March, 2012

Transitioning from a blanket guarantee or extended coverage to a limited coverage system

Discussion Paper

Prepared by the Research and Guidance Committee
International Association of Deposit Insurers

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TABLE OF CONTENTS

I. EXECUTIVE SUMMARY

The mission of the International Association of Deposit Insurers is to contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation. As part of its work, IADI undertakes research to provide guidance on deposit insurance issues. The findings and recommendations presented in this paper are preliminary, and their objective is to provide future guidance for countries considering or in the process of transitioning from a blanket guarantee or extended coverage to a limited coverage system.

A. Background

The main objective of deposit insurance systems is to avoid bank runs by small and uninformed depositors looking to protect their deposits. Large depositors are left largely unprotected, as they are considered to be better informed and thus in a better position to exert discipline on banks. In normal times, deposit insurance systems, together with lender-of-last-resort facilities, have a stabilizing effect by reducing the risk of contagion to illiquid but solvent banks and facilitating the orderly resolution of troubled banks.[1]

However, the effectiveness of deposit insurance systems in preventing bank runs is acutely weakened when large depositors and other counterparties are unable to appraise the solvency of individual banks and lose confidence in the overall stability of the banking system. This becomes particularly problematic in systems where short-term wholesale funding is dominant. In such conditions, extended deposit insurance coverage may turn into a necessity.

Governments may use extended insurance coverage to stabilize their financial systems in the absence of institutional, political or fiscal conditions to address the existing problems, despite the general understanding that this measure entails moral hazard. Extended deposit insurance coverage or blanket guarantees were a common response to the problem of bank runs and contagion during the international financial crisis of 2007/2008; they were introduced as an emergency measure to restore depositors' confidence while avoiding systemic implications.

A blanket guarantee can take different forms: the first is a combination of different policy measures which in concert help stabilize the system;[2] the other is when a blanket guarantee is openly enacted with a timeframe, or a declaration of full coverage is made by governments without a pre-determined time limit. Also, governments may often begin by extending deposit insurance coverage (level and/or scope) as the first action to prevent bank runs. If this fails, or if the financial

[1] Erik Feyen and Dimitri Vittas, "Blanket Guarantees. Necessary during the Crisis, but What Next?", Crisis Response, Public Policy for the Private Sector, World Bank, Note Number 4, June 2009.

[2] An example is what the US implemented during the crisis, which included an increased coverage limit to USD 250,000, plus the Federal Reserve's liquidity measures, plus the Troubled Asset Relief Program.

means of the government are limited, then a blanket government guarantee is officially declared.

In theory, if credible, both approaches can prevent bank runs.[3] However, the common feature is that both are disruptive to the financial system; they can add substantial fiscal costs to bank restructuring programs while lengthening the duration of the crisis, and cause moral hazard going forward. Of course, the guarantee itself carries no immediate cost; that is, the cost of the guarantee is equal to the financial shortfall in the banking system. If the system is relatively robust, the cost will be small; if the system is severely undercapitalized, the fiscal cost will be equal to the recapitalization of the system. However, it was a strong commitment device which signaled the willingness of the authorities to take action in order to avert the international financial crisis of 2007/2008. To contain both the risk of moral hazard and the fiscal cost, governments limit the volume and duration of the full guarantee.

Moreover, the adoption of extended deposit insurance coverage as an emergency measure will inevitably shape the expectations of banks and investors concerning government intervention in future financial crises. These expectations may influence their behavior, diminishing the monitoring incentives for investors while encouraging increased risk-taking by banks. Extended deposit insurance coverage distorts the marketplace by reducing the possibility of loss from bad business judgment, thus increasing the moral hazard, which continues to grow as the extended coverage approaches a full coverage or blanket guarantee.

Due to the distortions that extended deposit insurance coverage generates, it should be seen as a temporary measure, to be withdrawn when normal economic and financial conditions are restored. It is important to note that, although a blanket guarantee is not a tool for deposit insurers, but governments, the deposit insurer should play a central role in deciding when to withdraw this guarantee, in order to ensure a smooth, effective transition.

B. Suggested IADI guidance

Core Principle:[4] Transitioning from a blanket guarantee to a limited coverage deposit insurance system

When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as the circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.

[3] The success of extended insurance coverage in preventing bank runs depends, among other factors, on funding constraints and macroeconomic stability. “Deposit Insurance, Moral Hazard and the Risk of Runs”, Nancy Silva, Central Bank of Chile, Working Papers, N° 474, June 2008.

[4] See Appendix I for the definition of “core principle” and “supporting guidance points”.

Main conclusions and supporting guidance

The following points of guidance summarize the main conclusions and recommendations to help policymakers in the process of transitioning from a blanket guarantee to a limited coverage deposit insurance system. These points are reflective of, and adaptable to, a broad range of circumstances, settings and structures.

1. Extended deposit insurance coverage involves trade-offs. It can significantly reduce the incidence of bank runs, or halt runs in jurisdictions during a crisis or other shock to the financial system, if implemented in the presence of strong prudential supervision and resolution regimes; or it may fuel future bank crises by giving banks perverse incentives to take excessive risk (i.e. increased moral hazard).

2. Extended deposit insurance coverage is by no means a magic bullet, and comes at a cost. It may lead to moral hazard, and possibly large fiscal contingent liabilities. Therefore, the measure should be phased out as soon as the economic and financial environment is stabilized and public confidence in the banking system is restored. It is also important that the supervisory framework has been adequately strengthened and an effective resolution mechanism is in place.

3. Once policymakers decide to begin the transition to limited coverage, a transition task force should be created and charged with building a broad transition strategy and action plans.

4. The public policy objectives to be obtained from the transition need to be clearly outlined beforehand, so that any changes are in line with these stated goals.

5. The transition task force should include a broad range of safety net players, such as the central bank (which will need to ensure adequate liquidity), the supervisor (which will need to monitor and confirm financial sector soundness), the deposit insurer (which is in charge of protecting depositors) and a department of the government such as the Ministry of Finance (which may need to provide financial support).

6. One issue of particular importance which must be taken into account prior to considering a transition to a limited coverage system is the issue of political will. Full political support is needed for a transition to be successful.

7. Once the decision to begin a transition is taken, the factors that need to be addressed regarding the deposit insurance system to be transitioned to include institutional arrangements, decisions on the amount and scope of coverage, funding sources and public awareness strategies.

8. When carrying out a transition to a limited coverage system, it is relevant to assess what the target coverage levels will be, to avoid a destabilizing effect.

9. The transition to limited coverage may cause concern and uncertainty among the public. Thus, it is important that the transition plan includes a strategy to clearly and promptly communicate with the public and other stakeholders.

10. Cross-border coordination and cooperation among financial safety net members should be encouraged during the preparation and execution of the transition. This aspect is particularly important in those jurisdictions where financial markets are closely related and interconnected. Effective international coordination and cooperation can contribute to minimizing different adverse effects, and avoid distortions or an unfair competitive impact on the financial institutions of other jurisdictions.

II. INTRODUCTION

The international financial crisis of 2007/2008 has provided deposit insurers with some lessons concerning their ability to respond effectively and maintain depositor confidence during a systemic crisis, as well as to test their guarantee scheme. The amount and frequency of financial crises seem to reveal that the financial sector is vulnerable and the banking sector is particularly susceptible.[5] The nature of banking is to accept deposits from its customers, which in a large proportion are demand deposits (liquid deposits), and channel those resources into longer-term projects (illiquid loans). This leads to increased exposure and susceptibility to the risk of a run if depositors believe that their savings are not safe and try to withdraw them at the same time.

During a crisis, many governments or jurisdictions provide blanket guarantees or increase coverage for bank deposits, as a temporary measure, in order to boost the confidence of depositors. However, it is not enough to prevent instability and lessen depositors' concerns regarding the loss of their savings. In addition, complementary measures should be implemented simultaneously to diminish any potential negative impact, such as increased moral hazard caused by a blanket guarantee. These measures include, in particular, the strengthening of the supervisory framework with an early warning system and an effective framework of prompt corrective action, and a problem bank resolution framework that works quickly and where shareholders suffer a first loss. These are strong mitigants to moral hazard because they ensure that shareholders and directors will suffer if they take on excessive risk.

As evidenced above, when a jurisdiction decides to change the amount and/or scope of coverage in any way, this becomes a delicate issue. Financial authorities should consider many factors and pre-conditions that should be met in order to minimize the risk of instability during the transition period, and to maximize the effectiveness of the resulting measure. Furthermore, although the decision to implement a blanket guarantee may be taken by the government rather than the deposit insurer, when transitioning back to limited coverage it is important to involve the deposit insurer to ensure a smooth, effective transition.

The first issue to consider is the existence of political will. A transition is not a technical exercise that can be completed simply because a series of conditions have been met. It is a difficult political process that cannot succeed and can seriously destabilize an economy in the absence of full political support for its implementation.

Moreover, as stated in Principle 10 of the Core Principles, when transitioning from a blanket guarantee to a limited coverage system, protection for depositors and other possible creditors is reduced. Therefore, policymakers should pay

[5] In the last 20 years there has been a series of financial crises: The "Scandinavian Crisis" in Sweden and Finland (1991-1993); the "Tequila Crisis" in Mexico (1994-1995); the "Asian Crisis" in Indonesia, South Korea and Thailand, and to a lesser extent Hong Kong, Malaysia, Laos and the Philippines (1997); the "Ruble Crisis" in Russia (1998); the "Corralito Crisis" in Argentina (2001); the banking crisis in Uruguay (2002), and the "Subprime Crisis" in the US (2007-2008).

particular attention to public attitudes and expectations. That is, the goal is to have the transition begin when it is a “non-event”, i.e. when depositors and creditors are indifferent to the elimination of the high coverage levels because they know the system is stable and the supervisory regime is strong.

Also, the transition to limited coverage usually involves the imposition of new or revised premiums or levies on banks. If funds are insufficient to pay for the cost of the blanket guarantee, especially if it stems from a systemic crisis, the cost is usually shared between banks and the government. It is important to have a clear mechanism in place to ensure that the deposit insurance system has access to adequate funding during and after the transition. Likewise, the speed with which coverage levels are adjusted during the transition period poses trade-offs that must be carefully evaluated.

