International Association of Deposit Insurers

Transitioning from a Blanket Guarantee to a Limited Coverage System

Research Paper

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I. INTRODUCTION

Occurrences of financial crisis have increased in the wake of the financial globalization and liberalization of the past decade. In countries where such crises have emerged, governments have mobilized public funds to extend a “blanket guarantee” for deposits. The reasons for doing so vary from country to country, but in each case the common policy objective has been to stabilize financial order, maintain depositor confidence and prevent the collapse of financial and payment systems during times of systemic crisis.

Since a blanket guarantee can lead to increasing moral hazard and higher costs in disposing of problem institutions, most such systems are structured as transitional mechanisms. When financial stability is restored, governments need to consider returning to a limited coverage system at a suitable time, and to plan supporting measures for a smooth transition.

The Research Subcommittee of the Asia Regional Committee (ARC) of the International Association of Deposit Insurers (IADI) has conducted research on the issue of transition from blanket guarantee to limited coverage. The Central Deposit Insurance Corporation, Taiwan (CDIC) has taken responsibility for this research and conducted a questionnaire-based survey among IADI members regarding the adjustment of deposit insurance systems, current status of financial systems, timing of the shift to limited coverage, and measures taken to inform the public about the change (public awareness propaganda). This research paper is based on information available on September 26, 2005.

II. BACKGROUND AND KEY POINTS OF BLANKET GUARANTEE SYSTEMS

A. Background and Objectives

Since the 1980s, financial liberalization and globalization have gathered pace around the world. The integration of the global financial system, the emergence of new financial technologies and products, and developments in international finance have all expanded the scope of financial activities.

However, these changes have been accompanied by intensifying competition, which has increased the risks faced by financial institutions. When these institutions fail, the failure not only damages depositors but also disrupts financial order and impedes the sound development of a nation's economy and financial sector.

In the 1990s, the global economy was shaken by a series of financial crises in Scandinavia, Latin America, and Asia. Governments around the world needed sufficient time to deal with problem institutions, minimize bankruptcies, and thereby prevent or contain an outbreak of systemic financial crisis. Several measures were taken to deal with the situation; for example, provision of liquidity by central banks, restructuring of capital, and introduction of a blanket guarantee system to maintain the stability of financial systems. The aims of the blanket guarantee system were to prevent depositor panic or capital flight, and to maintain financial stability so as to permit large-scale financial reform and restructuring, which assists in restoring economic health and strengthening financial supervision, etc.

Taking the IMF report by Garcia (2000) and the 2004 CDIC transition project survey as our basis, we find that more than ten countries have implemented blanket guarantee systems. Most of them did so as an emergency measure to prevent or contain the outbreak of systemic financial crisis[1] (See Table in Appendix).

B. Key Implementation Points

1. Types of blanket guarantee systems adopted

According to the results of a questionnaire-based survey, most governments adopting blanket guarantee systems announced explicit guarantees for depositors and creditors. Countries adopting explicit blanket guarantee systems can be further divided into those with and those without deposit insurance systems:

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1 Among the countries surveyed, Hungary was the exception. During the centralized planning period of 1952 to 1993, personal deposits in Hungary were insured in accordance with national law, rather than as a result of financial crisis.

(a) In countries without a deposit insurance system (or before its establishment), the blanket guarantee system aimed to protect depositors' rights during a period of financial crisis. They include Sweden (before 1996), Thailand, Malaysia, Indonesia, and Jamaica (before 1998).

(b) In countries with a deposit insurance system, current coverage expands the scope of protection afforded to depositors and creditors, from limited coverage to the blanket guarantee, in the event of a financial crisis. Such countries include Finland, Japan, Korea, Turkey, Mexico, and Taiwan.

2. Scope of blanket guarantees

From our survey, we found that in most countries the blanket guarantee system covered the liabilities of financial institutions to their depositors and creditors.

However, most governments, constrained by funding, limited the scope of the guarantee to core banking institutions in order to control costs. In such cases, priority for covered institutions was generally given to commercial banks that served as deposit and lending intermediaries, and provided payment services. Nevertheless, in some countries non-bank financial institutions were also covered. In countries such as Korea and Malaysia, coverage extended to the overseas branches of domestic banking institutions.

