance systems and the removal of blanket guarantees have been postponed due to concerns over the withdrawal of large deposits from banks if these guarantees are eliminated too quickly. As a result, Indonesia and Thailand plan to rely on long transition periods, and at least initially, relatively high coverage limits to make transitioning more acceptable. More stable environments in Hong Kong, Malaysia, and Singapore have allowed authorities there to provide more limited coverage.

What about future developments in deposit insurance systems in the region? Certainly, one important new development will be what system emerges in the People's Republic of China and what implications this may have on deposit insurance systems in other East Asian economies. Another issue is regional cooperation. Given that these new deposit insurance systems are being set up at similar times one could ask how the region's insurers could work together more effectively to build their capabilities. A good start has been made by IADI in setting up a regional committee of deposit insurers to share information and experiences. There may also be other opportunities to cooperate in the future such

[67] Campbell, et al (2007).

as pooling regional resources and building partnerships with other international organizations.

Finally, with the increasing growth in international banking activities, future failures may well occur in entities with more extensive business throughout the region. And, since many of these institutions' foreign branches are increasingly covered by host country deposit insurance systems, this may become a major issue with the new schemes. Thus, pursuing opportunities for more formal cooperation and information sharing between deposit insurers and supervisory authorities in the region could also contribute to dealing more effectively with bank failures.

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