During the international financial crisis of 2007/2008, some jurisdictions provided a blanket guarantee, although most only increased coverage levels for depositors and implemented other ad hoc measures to protect asset markets, with the aim of restoring confidence in financial markets; however, the concern with this type of measure is that it may increase moral hazard. Thus, it is important for jurisdictions to plan a transition back to limited coverage. When a jurisdiction decides to remove the temporary deposit insurance coverage measures, in general, certain pre-conditions, transition factors and the timing should be taken into consideration, depending on existing prudential regulation and supervision, legal frameworks and accounting and disclosure regimes in place, among other things.

In order to develop this paper, the Subcommittee on Transitioning[6] of IADI’s Research and Guidance Committee prepared a detailed survey questionnaire, which collected information from a wide range of jurisdictions that have transitioned or will transition from a blanket or extended coverage system to a limited one as a result of financial crisis.[7]

[6] The Subcommittee on Transitioning was composed of individuals from: Hungary, Japan, Korea, Mexico, Nigeria, Taiwan, Turkey, the UK and the US.

[7] The survey was sent to 83 jurisdictions, of which 43 were IADI members, 24 were members of the European Forum of Deposit Insurers and 16 were members of both associations. Forty-four responses were received, of which 28 were from jurisdictions that have transitioned or have reported that they are in the process of transitioning to limited coverage and 16 from jurisdictions that have not experienced a transition.

III. WHY DOES A JURISDICTION NEED TO TRANSITION FROM A BLANKET GUARANTEE TO LIMITED COVERAGE?

It is well known that the blanket guarantee[8] increases moral hazard. The theoretical literature[9] is unambiguous that deposit insurance protects banks' claim-holders from losses, increasing the propensity by bank owners and managers to accept excessive risk.

In the context of deposit insurance, moral hazard manifests itself in two ways. First, deposit insurance creates incentives for insured banks to take greater risks because they can make more profits but shift losses to the insurer. Second, deposit insurance reduces incentives by depositors to monitor the performance of the banks or discipline their risk behavior.

Thus, far from being a theoretical concern, moral hazard in deposit insurance is quite real.[10] Moral hazard is why governments have elaborate banking regulation systems in place, which include entry restrictions, activity restrictions, prudential regulation, supervision, and sanctions. Likewise, strong banking resolution mechanisms – including early detection of and timely intervention in troubled banks, and prohibitions against bailouts of shareholders – are crucial to prevent moral hazard. Furthermore, coverage limits and differential or risk-adjusted premiums may also help mitigate some degree of moral hazard.

However, those measures are not sufficient to eliminate moral hazard. In addition, more efforts are required to curtail the risk caused by deposit insurance, which will be discussed in detail further on.

In addition, another factor that is often considered an issue when implementing a blanket guarantee is the fiscal cost. Nonetheless, it is important to note that the guarantee itself carries no immediate costs. The government guarantees the system. If the system is relatively robust, the costs will be small. If the system is extremely undercapitalized, then the costs may be high, equal to the recapitalization of the system. However, the fiscal costs may continue to grow if the full guarantee is maintained in the long term.

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[8] A "blanket guarantee" is a declaration by authorities that, in addition to the protection provided by limited coverage deposit insurance or other arrangements, certain deposits and perhaps other financial instruments will be protected (BCBS/IADI Core Principles for Effective Deposit Insurance Systems, Principles10). This can involve: 1) extending the scope of deposits or products previously protected; 2) coverage of deposits or products above the amount previously protected; or 3) the inclusion of financial institutions other than those previously protected.

[9] Reint Gropp and Jukka Vesala, "Insurance, Moral Hazard and Market Monitoring", European Central Bank, Working Paper Series, No. 302 / February 2004.

[10] Moral hazard will exist as long as the total expected profits from a bank's asset portfolio exceed the explicit costs of deposit insurance (premiums) plus the implicit costs (the costs of regulation). Patricia A, Mc Coy, "The Moral Hazard Implications of Deposit Insurance: Theory and Evidence", Seminar on Current Developments in Monetary and Financial Law, Washington, D.C., 23–27 October 2006.

Factors to be considered to curtail moral hazard

As extended deposit insurance coverage increases the risk of moral hazard, jurisdictions that have adopted this as a measure to cope with the international financial crisis of 2007/2008 should bear in mind the elements considered in Principle 2 of the Core Principles and Numeral 3 of the Financial Stability Forum Guidance for Developing Effective Deposit Insurance Systems,[11] which unanimously assert that moral hazard, which may arise as an undesirable consequence of deposit insurance, particularly in the face of a poorly designed financial system safety net, should be mitigated.

In particular, Core Principle 2 establishes that "*Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net".* There are several elements that may help policymakers design, implement, and continually assess a deposit insurance system with the goal of mitigating moral hazard. These are listed in **Appendix II**.

IV. CONDITIONS FOR TRANSITIONING TO LIMITED COVERAGE

In response to economic or financial crises, jurisdictions may adopt policies to enhance depositor protection, where scope and intensity differ from one jurisdiction to another. Some jurisdictions choose to rely on existing frameworks of deposit insurance but increase deposit insurance coverage levels and/or scope to strengthen public confidence, while others decide to provide a blanket guarantee.

As financial stability returns, many of these jurisdictions may look for ways to make a smooth transition to limited coverage. It is important to note that, given the possible destabilizing effects of transitioning back to limited coverage, the transition to lower coverage levels must be seen by depositors and creditors as a non-event (i.e. public confidence must be such that reducing coverage does not cause concern). For the former to be true, no bank should be expected to fail during the transition, as this would undermine confidence in the financial system. Also, banks should meet prudential and liquidity needs, and the impact of asset price changes or market changes should have already been fed through to the balance sheets of financial institutions, so most structural transformations should have been completed. Additionally, it is important that banks have returned to profitability before a transition to reduced coverage is even considered. In other words, the private sector must consider the system stable and the public must be confident in the safety of their deposits.

In order to ensure that the previously mentioned general conditions exist, policymakers must look closely at the following issues:

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[11] http://www.fdic.gov/deposit/deposits/international/guidance/guidance/finalreport.pdf.

A. Economic and financial environment

Prior to transitioning to limited coverage, jurisdictions need to achieve a certain degree of economic and financial stability. It is not necessary that all the problems in the economy or financial system be resolved, or that the entire system be reformed (given the potential adverse effects, such as increased moral hazard, of retaining the extended deposit insurance coverage or the blanket guarantee for too long). If the economy or financial system remains significantly weak or unstable, and there is still a general lack of confidence among depositors, then removing a blanket guarantee or reducing the coverage could be a destabilizing element that might have a negative effect on the jurisdiction strengthening process after a crisis, and could also increase the overall cost to the system.

Therefore, once a jurisdiction has achieved a degree of stability, a balance should be found to determine when the timing is right to begin the transition to limited coverage.

To determine the right time, it is important that policymakers define the economic and financial conditions that should be reviewed, the process to evaluate/asses them and the acceptable conditions or trigger points for beginning the transition to limited coverage.

The economic and financial conditions to be reviewed include:

1) **Macroeconomic conditions**, including the current monetary and fiscal policy. – These are particularly important because they may affect the financial system and exacerbate banking system problems. Concerns about macroeconomic conditions often result in a loss of confidence in the entire financial system. There are several indicators used to assess the macroeconomic condition of a jurisdiction, for example gross domestic product (GDP), inflation rate or consumer price index, interest rates, unemployment rate, fiscal deficit as a percentage of GDP, private investment and consumption, public debt as a percentage of GDP, exchange rate variation, balance of payments including the trade balance, current account and international reserves, savings and investment status of financial institutions, current and non-current loan portfolio, as well as growth in total credit and bank earnings.

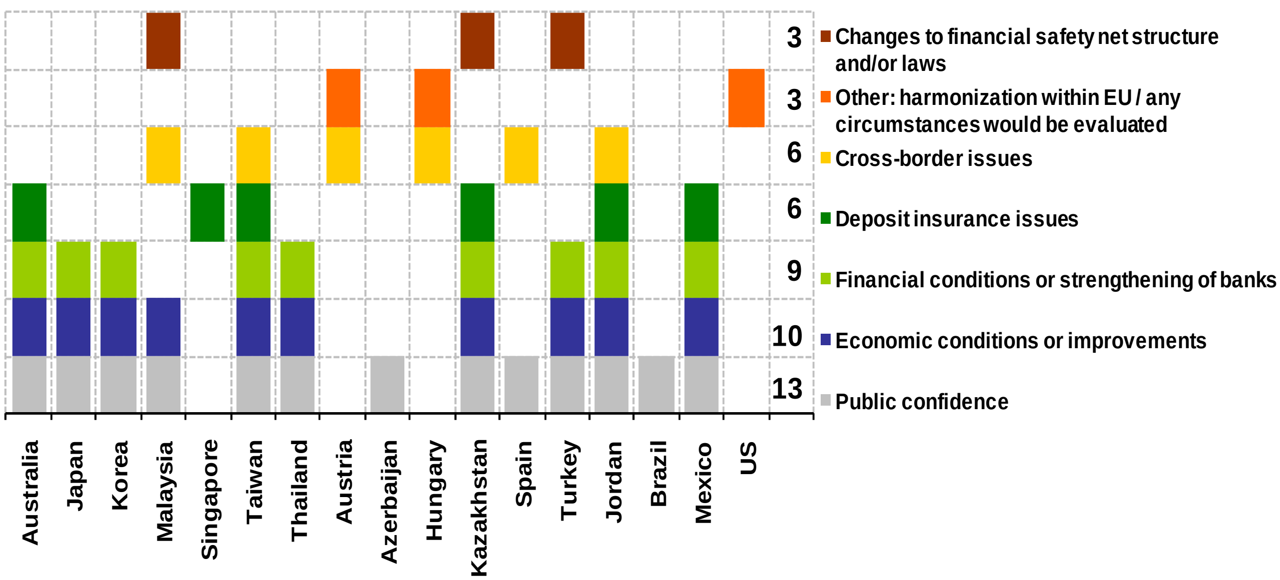
2) **Banking system structure and stability conditions**. – It is important to evaluate the state of the banking system because its condition is crucial in determining when and how to transition to limited coverage. If the banking system is characterized by severe problems, then the transition is likely to further destabilize the system. Conditions that should be evaluated include: capital adequacy, liquidity, credit quality, non-performing loans, concentration of lending, leverage, asset quality, foreign exchange positions, and risk management policies and practices. Also, credit and deposit growth, risk management indicators, and the amount of deposits under the limited coverage that would be eligible for protection by the deposit insurance should be evaluated. The movement of deposit liabilities in the financial system should also be closely monitored.