3. Blanket guarantee period

Most of the countries surveyed had established clear implementation periods for their blanket guarantee systems. The main reason was to avoid encouraging moral hazard. When the deposits and non-deposit liabilities of banks were fully guaranteed, the costs of moral hazard, such as embezzlement of assets by bank officials or high-risk lending, were borne by the taxpayer. Depositors, moreover, became less concerned about the risks assumed by the institutions they banked with under the blanket guarantee system.

Most countries only implemented the system for a few years and announced a date for its removal. For example, Korea, Japan, Mexico and Taiwan have set target dates[2]. However, some countries, like Malaysia and Thailand, have set no deadline. In the case of Malaysia, the blanket guarantee expired on September 1, 2005, with the introduction of limited coverage. And according to Thailand's survey response, no specific date for removal of the blanket guarantee has been set – it will expire when the deposit insurance agency is launched.

4. Reasons for extending the blanket guarantee period

As just noted, the majority of countries in our survey have announced expiration dates for their blanket guarantee systems. Some countries, however, have extended the deadline due to slower-than-anticipated progress of financial recovery and reconstruction. For example, Japan and Taiwan extended their blanket guarantee once.

In Japan, the "complete" blanket guarantee system was originally in force from June 1996 to the end of March 2001, approximately five years. The government initially hoped that the financial system could be restored by March 31, 2001; however, in April 2000 the authorities announced that the system would be extended to March 2002, as it was not appropriate to terminate the arrangement, given economic conditions, especially in the banking sector. In April 2002, the "complete" blanket guarantee system came to an end and deposits, except for current, ordinary and specified deposits, were shifted to limited coverage. In April 2005, Japan introduced "complete" limited coverage for all deposits except payment and settlement deposits.

In Indonesia, the government determined that the financial markets and financial institutions were not yet ready to accept the cancellation of the blanket guarantee. The authorities have therefore agreed to extend the deadline until a deposit insurance system is established.

In the case of Taiwan, the government set up the Financial Restructuring Fund in July 2001 as the basis for its blanket guarantee system. By July 2004, the original expiration date, the fund had disposed of 44 problem community institutions. However, since some underperforming institutions

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2 Japan and Taiwan adjusted their targets as the deadline approached.

remained, Congress extended the fund implementation period stipulated in the Financial Restructuring Fund Statute by one year, to July 2005. In June 2005, the government amended the Financial Restructuring Fund Statute to expand the scope of the fund, while also continuing to carry out related financial reforms, so as to ensure the smooth market exit of problem institutions.

5. Funding sources

Blanket guarantee systems are funded by premium payments and, in most cases, by public revenues from taxes and asset sales. Generally speaking, the majority of funding comes from public funds. When the financial system cannot afford to share the funding cost of a blanket guarantee system, most governments draw on a large public fund in order to deal with financial crises, anchor depositor confidence, and carry out necessary financial reforms.

The CDIC 2004 survey found that public funding as a share of GDP amounted to 20% or more in Korea; 10% or more in Sweden, Thailand and Mexico; and under 10% in Indonesia[3] and Taiwan.

III. NECESSITY OF TRANSITION TO LIMITED COVERAGE, AND EXTERNAL FACTORS TO BE CONSIDERED

During the period of transition from a blanket guarantee to a limited coverage system, governments need to carefully consider several factors in order to minimize disruption to the financial order.

A. Reasons for Setting a Period of Transition

In some countries, a transition period is stipulated by law prior to the implementation of a blanket guarantee system. In others, no transition period is stipulated. Nevertheless, a transition period for the changeover to

3 This figure rises to 40% if the cost of the capital restructuring fund is included.

limited coverage may still be necessary in these cases due to the following considerations:

1. Controlling moral hazard

We may know that blanket guarantee systems can increase moral hazard. But it is hard to evaluate the impact, in moral hazard terms, of introducing a blanket guarantee. In order to contain moral hazard, some countries have announced that the blanket guarantee is only a temporary measure. For example, Indonesia, Japan, Korea, Mexico, Thailand, and Taiwan have announced that their blanket guarantee will be replaced by a system of limited deposit protection.

2. Limiting the cost to society

Under a limited coverage system, deposits in problem or failed financial institutions are only protected up to the maximum coverage amount. A blanket guarantee system, on the other hand, enables problem institutions to deal with their problems using public funds. This can encourage bank managers to engage in unscrupulous and high-risk operations, thereby increasing the overall cost to society. It may also force sound institutions to compete on price with unsound financial institutions, thereby exacerbating the problem and indirectly creating risk for deposit insurance providers.