Once the jurisdiction has identified the conditions that should be evaluated before it begins a transition from extended deposit insurance coverage to limited coverage, the jurisdiction can conduct a comprehensive and detailed situational analysis of the state of said economic and financial conditions. Having a high quality and quantity of information is essential for an effective transition, as this will facilitate a correct assessment of the aforementioned factors, as well as of the strengthening and consolidation process.

According to the survey results, jurisdictions that have experienced or are planning to implement a transition to limited coverage take several factors or conditions into consideration (see **Figure 1**); in general, more than one factor is important. There is an apparent consensus regarding the importance of public confidence in the stability of the financial system. Economic conditions or improvements and/or financial conditions or strengthening are also considered by the majority of the jurisdictions. Deposit insurance and cross-border issues are taken into consideration by a smaller number of jurisdictions, while changes to the financial safety net infrastructure and/or laws are apparently less important.

For European Union jurisdictions, i.e. Austria and Hungary, harmonization and coordination within the region also have to be taken into consideration.

Figure 1. Conditions taken into consideration when deciding to transition to limited coverage



Source: Responses to survey questionnaire.

B. Financial safety net infrastructure

Before transitioning to limited coverage, it is important to ensure that the authorities comprising the financial safety net have a clearly defined mandate and appropriate legislative powers in order to facilitate interactions between them, define their responsibilities, and avoid overlapping roles. It is important to stress that the transition to limited coverage is not only about the design of the deposit insurance. A successful transition needs strong supporting supervisory and bank resolution frameworks. Public confidence will be maintained in the face of falling coverage levels only if supervision is seen as strong (with early supervisory intervention), and effective and rapid bank resolution frameworks exist. Thus, the transition period presents an opportunity to make modifications to the financial safety net with the aim of improving the design, mandates and roles of the agencies comprising the financial safety net (central bank, supervisory agency and deposit insurance). Strengthening the financial safety net infrastructure is critical to an effective transition.

In light of the above, jurisdictions should review and strengthen their regulatory and supervisory structure, including the accounting and disclosure regimes, and the legal framework. Furthermore, the governance of agencies comprising the financial safety net should be reviewed because sound governance[12] will help strengthen the financial system of the jurisdiction and therefore contribute to its stability.

Sound prudential regulation and supervision should allow only viable banking institutions to operate. Therefore, jurisdictions should assess whether banking institutions are sufficiently capitalized and if they comply with sound and prudent risk management, governance and sound business practices, as well as make a forward-looking evaluation of the bank's business model which convinces supervisors that the bank has a future and can be profitable over the medium term. Also, it should be evaluated whether the existing regulation provides for early intervention to address emerging problems, as well as establishing mechanisms for resolving failed institutions in a prompt, orderly and cost effective manner.

Also, the accounting and disclosure regimes should be accurate and reliable in order for the transition to limited coverage to be effective. Information on financial institutions' condition should be easily available, useful and timely for depositors, the market and authorities. Greater information and accountability help to increase market discipline and improve the effectiveness of deposit insurance.

Regarding the legal framework, policymakers should review and, if necessary, make modifications in order to improve it, as the proper legal framework is the basis for an effective bank resolution. A well developed legal framework should include, for example, a system of business laws, including corporate, bankruptcy,

[12] Sound governance comprises independence, accountability, transparency and disclosure, and integrity.

contract, consumer protection, anti-corruption/fraud and private property laws. A sound legal framework must also effectively enforce laws.

The financial safety net infrastructure should also have a deposit insurance system that clearly explains the level and scope of deposit insurance coverage, thereby promoting public awareness and confidence.

All of these conditions help to avoid any shocks to the system after the transition. Such shocks could reignite depositor fears and destabilize a recovery. A relevant caveat is that, if jurisdictions consider that no changes are needed in the financial safety net, perhaps an intensive review is necessary.

According to the survey results, when transitioning to limited coverage, most jurisdictions indicated that they would not need to make modifications to their financial safety net (regulatory and supervisory approach, legislation or mandates and roles). Few jurisdictions reported that they had to make modifications.

In Australia, before the international financial crisis of 2007/2008, the Financial Claims Scheme (FCS) was in the process of being established; so a higher coverage limit was adopted and established by regulation (in effect since 31 October 2008). On 12 October 2011, the current government guarantee on deposits was removed. However, the FCS will continue to apply to deposits under the scheme for amounts up to a new limit to be determined by the government. Therefore, regulation will need to be modified.

In Turkey, policymakers had to make modifications to the financial safety net as regards the regulatory and supervisory approach, legislation, mandates and roles.

In Malaysia, a comprehensive review of the Malaysia Deposit Insurance Corporation (MDIC) Act 2005 was conducted. A new MDIC Act 2011 was gazetted on 27 January 2011 and came into operation retrospectively on 31 December 2010. The new Act provides MDIC with adequate powers, a wider toolkit and greater flexibility to fulfill its mandate of maintaining and promoting public confidence and the stability of the financial sector.

C. Public policy objectives

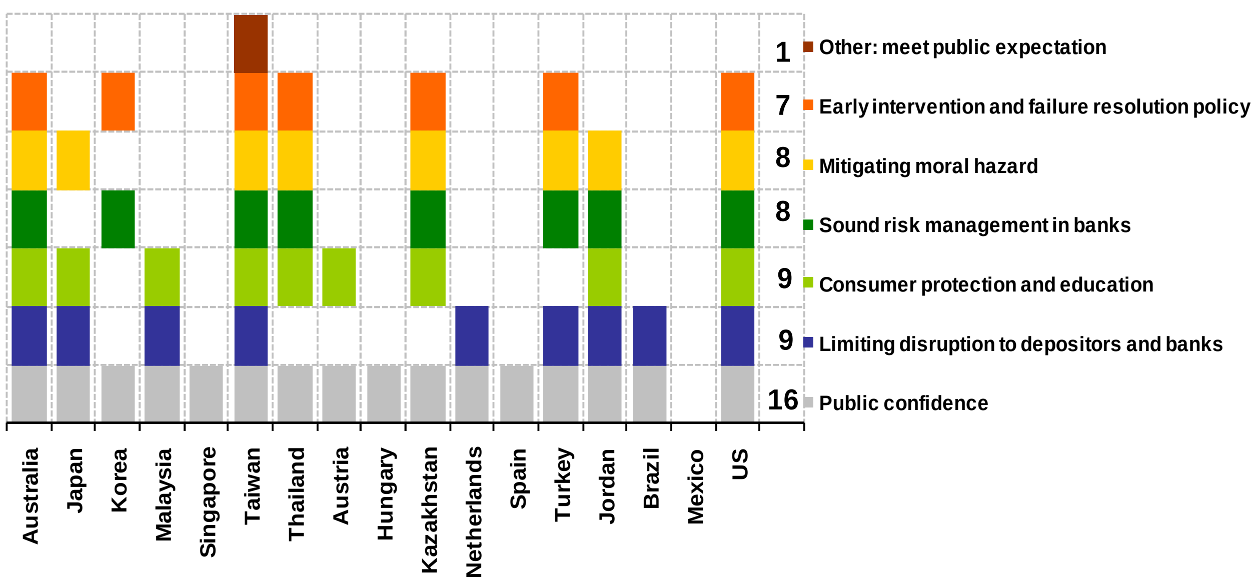
When transitioning to limited coverage, it is important to consider the public policy objectives of the deposit insurance system in the context of the economic and institutional framework of the jurisdiction.

Each jurisdiction has its own reasons for implementing a blanket guarantee or for increasing the level and/or scope of deposit insurance coverage while confronting an economic or financial crisis. This decision is generally influenced by factors outside of the sphere of the deposit insurance systems. However, depositor confidence and the need to maintain financial stability are common and important factors that influence the adoption of measures to avoid the collapse of the financial and payment systems. Whether or not increasing deposit insurance coverage will be permanent or temporary depends precisely on public policy objectives.

According to the survey results, public policy objectives regarding deposit insurance should take into account factors such as enhancing risk management in banks, mitigating moral hazard, limiting disruption to depositors, and enhancing consumer protection and education. For some jurisdictions the introduction or maintenance of early detection, timely intervention, and a failure resolution framework to mitigate future losses and provide certainty was or is also an important factor (see **Figure 2**).

Jurisdictions undergoing or considering a transition to limited coverage should establish clear public policy objectives for the deposit insurance system. The results from the appropriate situational analyses of the economic environment, since it affects the banking system and influences the effectiveness of a deposit insurance system, may be an important guide when policymakers make the necessary decisions.

Figure 2. Important factors to be maintained or introduced as part of transitioning to coverage



Source: Responses from Survey Questionnaire.

V. ISSUES IN TRANSITIONING TO LIMITED COVERAGE

Given that removing the blanket guarantee can raise private sector fears and re-ignite financial distress, it is important that, once policymakers have determined the existence of the necessary conditions and have evaluated them in order to decide when to transition to limited coverage, a transition task force should be created, and charged with:

1. Monitoring and analyzing conditions in the financial sector;

2. Identifying reforms in law and regulations for bank supervision and bank resolution needed to support financial stability;

3. Determining a broad strategy for the transition;

4. Developing a step-by-step implementation policy including any needed reforms in the safety net framework, and

5. Developing and implementing a public awareness plan.

The transition task force must include a broad range of safety net players, such as the central bank (which will need to ensure adequate liquidity), the supervisor (which will need to monitor and confirm financial sector soundness), the deposit insurer (which is in charge of protecting depositors and, depending on the jurisdiction, has extended powers or is a risk minimizer) and the ministry of finance (which may need to provide financial support). Also, it is of particular importance that the transition task force has political support for its activities and for the plan it develops.

Specifically, the task force must look closely at issues such as institutional arrangements, determining and communicating to the general public information on the characteristics of the deposit insurance system to which they are planning to transition (amount and scope), as well as the necessary funding mechanisms.

A. Institutional arrangements (coordination and cooperation among domestic and international financial safety net members)

Institutional arrangements refer to the coordination and cooperation which should be established, preferably via formal mechanisms, among the members of the financial safety net of a jurisdiction, with the aim of carrying out a transition to limited coverage in an orderly and effective manner.

In this respect, one of the first tasks to be carried out by policymakers consists of reviewing the effectiveness of the financial safety net in general and the soundness of the financial system, the first with the aim of deciding which member of the safety net represents the ideal institution to carry out the transition and the latter to determine the general changes necessary to stabilize the system. Whichever member of the safety net is chosen to lead the transition should have sufficient experience, in addition to the necessary tools and powers to carry out this task. At the same time, as mentioned above, it is necessary to formulate a transition plan which clearly stipulates the following:

1. The objectives and the general lines of action;
2. The economic, financial and whatever other conditions it has been determined need to be verified prior to the transition;
3. The actions which different members of the financial safety net or other institutions will carry out, in accordance with their corresponding mandates;
4. The period of transition, and
5. Other aspects which apply to the particular situation of each jurisdiction.

The institution in charge of carrying out the transition plan should be responsible for leading and coordinating the various tasks and activities set out in the aforementioned plan. In addition, political support at the highest level is of critical importance for the success of the transition. This is essential, given that the transition cannot be determined merely by technical groups if the political will to implement it does not exist.

It should be pointed out that the lack of effective coordination and cooperation among the different actors involved in the transition plan can have repercussions on its execution, and therefore cause confusion among the general public.

According to the survey results, in Austria, Jordan, Korea, Malaysia and Taiwan, the deposit insurer was or could be the institution charged with recommending or commencing the transition to limited coverage. Australia, Austria, Hungary, and Spain are either planning or have planned that the finance/treasury ministry should have this responsibility. Other jurisdictions such as Japan, Kazakhstan, Taiwan, Thailand, the US and Turkey, are considering or have considered that more than one member of the financial safety net should participate in recommending or commencing the transition to limited coverage. The institution chosen is not as relevant as the need for cooperation among the members of the financial safety net during the implementation of the transition plan.

B. International cooperation and coordination

On the other hand, in many cases, coordination and cooperation in the preparation and execution of the transition plan are required, not only among the members of the financial safety net or other institutions within the jurisdiction, but also with the members of the financial safety nets of other jurisdictions. This aspect is particularly important in those jurisdictions which, because of their geographical situation, regional integration policy, and/or financial interconnection, are aware that their actions could cause negative spillover to neighboring jurisdictions, including cross-border capital flight. Thus, jurisdictions with a high level of capital mobility, and/or a regional integration policy, should consider the effects of different jurisdictions' protection levels and other related policies.

In this respect, policymakers in the different jurisdictions have the task of, preferably, formally establishing effective coordination and cooperation mechanisms among the members of the financial safety nets of different jurisdictions;[13] the former with the goal of designing coordinated regional and international transition strategies, including the development of a regional transition plan, which will necessarily be taken into account in the design of each jurisdiction's particular transition plan.

Effective international coordination and cooperation can contribute to minimizing different adverse effects and avoid distortions or unfair competitive impacts on the financial institutions of other jurisdictions. As observed during the international financial crisis of 2007/2008, the actions taken to benefit the financial institutions of one jurisdiction necessarily affect those of others.

It should also be pointed out that those jurisdictions where no coordination with others was necessary during the crisis of 2007/2008, now must take into account that globalization requires cooperation and coordination in terms of mitigating potential cross-border issues. If anything, the crisis illustrated a lack of effective cross–border crisis management, partly due to a lack of coordination.

Thus, to ensure that this is addressed, as indicated in Principle 7 of the Core Principles, all relevant information should be exchanged between deposit insurers in different jurisdictions, and possibly between deposit insurers and other foreign safety net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which one will be responsible for the reimbursement process. The deposit insurance already provided by the home jurisdiction's system should be recognized in the determination of levies and premiums. Some mechanisms for international cooperation with these objectives in mind include:

1. Appropriate cross-border bilateral/multilateral agreements are in place in circumstances where, due to the presence of cross-border banking

[13] The option of establishing a regional task force involving members of the financial safety net of participating jurisdictions may be considered.

operations, coverage for deposits in foreign branches is provided by the deposit insurer in another jurisdiction or by a combination of deposit insurers in different jurisdictions.

2. Depositors in jurisdictions affected by cross-border banking arrangements are provided with clear and easily understandable information on the existence and identification of the deposit insurance system legally responsible for reimbursement, and the limits and scope of coverage.

3. Where a deposit insurer perceives a real risk that it may be required to protect depositors in another jurisdiction, its contingency planning allows for cross-border arrangements or agreements.

In this respect, in Australia, Croatia, Hungary, Malaysia, Singapore, Spain, the UK and the US, policymakers have initiated or are considering initiating efforts to collaborate with other jurisdictions in order to mitigate cross-border issues, such as deposit insurance arbitrage. It should be mentioned that, among jurisdictions of the European Union, coordination takes place within the European committees and bodies, although, in such jurisdictions, coordination among deposit insurance systems in crisis situations remains limited thus far.

Furthermore, Malaysia, Singapore and Hong Kong have established a tripartite working group to coordinate a strategy for their transition to limited coverage.

On the other hand, as a result of the international financial crisis of 2007/2008, there was an evident need to introduce legislation enabling jurisdictions to deal with blanket or government deposit guarantees should they be required in the future. Hungary, Korea, Malaysia, Taiwan, Turkey and the US have established measures or mechanisms in their legislation to manage systemic crisis.

C. Amount and scope of coverage

A suitable coverage level and scope for the deposit insurance system are two central features of a successful transition to limited coverage. Appropriate coverage recognizes the existence of moral hazard and helps mitigate it. There is no presumption about the appropriate coverage level; however, the design of the deposit insurance system has to be consistent with this objective. As such, it is always important to take into consideration the actual impact of design features. If a system has limited coverage, but that coverage is so high that 100 percent of the value of deposits is effectively covered, moral hazard is not mitigated through the coverage limit.

There are essentially three options regarding coverage:

1. Return to the original coverage level – the one that existed prior to the increase or implementation of a blanket guarantee.

2. Establish a coverage level with an amount/scope above the original coverage.

3. Establish a coverage level with an amount/scope below the original coverage.

In order to determine the new coverage level, policymakers should review bank deposit instruments, operations and institutions which were covered before increasing the coverage or implementing a blanket guarantee. In addition, the level and/or scope of coverage should be sufficient to ensure that the deposit insurance system is credible, in other words, that it maintains public confidence, depending on the circumstances of each jurisdiction.[14] In this way, a smooth transition to limited coverage can be achieved, reducing the impact of the transition.

Factors to be considered

The first step in assessing coverage is to evaluate the overall coverage level. It may be useful to obtain information on the number of depositors covered and the percentage of the value of deposits covered at a series of different coverage levels. Coverage levels should then be set to cover as many depositors as possible while leaving a significant portion of deposits still subject to market discipline.[15]

Once the percentage of depositors protected at each coverage level and the distribution of protected deposits is identified, several additional issues regarding coverage levels will need to be reviewed, specifically:

- The coverage levels of deposit insurance systems in neighboring countries will affect the appropriateness of coverage levels. Setting a coverage level that is disproportionately higher or lower than in neighboring jurisdictions can lead to depositor flight into or out of the jurisdiction. The considerations in determining the amount and/or scope of coverage of deposit insurance are particularly relevant in those jurisdictions where, because of their geographical situation, regional integration policy, financial interconnection or other circumstances, they influence or are influenced by neighboring jurisdictions.

- The issue of how to treat term deposits that were deposited before the reduction in coverage levels must be analyzed, particularly in those systems where there are many long-term deposits. In this case, perhaps

[14] For example, a high level of coverage could represent weak market mechanisms, but nevertheless it can contribute to increasing public confidence and reducing fluctuations in deposits.
[15] Coverage levels should be set so that small retail depositors do not have an incentive to run at the slightest provocation, and large depositors do not feel complacent in the face of risky or unsafe banking activities.

the "grandfathering"[16] of transition provisions could be useful. Factors to consider include: the maturity structure of deposit liabilities, as well as the number of long-term deposits in the system (if there are few, then the measure could help foster public opinion in favor of the transition and would not pose a significant problem with regard to funding. If there are many long-term deposits, then the long-term funding factor may be a problem and must be taken into account).

- The history of banking crises may lead countries to maintain relatively high coverage levels until public confidence is fully restored.

- High coverage levels may be a policy of choice undertaken while the authorities clean up the financial sector, implement new prudential rules and regulations, or other factors.

Ultimately, the determination of appropriate coverage levels depends on the effectiveness of the safety net. If coverage levels are extremely high, with a large portion of depositors covered and a majority of the value of deposits covered, there must be additional factors mitigating moral hazard;[17] in particular, these must lead to strong supervision, and an effective problem bank resolution regime.

In some cases, and again depending on the particular circumstances of each jurisdiction, it can opt to adjust the coverage gradually while it transitions to limited coverage. However, jurisdictions also need to evaluate the advantages and disadvantages of carrying out a "phasing-out" transition, a topic which will be discussed in the section entitled "Timing and pace of the transition".

According to the survey results, Austria, Hungary, Jordan, Korea, Malaysia, the Netherlands, and Taiwan have established or are planning to establish a level of coverage above the original coverage that existed prior to the recent financial crisis or a previous one; Japan, Singapore, Thailand, Turkey and the US[18] have returned or are planning to return to the original level of coverage.

As far as the scope of coverage is concerned, in Austria, Azerbaijan, Croatia, Jordan, Kazakhstan, the Netherlands, Russia, Singapore, Spain, Thailand, Turkey and the US, policymakers have kept or will keep coverage for the same kind of banking deposits, instruments, operations and institutions as it was prior to the crisis; in other words, policymakers did not or will not extend the scope of coverage. In Brazil they will cover fewer types of banking deposits, instruments, operations,

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[16] Meaning that certain term deposits will receive blanket coverage until maturity, even after the transition deadline, if the funds in question were deposited when the blanket guarantee was still in effect.