B. Considerations in the Transition Process

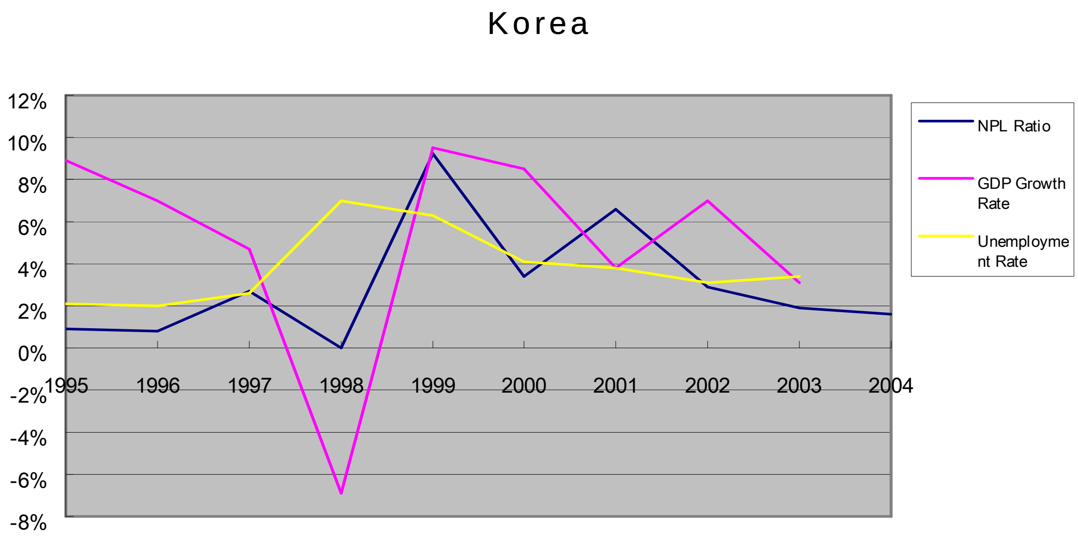
The transition from a blanket guarantee to a limited coverage system should be handled in a manner that balances financial safety and stability with efficient and beneficial financial development. Our survey revealed several conditions and indicators for identifying the right time for transition:

1. Overall economic situation

The main factor in determining the timing of transition to limited coverage is a country’s overall economic health. Among the countries surveyed, some continued with a blanket guarantee or a high level of coverage until the economy as a whole had improved or recovered.

Figure 1 shows the trend of economic growth, unemployment, and non-performing loan ratios in Korea, Malaysia, and Taiwan during the blanket guarantee and transition to limited coverage.

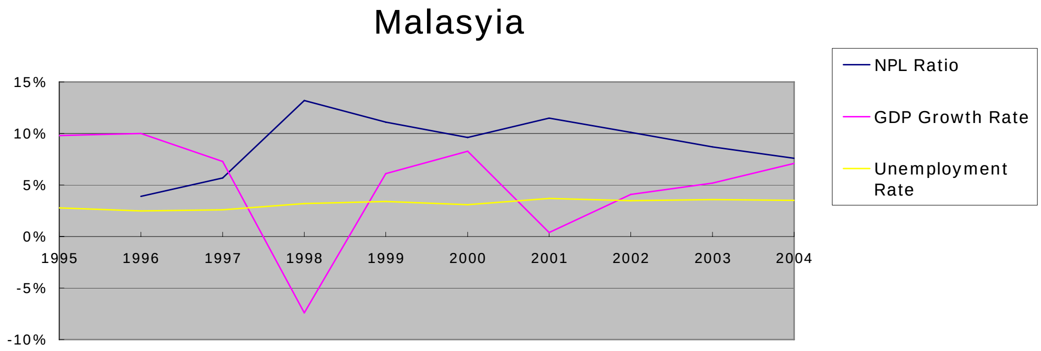
Figure 1: Korea



In Korea, the government adopted a blanket guarantee in December 1997 to see the economy through a period of financial problems. The blanket guarantee was set to expire in three years. The government used this period to carry out major financial reforms.

The GDP growth rate rose from –6.9% in 1998 to 8.5% in 2000. Moreover, at the end of 2000, the NPL ratio had fallen to 3.4%, from 9.2% in 1999. With the economy clearly back on track, the government returned to the limited coverage system in January 2001, as scheduled.

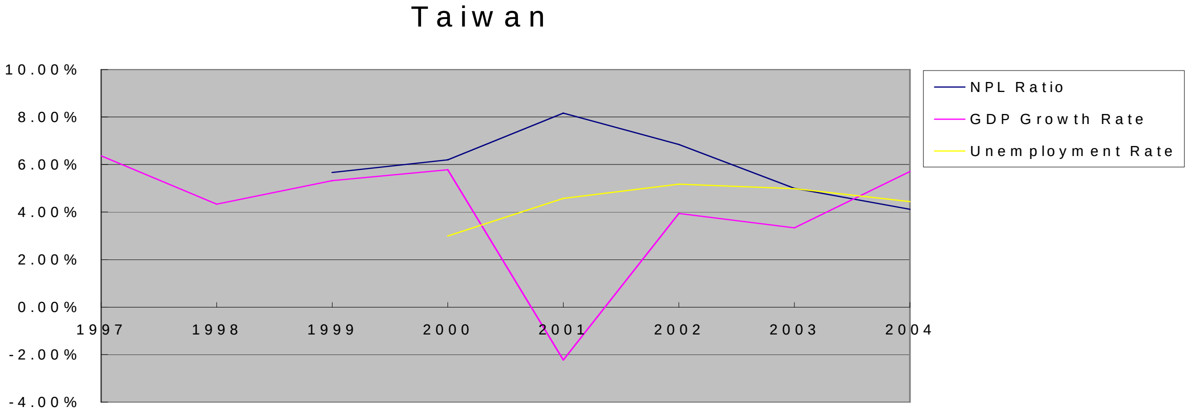
Figure 2: Malaysia



Owing to the severity of the 1997 economic and financial crisis, the government adopted an explicit blanket guarantee in 1998. From the chart, we can see that the economy and financial system were worst in 1998. But one year later, they had begun to improve. The GDP growth rate recovered to 7.1% in 2004, from –7.4% in 1998. The NPL ratio decreased from 13.2% in 1998 to 7.6% in 2004 [4]. Finally, on September 1, 2005 Malaysia established an independent statutory deposit insurance corporation to administer the deposit insurance system.

Figure 3: Taiwan

In 2001, when Taiwan adopted the blanket guarantee system, the overall condition of the economy and the financial system was at its worst.



4 NPLs were sold by banks to Banaharta. A total of RM 19.7 billion worth of NPLs

But one year later, all three curves had improved substantially. In 2004, the GDP growth rate rose to 5.7%, from –2.2% in 2001. The NPL ratio decreased from 8.2% in 2001 to 2.9% in June 2005. In July 2005, Taiwan shifted to the limited coverage system smoothly and there was little shock effect on the financial market.

2. Condition of the financial system

The timing of the transition to a limited coverage system needs to be carefully considered, as regards the impact on financial markets. Before transition, it is important to confirm that the circumstances which initially motivated the adoption of the blanket guarantee have been appropriately resolved.

In Taiwan, for example, the Financial Restructuring Fund was underfunded and there were some problem institutions which were not competitive and not well operated by their management, and which had not yet been disposed of by the original expiry date of the blanket guarantee. It was therefore necessary to extend the original expiry date of the fund and list all problem institutions which needed to be dealt with before expiry, in order to continue the later disposal procedure.

Moreover, when a financial system shows signs of instability or weakness, the transition to limited coverage might only deepen that instability and increase the overall costs to the financial system. Before transitioning to limited coverage, the countries surveyed had at least achieved a certain degree of financial stability. In Korea, for example, financial institutions had a negative ROE, of –14.2%, in December 1997, when the government decided to enact a transitional blanket guarantee. The rate was improved through the transitional period, reaching –11.9% in 2000 and 15% in 2001.

IV. MEASURES TO BE CONSIDERED IN THE TRANSITION TO LIMITED COVERAGE

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were sold at a purchase price of RM 9 billion.