[17] Including, but not limited to, deposit insurance premiums that are assessed on a differential or risk-adjusted basis, and minimizing the risk of loss through timely intervention and resolution by the deposit insurer or other participants in the safety net with such powers.

[18] After the survey responses were submitted, the US passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which, in part, permanently raised the standard maximum deposit insurance amount to USD 250,000 (i.e. the US ultimately chose to maintain the level of coverage it implemented as a result of the crisis, which was previously USD 100,000).

and institutions. On the other hand, Hungary mentioned that the European Commission has published its intention (legislative proposals) to discontinue coverage of debt securities by banks. Estonia, Japan, Korea, Malaysia[19] and Taiwan have considered or are considering extending the scope of coverage (see **Figure 3**).

Figure 3. Scope of coverage during the transition to limited coverage

Jurisdiction	**Banking deposits, instruments, operations, and institutions that would be included in the coverage**
Estonia	The Ministry of Finance has initiated the extension of the scope of coverage for all enterprises and companies regardless of size.
Japan	Deposits for payment and settlement purposes, and settlement payments were added to be the list of fully covered instruments.
Taiwan	CDIC has extended the scope of coverage. Among other things, interest is now covered (it was not covered for "*controlling moral hazard*"), and foreign currency deposits are also included.

Source: Responses to survey questionnaire.

On the other hand, as a consequence of the international financial crisis of 2007/2008, the impact that institutions deemed “too big to fail” have on the financial system and the need to create regulation which would allow this to be dealt with, and if necessary, allow for their exit from the financial system in case of failure, is evident. In this respect, surveyed jurisdictions were consulted if, within their plans of regulation, they were considering establishing a higher-than-standard coverage for banks deemed “too big to fail”. The majority of jurisdictions gave a negative response.

Methodology for determining coverage levels

In deposit insurance systems, the determination of the coverage limit must take into consideration three components:

1) Types of institutions covered by deposit insurance.

2) Types of deposits or financial products that are covered.

3) Credibility of the coverage limit on deposit insurance guarantees (in order to put large creditors of banks on notice that their deposits are not covered).

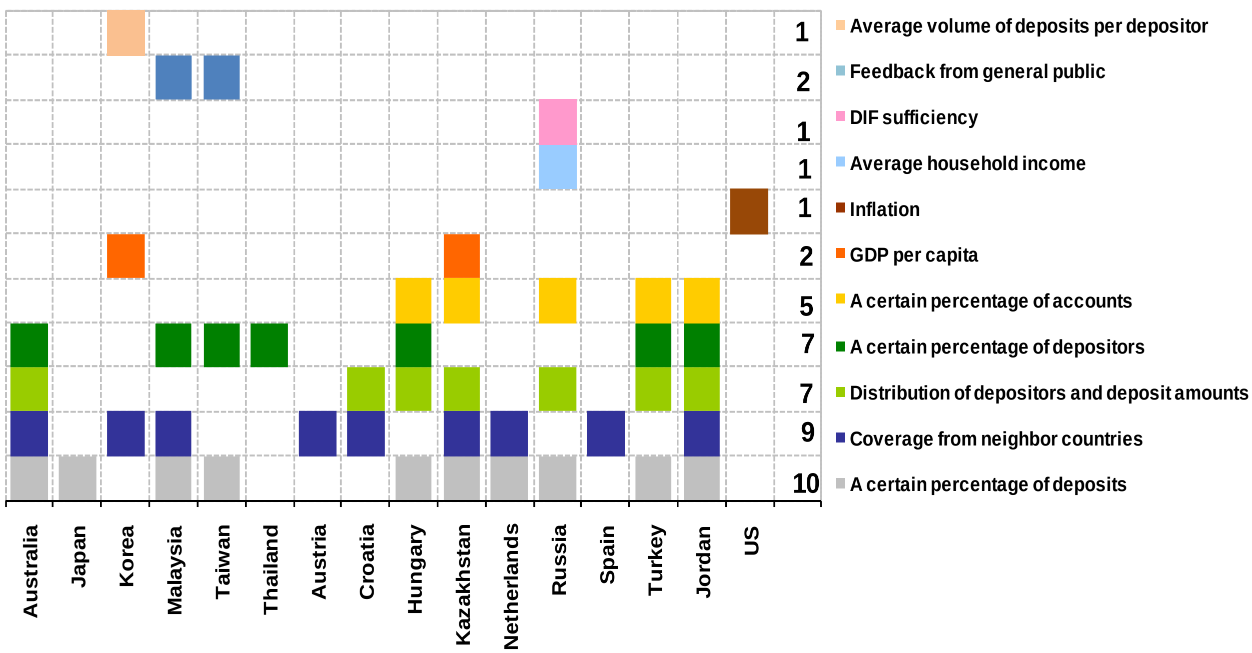
A suitable combination of these three components gives large creditors – including major depositors, holders of subordinated debentures, and correspondent banks – strong incentives to monitor the banks with which they do business. In this

[19] MDIC has extended its scope of coverage to include foreign currency deposits.

sense, it is especially important to consider not insuring interbank deposits, in order to encourage monitoring by fellow banks.

The jurisdictions surveyed indicated that, in order to determine the amount of coverage, they mainly take into consideration a certain percentage of deposits, the coverage amount provided by other insurers from neighboring jurisdictions in the region, and the distribution of depositors and deposit amounts. Other relevant aspects taken into consideration are: GDP per capita, inflation, deposit insurance fund sufficiency and average income of householders.

Figure 4. Factors taken into consideration to determine the amount of coverage



Source: Responses to survey questionnaire.

It is worth noting that, according to the survey results, there is not a standard, complex methodology for determining the coverage level.

D. Funding sources

Another element of the deposit insurance systems that should be analyzed before transitioning to limited coverage is the funding mechanisms. It is necessary to have clear mechanisms which ensure that the deposit insurance system has access to adequate funding during and after the transition, taking into account that the cost of a limited coverage deposit insurance system is usually paid for by, or shared with, insured institutions through deposit insurance premiums.

In this way, the transition to limited coverage generally includes the revision and, if necessary, modification of the premium scheme and/or the application of levies or additional special premiums to insured institutions. In deciding premiums, policymakers should take into account the ability of the banking system to fund the new limited coverage, the financial condition of the insured institutions (because the transition could be carried out when they are still in a generally weak financial condition), the level of the deposit insurance fund; the powers of the deposit insurer to increase premiums or to levy additional special premiums, the financial situation of the deposit insurer, and the policies and procedures required in order to obtain government support, among other factors.

Funding arrangements for the deposit insurance system should also include pre-arranged and assured sources of backup funding for liquidity purposes. Such sources may include a funding agreement with the central bank, a line of credit with the treasury, or another type of public fund or market borrowing. If market borrowing is used by the deposit insurer, this should not be the sole source of backup funding. The deposit insurer should not be overly dependent on a line of credit from any single private source.

According to the survey, most jurisdictions did not increase the premium for banks when increasing the limit/scope of coverage or implementing the blanket guarantee; however, some jurisdictions modified the premiums levied (see **Figure 5**).

Figure 5. Premium modification when increasing the limit/scope of coverage

Jurisdiction	**Premium modification**
Brazil	A special contribution to a specific program was created in response to the international financial crisis of 2007/2008.
Estonia	A new rate was introduced based on the target of the Deposit Guarantee Sectoral Fund.
Japan	The insurance premium was increased and a special premium was levied in addition.
Kazakhstan	Premiums for member banks were decreased by 25% in order to give them support during the international financial crisis of 2007/2008.
Malaysia	In addition to the deposit insurance premiums they pay, based on the existing Differentiated Premiums System, an annual guarantee fee was levied for deposits over and above the deposit insurance coverage limits.
Romania	The annual contribution rate was doubled in order to maintain the exposure coverage ratio at almost the same level as before the increase in coverage.
Russia	The premium level was decreased.
Taiwan	Special assessment fees were charged for interbank call loan guarantees; punitive premiums could also be charged under certain conditions.
US	There was no change in deposit insurance premiums directly associated with the temporary increase in deposit insurance. However, the Transaction Account Guarantee Program is a temporary fee-based program.

Source: Responses to survey questionnaire.

Regarding the plans to change the premium for banks during the transition to limited coverage, Azerbaijan, Austria, Croatia, Jordan, the Netherlands, Spain, Thailand, Turkey and the US did not or will not change the premium for banks during the transition process. Brazil, Hungary, Japan, Korea and Taiwan have changed or have plans to change it. Australia, Singapore and the UK reported to be evaluating the possibility of doing so (see **Figure 6**).

Figure 6. Premium modification during the transition to limited coverage

Jurisdiction	Premium modification
Brazil	Planning to eliminate the special contribution.
Hungary	Amendment to the Directive may envisage a 2% target ratio to be rebuilt within 10 years in all European Union member states.
Japan	The special premium was eliminated. Meanwhile, the premium rates were increased for special and other deposits, but the effective rate was kept at the same level.
Korea	The premium rate for banks was increased to supplement the balance in the Deposit Insurance Fund.
Taiwan	Planned to raise the premium rates when the overall economic and financial conditions were stable, as part of the transition plan. The Central Deposit Insurance Corporation (CDIC) was also given an "instruction/mandate" to rebuild the fund by the Parliament within a specific time frame.[20]
Singapore	With the proposed increase in deposit insurance coverage, the premium rates are being reviewed to mitigate the costs to scheme members.

Source: Responses to survey questionnaire.

Most of the jurisdictions which do not already have a differential premium scheme are not planning on establishing one once the transition is complete.

On the other hand, the survey showed that, should the premiums prove to be insufficient to pay for the increase in the coverage or the blanket guarantee, the cost is usually shared between the insured institutions and the government. The latter can resort to budgetary resources (i.e. higher taxes), asset sales, or debt issues. In this respect, Australia, Austria, Japan, Kazakhstan, Korea, Singapore, Taiwan, Turkey and Ukraine funded the cost of increasing the limit/scope of coverage with public resources.