A. Strengthening the deposit insurance system and its mechanism

In most countries with a deposit insurance system, a deposit insurer, usually in conjunction with competent financial authorities, is an executive agency in charge of the transition from a blanket guarantee to a limited coverage system. Such countries include Korea, Japan, and Taiwan. Among countries providing an implicit blanket guarantee without a deposit insurance system, the transition to limited coverage occurs when a deposit insurance system is set up, as in Indonesia and Mexico. In those cases, the establishing deposit insurance agency is also in charge of carrying out the transition.

Meanwhile, prompt pay-off to depositors can also help maintain depositor confidence. In Japan, the transition to “complete” limited coverage was implemented at the same time as improvements to the pay-off system. For example, the Deposit Insurance Corporation of Japan strengthened its inspections of insured institutions in order to quickly handle claims and ensure that name-based aggregation was correctly processed in the event of bank failures under the limited coverage system.

B. Transition approaches

Two general approaches have been taken to transition from blanket guarantee to limited coverage systems. One approach is to set a deadline for the blanket guarantee to revert to a limited coverage system. This is known as the “Fast Approach”.

Under the “Gradual Transition” model, by comparison, a deadline is set but the scope and amount of the guarantee are reduced gradually so as to minimize the impact on financial markets and depositors. The gradual approach gives bank shareholders, depositors, and other interested parties ample time to adjust to the new system. However, an overly long transition period can create uncertainty over the implementation of the limited coverage system and hamper the ability to control moral hazard. Among the countries we surveyed, the gradual transition approach was adopted by Japan, Indonesia, Turkey, and Mexico. In these cases, the transition was accomplished through a phased lowering of the scope and ceiling of coverage. The fast transition approach was adopted in Jamaica, Finland, and Sweden following the completion of financial reconstruction[5].

C. Coverage amount

Each country has taken a different approach to the issue of whether or not to raise the coverage ceiling when reverting to limited coverage. In Korea, the government raised the maximum coverage from 20 million won to 50 million won to prevent the return to limited coverage from triggering large deposit fluctuations. Japan, on the other hand, kept its ceiling at 10 million yen, while maintaining full coverage for settlement and payment deposits as a permanent measure.

Most countries surveyed, including Sweden, Finland, Hungary, Japan, Jamaica, and Korea, set their post-transition coverage ceiling at one to four times per capita GDP. A smaller number, however, such as Turkey and Mexico, adopted ceilings of 10 or more times per capita GDP. In countries taking the latter approach, the high coverage rates per capita GDP could have weakened market mechanisms but they also served to anchor depositor confidence and reduce deposit fluctuations. This helped to limit the impact of the transition and allowed for a smooth shift to a limited coverage system.

D. Deposit items

When shifting to a limited coverage system, the items insured under deposit coverage also may be reviewed at the same time. Especially with a gradual transition approach, the list of insured items may be adjusted during different phases of the transition, though such items are not necessarily the same in every country.

E. Premiums

The decision over whether or not to increase deposit insurance premiums depends on the funding level of the deposit insurance fund. In Korea and Japan, the DIF was used during the blanket guarantee period to

[5] In Hungary, another transition approach has been adopted to stabilize depositor confidence and smooth the transfer to a limited coverage system as the country reforms its planned economy. A fast-track approach has been employed for new deposits and a gradual approach for old deposits.

dispose of problem institutions. After the transition to limited coverage, the deposit insurance premium was raised to build up the DIF.

Korea increased its premium rates from 0.05% to 0.1% in 2001. In Japan, when the “complete” blanket guarantee was implemented in 1996, premiums were raised from 0.012% to 0.084% (ordinary premium of 0.048% + special premium of 0.036%), and were maintained at almost the same level even after the return to a “complete” limited coverage system. Reflecting the different coverage level, in 2005 Japan imposed different premium rates for ordinary deposits (0.083%) and for settlement and payment deposits, which are under full coverage (0.115%).

F. Funding sources

During a transition period to limited coverage, a certain amount of deposits will be shifted to other institutions, creating liquidity problems for financial institutions. In some cases, bank runs may also occur. Guaranteeing bank liquidity is therefore a major consideration in preventing such problems. Some countries, including Korea and Indonesia, provide liquidity through their central banks.

Another important factor is the ability of the deposit insurance fund to effectively deal with problem institutions. In some countries, the amount of the deposit insurance fund was negative during transition phases. In order to ensure that deposit insurance funds operate independently and normally, in Korea, for example, a DIF Bond Repayment Fund was established since the original deposit insurance fund separated assets and liabilities in financial restructuring work. In 2003, this new DIF was relaunched as an independent entity and put in charge of the subsequent disposal of problem institutions and related costs.

G. Public awareness

It is important that the transition be accompanied by a strong campaign to build public awareness and the dissemination of accurate information to financial institutions, depositors, and creditors. This can prevent confusion among the public over the extent to which their interests are covered and also can help to maintain order in the financial system.

In countries where the transition is underway, depositors should be the principal target of awareness-building campaigns. The most important information is the maximum coverage amount, followed by the timing of the transition to limited coverage. Some countries also have included the scope of insured deposits in their promotional efforts. Both Japan and Korea launched large-scale public awareness campaigns prior to transition, including presentations by deposit insurance authorities at large public events to publicize the main concepts of transition. Information on the return to limited coverage was also disseminated to depositors through insured institutions or media channels, such as print advertisements and the arrangement of seminars. In addition, public surveys were carried out to gauge awareness of the transition.

Promotional work should be started as early as possible to allow sufficient time for financial institutions and depositors to gradually accept the change and for the transition to achieve its intended results. In Korea, for example, the public awareness campaign was launched two years before the transition to limited coverage.

H. Other measures

The following points can be mentioned as further measures to be considered in the transition to limited coverage, especially as they are regarded as difficult for the deposit insurance system alone to deal with.

1. Implementation of comprehensive financial supervision mechanisms

A clear and comprehensive legal basis and supervisory framework can enable an efficient transition to a limited coverage system, and a robust set of accompanying arrangements can provide for the smooth operation of the new mechanism.

In most of the countries surveyed, the transition to limited coverage was preceded by the introduction of measures related to corporate governance, information disclosure, credit rating, enterprise reconstruction, and prompt resolution. The implementation of these mechanisms, moreover, was further strengthened after transition.

2. Strengthening financial supervision mechanisms

Market discipline under a limited coverage system needs to be rooted in a transparent accounting system and public disclosure of information. In Korea, the mechanism for information disclosure was established before the transition and was enhanced during the transition process. In 1998, Korea revised its financial supervision regulations to bring them into line with international accounting standards. Other supporting measures have been introduced in the areas of prompt corrective action, credit rating, and corporate governance. Most of the countries surveyed already had such mechanisms in place and simply continued to enforce them after shifting to a limited coverage system. Some countries began to establish relevant mechanisms (such as prompt corrective action) in conjunction with financial reforms during the blanket guarantee period to strengthen the financial system.

3. Strengthening mechanisms for dealing with problem institutions

We know from experience that some countries established systems for injecting capital into problem institutions in order to raise their capital adequacy ratio. In Korea, problem institutions with a “Basel ratio” of less than 10% were provided with capital injections to help them improve. In Japan, the government also bought up shares in problem institutions so as to boost their capital reserves.

Japan and Korea also continue to implement other mechanisms to support the restructuring of financial institutions, including acquiring non-performing loans and restructuring enterprises.

V. CONCLUSION

It can be concluded that, from the findings of our research and survey, the limited coverage system is more appropriate for maintaining a sound and stable financial system in most of the countries. It can thus be said that a blanket guarantee system should be removed and replaced by a limited coverage system as soon as is feasible. In other words, a blanket guarantee system should be regarded as only a temporary measure and should be followed by the creation of or return to a limited coverage system once financial stability is achieved, because a blanket guarantee system may have a negative impact on the financial system and the economy as a whole.

When a country is faced with a financial crisis, its government tends to mobilize public money or introduce special premiums to fund a blanket guarantee system. This can, in certain respects, be an effective tool to prevent bank runs and the collapse of financial and payment systems. Also, by preventing the outbreak of a systemic crisis, a blanket guarantee system can provide time in which to deal with problem institutions and carry out financial reconstruction.

However, a blanket guarantee can lead to an increase in moral hazard and a decrease in the efficiency of bank risk management, resulting in higher costs to society in the end.

Several factors need to be considered during the transition to limited coverage. First and foremost must be the state of the economy. In most cases, the countries studied had improved their economic situation and financial system before establishing or returning to a limited coverage system.