E. Public awareness

Because the transition to limited coverage implies that the protection for depositors and other possible creditors will be reduced, this could cause concern and uncertainty among the general public. As such, it is important that the transition plan includes a strategy to publicly, clearly and promptly communicate the transition to limited coverage. The strategy should indicate: the target audience – depositors, creditors, insured financial institutions, general public, among others; the objectives that the authorities wish to achieve per type of audience; the elements of the deposit insurance system on which they would put greater emphasis; and the various communication tools which could be used. These

[20] The CDIC raised premium rates for banks and credit cooperatives as of 1 January 2011, when it returned to the limited coverage deposit insurance system.

elements will allow the design of a public awareness campaign. Ideally, the deposit insurer should be the primary party responsible for promoting public awareness concerning deposit insurance. However, the deposit insurer should work closely with other financial safety net members, insured institutions,[21] and the media to maximize resources and widen public awareness efforts.

Initially, and in order to measure confidence levels, particularly regarding the transition process, a baseline public awareness survey would be useful to help policymakers both a) gauge public sentiment regarding the reduction of coverage and b) identify areas which require more attention so that, when designing a campaign to inform the public about the transition process, these areas will be specifically addressed.

Following this baseline survey, what is highly recommended is to design a large-scale, strong public awareness campaign through which the target audience and general public would be informed of: the reduction of the coverage amount and scope; the time frame for carrying out the transition; and the date on which the new limited coverage takes effect. Also, policymakers could consider providing information regarding the functions and mandates of the deposit insurer. with the aim of strengthening public confidence, avoiding misconceptions and confusion regarding deposit insurance coverage, and preventing possible bank runs.

Given their importance, these campaigns should commence as soon as possible after the decision to begin the transition has been made, with the aim of allowing sufficient time for the depositors and insured financial institutions to become aware of and gradually assimilate the change in coverage. In this way, the transition should reach the planned objectives.

Policymakers should pay particular attention to the attitudes and expectations of the general public. For this reason, it is very important to evaluate the ongoing effectiveness of the public awareness campaign using surveys, questionnaires and focus groups, among other tools which allow for verification, measurement, and monitoring, and ensure that the transition to limited coverage is efficient and well understood by the general public. The results obtained from the application of some of those measures will indicate whether the campaigns are achieving the planned objectives and, when necessary, should permit the strengthening or redirecting of the campaign towards addressing weak elements which have been detected.

According to the survey, most of the jurisdictions have launched or are considering launching a campaign to communicate the transition plan to the general public, and are planning to employ mainly banks and their distribution channels (branches, ATMs, web pages, etc), electronic media (TV, radio, internet) and print media (newspapers, magazines, etc). Also, most jurisdictions have communicated or are planning to communicate the transition plan through the deposit insurer or the ministry of finance/treasury. However, in other jurisdictions the central bank or the supervisory authority would be in charge of this task.

[21] A variety of information on transition could be provided to depositors via the insured institutions using a wide range of media.

VI. TIMING AND PACE OF THE TRANSITION

It has been observed that, in order to carry out an effective transition, each jurisdiction should evaluate the impact of transition on financial markets, whichever form of transition is chosen (rapid or gradual). Therefore, it is necessary to establish a plan or program within the transition time frame which would permit the adjustment of the same,[22] reducing or widening it according to various external factors, in accordance with the expectations established in the program.

It seems that after a crisis it is difficult to carry out an immediate transition, whatever the jurisdiction, unless the external factors indicate an economic recovery which would permit an immediate return to the type of coverage in place prior to the crisis. Therefore, during a transition period the relevance given to the gradual process is of major importance.

As such, the importance of planning a time frame for carrying out a transition to limited coverage is crucial for it to be effective. The priority is to decide between the convenience of having an immediate process versus a gradual one.[23]

The decision on whether to implement a gradual or an immediate transition will depend on:

1) The specific conditions of each jurisdiction,

2) The state of the financial system, and

3) The strength of the supervisory and regulatory systems.

If the financial system is strong and few changes are needed in supervision and regulation, the conditions may be suitable for a rapid transition. If considerable strengthening is needed, then a more gradual approach might be justified. In general terms, it could be argued that sophisticated, non-depositor creditors should be the first to lose protection, including interbank depositors and senior creditors. Once they are exposed to market discipline, then depositors could be exposed to risk.

The gradual elimination of a blanket guarantee will give policymakers and banks sufficient time to carry out the necessary supervisory and regulatory reforms, and banks enough time to adapt to the necessary institutional changes. Moreover, a gradual transition will allow bank management to become proficient in risk management, and will also provide depositors with sufficient time to become accustomed to the new deposit insurance features. However, a big disadvantage of

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[22] An Interim Report by IADI entitled Transitioning from a Blanket Guarantee to an Explicit, Limited Coverage Deposit Insurance System (February 2009).

[23] Hoelscher, IMF; FSF Working Group on Deposit Insurance, Subgroup Discussion Paper, "Special Considerations when Transitioning from Blanket Guarantees to an Effective, Limited-Coverage Deposit Insurance System"; Schich, OECD.

gradual transitioning is that the time frame could be seen as being too long, and this could cause doubts among depositors as regards the government's commitment to remove the coverage. The longer the extended insurance coverage or blanket guarantee remains in place, the more likely it is to give rise to additional moral hazard.

Thus, the gradual approach must establish strict controls in order to reduce moral hazard, for example by adopting a system of differential premiums where the banks pay premiums according to the level of risk of their operations,[24] and on the other hand, by properly defining the sanctioning powers of those authorities responsible for supervising compliance by the banks.

According to the responses received, the surveyed jurisdictions have carried out or are carrying out their transition as follows:

Immediately	Gradually
Austria, Hungary, Jordan, Kazakhstan, Korea, Malaysia, Singapore, Spain and Taiwan	Japan, Thailand and Turkey

In this sense, various policies and/or controls can be used to mitigate moral hazard while carrying out a transition to limited coverage. In particular, factors that must exist for the effective reduction, though not elimination of moral hazard include a supervisory framework that has an effective early warning system and prompt corrective action regime, coupled with an efficient resolution framework that works quickly and ensures that shareholders incur the first loss. In these circumstances, shareholders and directors will suffer losses if they take on excessive risk, which is what effectively mitigates moral hazard arising from a blanket guarantee. Additionally, the policies of some jurisdictions are shown in **Figure 7**.

24 Regarding differential premiums, there is a caveat that must be taken into consideration. While in any graduated system, the regulatory environment for risk mitigation is essential, risk-based premiums only increase the costs for the weakest institutions. While implementing a risk-adjusted premium system is justified in stable periods, this policy may be counterproductive as institutions are struggling to gain some growth and momentum. Thus, the use of this risk mitigation mechanism must be evaluated carefully in the context of the economic and financial environment of each specific jurisdiction, as well as in the context of their experience in managing flat premiums, and other factors, including, but not limited to, having access to trustworthy up-to-date information to gauge risk factors and effectively measure risk. Also, there must be an effective early warning system and the supervisory authority must be able to implement prompt corrective action.

Figure 7. Policies in the selection of rapid or gradual transition in terms of moral hazard

Jurisdiction	**Policies**
<Immediate transition>	
Jordan	• Must be an immediate transition to reduce moral hazard
Korea	• Transition to the previous limit
Singapore	• In the notice of coverage, specified a time frame for completion, in order to mitigate moral hazard
US	• Severity of the recession and time to address the problems with the banking sector
<Gradual transition>	
Japan	• The financial and economic conditions must improve before the transition • Public confidence • Depositors should be aware that they will be protected
Thailand	• Deposit insurance established in 2008

Source: Responses to survey questionnaire.

Only one jurisdiction – Thailand – noted in the survey that its focus during the transition period was on educating depositors about deposit insurance.

VII. SUMMARY OF FINDINGS

Considerations	Content / Actions
Conditions to consider in transitioning	1. Stable economic and financial environment. 2. Proper financial, supervisory and regulatory framework. 3. Sound risk management, mitigation of moral hazard, enhanced consumer awareness and protection.
Transition	A. Decide exit approach 1. Immediate approach. Pros: (1) avoid excessive moral hazard; (2) if there is strong prudential regulation and supervision, increase public confidence in the government and the deposit insurance system in implementing limited coverage.[25] Cons: (1) member institutions and the public may not have enough time to adapt to the transition and new mechanisms; (2) may cause negative impact if economic and financial conditions have not recovered sufficiently. 2. Gradual approach. Pros: (1) member institutions and the public have more time to adapt to the transition and new mechanisms; (2) more time to conduct necessary regulatory and supervisory reforms. Cons: (1) if the transition period is too long or complicated, it may confuse the public and reduce public confidence in the government and the deposit insurance system; (2) may generate doubts regarding the political will to transition, and thus induce increased moral hazard. B. Strengthen public awareness: a large-scale public awareness campaign should be conducted to deliver a clear and positive message about the deposit insurance system, the transition, and the new scope and level of coverage. C. Consider strategies and roles regarding different parties in transition: 1. For financial consumers: monitor public opinion and responses; provide clear and correct deposit insurance messages. 2. For member institutions: educate their staff, monitor their liquidity, conduct stress tests, and build up communication mechanisms between them and the financial safety net members, including the central bank and the deposit insurer. 3. Cross-border collaboration: enhance communication and cooperation with other governments, especially for jurisdictions with close financial links.

[25] However, in general terms, it is important to make sure that good public confidence levels exist as a necessary condition before attempting a rapid transition.

Considerations	Content / Actions
	4. Central banks: closely monitor bank liquidity and movements of large deposits, provide emergency liquidity support, conduct stress tests on bank liquidity, and provide suggestions on the transition. 5. Deposit insurers: review and suggest deposit insurance coverage limit and scope, design and implement a massive public awareness program, and provide suggestions on the transition, including the approach and timing. 6. Financial safety net and government: related financial and government sectors should work closely on the transition.
Factors for a successful and smooth transition	1. Enhanced supervision by the competent authority. 2. A reliable financial safety net. 3. Clear public policy objectives of the financial market and the deposit insurance system. 4. Sufficient resolution authority and capability for prompt reimbursement. 5. No major fund/liquidity movement in the financial markets. 6. No major concerns over public confidence (no abnormal deposit withdrawals). 7. Problem banks were properly handled/restructured and their assets were managed by a market mechanism. 8. Cross-border cooperation.

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APPENDIX I

TERMS AND DEFINITIONS

Core Principles: the Core Principles for Effective Deposit Insurance Systems of the International Association of Deposit Insurers and the Basel Committee on Banking Supervision.[26]

Supporting guidance points: help to clarify the Principle(s) and can add information to help policymakers apply the Core Principles.

Blanket deposit coverage/guarantee: A declaration by the authorities that, in addition to the protection provided by limited coverage deposit insurance or other arrangements, certain deposits and perhaps other financial instruments will be protected.

Immediate transition approach: This process sets a deadline for the blanket deposit guarantee or temporary increase in the limit and/or scope of coverage to revert to a limited coverage system.

Gradual transition approach: This process sets a deadline but the scope and amount of the guarantee are reduced gradually to minimize the impact on financial markets and depositors.

Limited coverage: A guarantee that the principal and/or the interest accrued on protected deposit accounts will be paid up to a specified limit.

Crisis: may refer to either the recent financial crisis (2007/2008) or to previous crises experienced by particular jurisdictions.

[26] http://www.iadi.org/cms/secure/docs/JWGDI%20CBRG%20core%20principles_18_June.pdf.

APPENDIX II

MAIN ELEMENTS IN DESIGNING, IMPLEMENTING AND ASSESSING A DEPOSIT INSURANCE SYSTEM

The following points of guidance summarize the main elements to help policymakers design, implement, and continually assess a deposit insurance system with the goal of mitigating moral hazard. These are general elements that can be adapted to a broad range of jurisdictions with varied circumstances, structures and settings.

1. Appropriate deposit insurance design features that may help to mitigate moral hazard include:

   i. Placing limits on the insured amounts;

   ii. Excluding certain categories of depositors from coverage;

   iii. Implementing differential or risk-adjusted premium assessment schemes;

   iv. Minimizing the risk of loss through early detection of and timely intervention in troubled banks;

   v. An effective resolution framework that works quickly and where shareholders suffer the first loss; and

   vi. Demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts.

2. A well-designed financial safety net infrastructure contributes to keep moral hazard in check by creating and promoting appropriate incentives through:

   Good corporate governance and sound risk management of individual banks, which help to ensure that business strategies are consistent with safe and sound banking operations, and can act as the first line of defense against excessive risk-taking, including:

   i. Standards, processes, and systems for ensuring appropriate direction and oversight by directors and senior managers;

   ii. Adequate internal controls and audits;

   iii. Risk management;

   iv. The evaluation of bank performance;

   v. The alignment of remuneration with appropriate business objectives, and

vi. Management of capital and liquidity.

Effective market discipline, exercised by shareholders as well as by larger creditors and depositors who are exposed to the risk of loss from a bank failure. However, for market discipline to be effective, these groups must have the knowledge required to assess risks.

i. Information should be readily available and be generally understood by the public;

ii. Sound accounting and disclosure regimes are required; as well as

iii. Ongoing attention to the soundness of banks by ratings agencies, market analysts, financial commentators and other professionals.

Frameworks for strong prudential regulation, supervision and laws.

Regulatory discipline can be exercised through:

i. Sound and effective regulations covering the establishment of new banks;

ii. An early warning system and an effective prompt corrective action framework;

iii. The implementation of minimum capital requirements;

iv. Adequate qualification of directors and managers;

v. Sound business activities;

vi. Proper tests for controlling shareholders;

iv. Standards for risk management; and

v. Strong internal controls and external audits.

Regarding supervisory discipline, this can be implemented by ensuring that banks are monitored for safety and soundness as well as compliance issues, and that prompt corrective actions are taken when problems arise.

The above elements involve trade-offs and are most effective when they work in concert.

APPENDIX III

CASE STUDY: Planning for a seamless transition from the Government Deposit Guarantee – Malaysia's approach

Introduction

"Ghost estates aren't just symbolic of Ireland's fall from grace. They are one of its key causes, the most conspicuous legacy of the unhinged building boom and incontinent bank lending spree that have driven a once affluent nation into staggering debt."[27] Faced with a potential financial meltdown, the Irish government undertook to fully guarantee the debts and deposits of six major banks on 29 September 2008. Ireland is the epicenter of the government blanket guarantee tsunami and its action sent powerful shockwaves to other neighboring countries, pressuring them to shore up their banks as the crisis intensified following the collapse of Lehman Brothers. Germany and Austria (retroactive to 1 October) were next followed by Denmark and Iceland. The blanket guarantee tsunami eventually reached the shores of East Asia, with Taiwan the first to announce a blanket guarantee on 7 October.

The next Asian country to announce a government guarantee was Hong Kong, following similar announcements by Australia and New Zealand. Days later, given their financial inter-connectivity and to reduce the possibility of contagion arising from the global financial crisis, Malaysia and Singapore, in a coordinated effort, also announced a blanket guarantee on 16 October 2008.

Recognizing that an uncoordinated withdrawal of support measures might have spillover effects on other countries, Malaysia, Singapore and Hong Kong pre-announced a common target exit date of 31 December 2010, and have also formed a regional tripartite working group to coordinate the scheduled exit.

On 31 December 2010, Malaysia successfully exited from the Government Deposit Guarantee (GDG). This case study outlines the Malaysian approach to a seamless GDG exit. The study highlights that careful and comprehensive planning, based on a thorough understanding of the consumer psyche and expectations, is key to a seamless exit.

This study explains why Malaysia implemented a blanket guarantee and describes key considerations when planning for a seamless GDG exit.

[27] Mayer, Catherine, "This is the House that Ireland Built," Time, Saturday, 4 December 2010.

Why a blanket guarantee?

A blanket guarantee is often associated with high fiscal contingent liabilities and moral hazard. Blanket guarantees may exacerbate risky behavior at banks and potentially increase the cost of dealing with problems at a later date. However, given the systemic nature of a crisis and the ensuing erosion of confidence, during the recent crisis many governments had no option but to introduce a broadly based guarantee of most bank liabilities, to restore public confidence by eliminating the incentives to withdraw deposits.

However, in Malaysia's case, when the GDG was implemented, the banking institutions were sound and strongly capitalized, with depositor confidence still intact. There was ample liquidity to support economic growth. Capital flows were not significantly large or unusually volatile. And financial institutions were well-regulated and well-supervised by Bank Negara Malaysia (BNM), the central bank of Malaysia, with the Malaysia Deposit Insurance Corporation (MDIC) reinforcing financial discipline.

MDIC supports BNM in promoting financial prudence in the banking system via a number of means. The first is through the implementation of its Differential Premium Systems, where deposit insurance premiums are charged based on the banks' individual risk profile. Banks with a higher risk profile are assigned higher premium rates, providing a financial incentive for banks to enhance their risk management. The second is through the power to impose premium surcharges for non-compliance, and to terminate membership of non-viable banks and intervene promptly to find resolutions which minimize the cost to the financial sector. And lastly, MDIC supports the supervisor through the imposition of its Terms and Conditions of Membership, a regulation which sets out the obligations of its member banks as to MDIC's expectations with regard to their safety and soundness, liquidity requirements and information to be disclosed to MDIC.

Why then did Malaysia introduce a GDG? It was implemented as a pre-emptive and precautionary measure to prevent potential contagion from cross-border capital flows, the possibility of deposit insurance arbitrage, and competitive distortions among banks across jurisdictions.

Malaysia's GDG covered all ringgit and foreign currency deposits with commercial, Islamic and investment banks, and deposit-taking development financial institutions regulated by BNM; such deposits were fully guaranteed by the government through MDIC until December 2010. The guarantee was extended to all domestic and locally incorporated foreign banking institutions.

Planning for a seamless GDG exit - key considerations

In light of its potential distortions, a GDG is meant to be used only as a temporary measure and its withdrawal should be as quick as possible, although this would hinge on prevailing economic conditions.

It is much easier to introduce a GDG than it is to withdraw it. The difficulty lies in managing public perceptions, which could be fickle. Hence, careful planning and execution are paramount. When should one start planning for an exit? From MDIC's perspective, the right time to begin developing an effective exit plan is at the conception of the GDG, as part of a comprehensive approach to the design of the GDG. Indeed, the task of withdrawing the GDG in Malaysia was greatly facilitated by the inclusion, in the initial GDG programs, of elements that eventually paved the way for its seamless removal.

This section describes how MDIC planned for a smooth exit from the GDG, and the essential steps taken to ensure an effective execution of these plans.

Essentially, there were three steps in planning for a seamless GDG exit. The first was to set the goals of the transition. The second was the design of an exit plan. The third was the selection of the right strategies, or the courses of action needed to achieve these goals, and their execution.

Step 1: Setting the goals

There were three important goals essential to a seamless transition, and all MDIC's initiatives were built around them. The goals were as follows:

I. **Maintaining stability in the financial system** by ensuring public confidence in the safety of their deposits and developing an enhanced consumer financial protection package that could maintain public confidence with the expiry date of the GDG fast approaching. This is the primary objective in a transition from a blanket guarantee to normal conditions.

II. **Maintaining and enhancing the credibility of MDIC** during the period of the GDG. In many instances, the implementation of a blanket guarantee causes the deposit insurer to become inactive or to fade into the background during the period of the blanket guarantee. In Malaysia's case, MDIC was not only heavily involved in planning and developing the whole GDG plan with BNM from the outset, it was also the agency responsible for administering the GDG and driving the GDG transition process. In this context, it was critically important for MDIC to be credible in the eyes of the public. Without depositors having confidence in the ability of MDIC, as the national deposit insurer, to ensure the safety of their deposits, it would be challenging to successfully manage and execute the transition plans. Therefore, a key part of our efforts revolved around promoting and reinforcing depositors' understanding of the role of MDIC within the safety net framework throughout the period of the GDG.