With regard to deposit insurance systems, a sufficiently large deposit insurance fund should be built up and the efficiency of pay-out work should be improved to anchor depositor confidence and dispose of problem institutions in the most expedient and cost-efficient manner. In addition, it is necessary to consider whether the coverage limits, premium rates, and coverage scope should be adjusted. Furthermore, it is advisable to establish a clear mechanism for dealing with future systemic financial crises. Such mechanisms should forgo limits on least-cost resolution and maximum coverage in order to provide the flexibility needed to respond to crises.

In the area of public awareness, information should be disseminated as quickly as possible so as to raise public consciousness and allow enough time for the public to respond to such changes.

On the other hand, the financial supervision sector should be strengthened through the implementation of a prompt corrective action (PCA) mechanism, and the establishment of capital-based regulation for the purpose of effective supervision. In addition, it is advisable to strengthen mechanisms for coordination and cooperation among the financial safety net players to maximize the combined efficacy of that safety net in maintaining the stability of the financial system. With regard to the regulatory environment, relevant laws and regulations should be amended and brought into line with rules on corporate governance, international accounting standards, public disclosure of information, and other systems.

Finally, as mentioned above, a blanket guarantee system should be regarded as a temporary measure to weather financial crisis and turbulence. And it should be replaced by a limited coverage system at the appropriate time. The more complete the supporting measures, the greater the likelihood that a negative impact on financial markets can be prevented or minimized.

APPENDIX

Table: Overview of Blanket Guarantee Systems by Country

Country	Period	Duration	Extended	No. of Extensions	Reason for Extension	DIS in Place at Time of Transition	Transition Approach	Notes
1. Sweden	1993.1–1996.7	~4 yrs	No			No	Fast	Blanket guarantee cancelled with the implementation of DIS in July 1996
2. Finland	1993.2–1998.12	~6 yrs	No			Yes	Fast	
3. Japan	1996.6–2002.3 (Note 1)	~6 yrs	Yes	1	State of banking sector did not allow end of blanket guarantee	Yes	Gradual	
4. Korea	1997.12–2000.12	~3 yrs	No			Yes	Fast (Note 2)	
5. Thailand	1997–	7+ yrs				No	Not Stated	Blanket guarantee to be lifted with establishment of DIS in 2006
6. Malaysia	1998–2005.8	7+ yrs				No	Fast	DIS was established on Sep. 1, 2005 to replace the blanket guarantee.
7. Indonesia	1998.1–2007.1	8 yrs	Yes	1	Need for further financial market stabilization	No	Gradual	Blanket guarantee to be lifted with establishment of DIS in Feb. 2007

Country	Period	Duration	Extended	No. of Extensions	Reason for Extension	DIS in Place at Time of Transition	Transition Approach	Notes
8. Taiwan	2001.7–2005.7	4 yrs	Yes	1 (Note 3)	Ongoing disposal of problem institutions; ongoing financial reforms	Yes	Fast	
9. Turkey	2000.12–2004.7	~4 yrs	No			Yes	Gradual	
10. Jamaica	1997.1–1998.8	~2 yrs	No			No	Fast	Blanket guarantee lifted with establishment of DIS in Aug. 1998
11. Mexico	1990–1999	~10 yrs	No			Yes	Gradual	DIS established in 1999; limited coverage commenced in Jan. 2005

Notes:

(1) From April 2002 to March 2005: Only current deposits, ordinary deposits and specified deposits were fully protected (others such as time deposits, installment savings, money in trust under the guarantee of principal, and bank debentures were excluded in March 2002).
From April 2005, only payment and settlement deposits (bearing no interest, being redeemable on demand and providing normally required payment and settlement services) will be fully protected.

(2) In August 1998, Korea limited the scope of the blanket guarantee on principal and interest for deposits up to 20 million won, while for deposits above 20 million only the principal was covered. In 2001, Korea shifted to limited coverage and raised the maximum coverage from 20 million won to 50 million won. A blanket guarantee on checking deposits and other non-interest-bearing deposits was extended to the end of 2003.

(3) The fund was to have been operative for a period of three years from July 2001 to July 2004, as stipulated in the Financial Restructuring Fund Statute. However, the period was extended by one year to July 2005 with the approval of Congress.

Sources:

(1) Gillian G.H. Garcia, 2000, “Deposit Insurance Actual and Good Practices”, IMF.
(2) CDIC Transition Survey, 2004.