Measures implemented to maintain and promote the role of MDIC included:

- An official press statement by the Minister of Finance announcing that MDIC was responsible for administering the GDG on behalf of the government. Hence, in the eyes of the public, MDIC was the official face or guarantor for all the guaranteed deposits;

- The government granted MDIC the responsibility for designing the exit plan and driving the transition process;

- The continued functioning of MDIC's explicit deposit insurance system alongside the GDG. In other words, MDIC continued to administer the explicit limited deposit insurance system and insure deposits up to RM60,000, while the government provided a blanket guarantee for deposits over and above the RM60,000 coverage limit and for other deposits not protected by MDIC. Transitioning was made easier as Malaysia only needed to revert to the existing explicit deposit insurance system;

- MDIC was responsible for handing all media enquiries on the Enhanced Financial Consumer Protection Package, and dealing with all depositors' queries on all matters relating to the GDG;

- A comprehensive public awareness campaign to promote and reinforce depositors' understanding of the role of MDIC within the safety net framework throughout the period of the GDG and to educate the public on the GDG. The key message was to highlight the importance of an effective and efficient deposit insurer in contributing to the stability of the country's financial system at all times. Hence, in conjunction with MDIC's 5th anniversary in September, a five-part advertorial was also featured in English, Bahasa Malaysia and Chinese dailies to highlight MDIC's role and its achievements. In the last quarter of 2010, radio commercials were also aired to reinforce awareness of the role of MDIC as the protector of deposits. The campaign helped maintain MDIC's visibility with depositors.

III. **Mitigating moral hazard.** While potentially able to prevent bank runs during a crisis, government guarantees are often associated with potential problems such as higher fiscal contingent liabilities and moral hazard. Moral hazard arises because, with blanket guarantee, depositors no longer see the need to monitor and exert financial discipline on banks. And there is also an incentive for banks to engage in risky activities while the guarantee is in place. Hence, regulatory scrutiny is necessary to mitigate such potential problems.

How did MDIC incorporate mitigating factors into the plan to address moral hazard? The measures were as follows:

- Deposit-taking members were subjected to heightened oversight and supervision to prevent excessive risk-taking;
- Guaranteed institutions were prohibited from using the GDG as a marketing device to attract deposits;
- An annual guarantee fee, which MDIC collected on behalf of the government, was imposed on the guaranteed institutions. The fee was computed based on the amount of deposits protected under the GDG;
- While announcing the GDG, the government made it clear that the guarantee was temporary and that it would expire on 31 December 2010. This was reinforced by MDIC's communications programs during the GDG period;
- MDIC was empowered to impose premium surcharges on non-compliant guaranteed institutions, and could terminate membership and petition for the winding-up of a member bank; and
- MDIC's existing Differential Premium Systems provided incentives for sound risk management by discouraging banks from taking on excessive risk.

Step 2: The exit plan

Work began on the exit plan within six months after the implementation of the GDG. The exit plan included an Enhanced Financial Consumer Protection Package and measures to boost MDIC's efficiency and effectiveness in promoting financial stability via legislative initiatives.

I. The Enhanced Financial Consumer Protection Package

Central to the Exit Plan was an Enhanced Financial Consumer Protection Package, designed to mitigate public concerns about the expiry of the GDG. Deciding what would replace the GDG was one of the most critical transitioning issues. Hence, MDIC invested much time and thought in developing an appropriate package. The Enhanced Financial Consumer Protection Package had four components, as follows:

a. The first component was to substantially raise the deposit insurance limit and scope of coverage. To exit the GDG successfully, MDIC thought it was important to provide for a much higher limit, to create a “feel-good factor” among depositors and take account of the growing economic wealth of Malaysian depositors. The aim was to provide a limit that would likely exceed the public's expectations. Also, the new limit would need to be adequate to meet depositors' needs for the next few years since the limit would not be reviewed until 2016. To provide adequate deposit insurance coverage, as a general yardstick it was suggested that between 85% and 95% of depositors be covered in full. Therefore, a new coverage limit of RM250,000 was proposed, which covered 99% of depositors in full;

b. The second component was to expand the scope of deposit insurance coverage to include foreign currency deposits, in support of a broader plan to develop a more vibrant foreign currency market in Malaysia;

c. The third component was to extend MDIC's protection to owners of takaful certificates[28] and conventional insurance policies. The explicit Takaful and Insurance Benefits Protection System (TIPS) provides protection against the loss of part or all of takaful or insurance benefits in the unlikely event of a failure of an insurance company or a takaful operator. The primary aim is to ensure that takaful certificate and insurance policy owners enjoy government-backed financial consumer protection, similar to that provided for depositors. The implementation of TIPS is also expected to promote the growth of the insurance and takaful industry. The insurance industry in Malaysia plays an important economic role as intermediaries for mobilizing savings, and Malaysians are increasingly using insurance policies as a savings option. The TIPS was designed to protect 95% of all insurance policy and takaful certificate owners;

d. The fourth component was the introduction of the Provision of Information on Deposit Insurance Regulations 2011, which enhance financial protection through greater product transparency and disclosure. MDIC has an obligation to ensure that depositors receive accurate, relevant and timely information on deposit insurance matters. These Regulations, among other things, require deposit-taking members to deliver clear representations about their membership in MDIC in their advertisements; disclose, at the point of sale, whether a deposit product is eligible for deposit insurance protection or not; and provide accurate information on deposit insurance and its benefits to depositors. And deposit-taking members are required to provide depositors with a copy of MDIC's information brochure on the opening of a new bank account.

The underlying key considerations for these Regulations were to ensure product transparency for depositors and to give them easy access to relevant and timely deposit insurance information. For this purpose, deposit-taking members are required to provide information about the features of their new deposit products to MDIC before they are marketed,

[28] Takaful Certificate is an Islamic insurance policy/contract.

so that MDIC can determine whether the products are eligible for deposit insurance coverage or not. All such information is captured by its Product Registry System, an IT system which is integrated with MDIC's payout system. This system rates the insurability of such deposit products based on a set of criteria. It also provides a record of all deposit products offered by deposit-taking members that have been certified by MDIC as eligible for deposit insurance coverage. MDIC and depositors are able to check, at any time, the list of deposit insurance protected products. Hence, at the time of payout, there will be no confusion about which products are insured and which are not. This will also shorten the process for computing the amount of payment due to a depositor.

II. Enhancing the capacity and capability of MDIC to meet its mandate

MDIC has an internal policy to stress-test our legislation to ensure that the Corporation is able to meet its mandate effectively and efficiently. The review proved to be timely as the 2008 global financial crisis highlighted one important lesson, which is that depositors lack confidence in deposit insurers that do not have or cannot demonstrate the capacity and capability to meet their mandate, whether in making a payout or in resolving troubled banks. And MDIC saw the crisis as a good opportunity to seek broader support from public policy decision-makers in areas which would make the Corporation stronger and more effective in fulfilling its enhanced mandate and support the supervisors in promoting and contributing to the stability of the financial system.

For this purpose, a comprehensive review of the MDIC Act 2005 was conducted, leading to the tabling of the new MDIC Bill 2010 in parliament on 30 November 2010 to enhance MDIC's capacity and capability and also to enable MDIC to fulfill its enhanced mandate in respect of TIPS and its broader mandate to promote and contribute to the stability of the financial system.

The new MDIC Act provides MDIC with adequate powers, a wider toolkit and greater flexibility to fulfill its mandate of maintaining and promoting public confidence and the stability of the financial sector.

The new legislation included a package of stabilization measures aimed at providing flexibility to respond to the needs of depositors in the event of a crisis. The key provisions of the new MDIC Act are highlighted below:

- Authority to increase deposit insurance beyond the regular limit and scope of coverage. This authority enables MDIC to specify the new stabilization limit and coverage by way of subsidiary legislation. The objective is to give MDIC speed and agility to respond to and neutralize emerging threats to financial stability. In line with this authority, the new MDIC Act no longer specifies a statutory limit or coverage, even for normal conditions. The Minister of Finance is now empowered to set the limit and scope of coverage by an Order, on the recommendation of MDIC;

- Financial institutions which are not member institutions of the regular deposit insurance system can be classified as members of the deposit insurance system. Under the repealed Act, "member institutions" referred only to commercial and Islamic banks. There are, however, other financial institutions which could conceivably become systemically important in future. To maintain public confidence in the overall stability of the financial system, it may be necessary to provide deposit insurance coverage for such institutions. Hence, the provision for the Minister of Finance to classify other financial institutions as member institutions of MDIC on the recommendation of BNM and MDIC;

- Authority for the Minister of Finance to prescribe the rate of annual premiums. The repealed Act provided for the annual premium rate to be capped at 0.5% of the total insured deposits held by a deposit-taking member. Given the lessons learnt from the recent financial crisis with regard to challenges in rebuilding deposit insurance funds, the cap for the premium rate was removed so that the Minister of Finance may prescribe any rate, for greater flexibility;

- Authority for MDIC to establish and implement a "bridge institution", as part of its powers to deal with troubled deposit-taking members so that it may fulfill its mandate more effectively and efficiently. Under the Act, MDIC was conferred with certain intervention and resolution powers in respect of a troubled deposit-taking member, once BNM had issued a "non-viability" notification to MDIC. These powers include the authority for MDIC or its appointed representative to assume control of the deposit-taking member, to appoint a receiver, or to apply to the court for a winding-up order.

  Under the "bridge institution" option, MDIC is empowered to transfer certain assets and liabilities from the troubled deposit-taking member to a "bridge institution", which will operate as a bank. The "bridge institution" will be stabilized and rehabilitated, with a view to being sold to a private sector purchaser.

MDIC has also continued to enhance its operational readiness to undertake intervention and failure resolution activities. In this regard, good progress has been made in the development of an integrated payout system to enable us to conduct a prompt and accurate reimbursement of insured deposit claims, when called upon.

Steps 3: Development and implementation of strategies

Developing execution strategies was a critical part of MDIC's planning process. Without a set of well-thought-out strategies, the objective of a smooth transition could be undermined. Hence, MDIC had devoted a considerable effort to formulating the strategies for implementing the exit plan.

MDIC's **first strategy involved an early announcement by the Prime Minister of Malaysia on 11 May 2010 on the Enhanced Financial Consumer Protection Package.** The advance notice of an exit plan, its objectives and timelines, made more than seven months before the expiry of the GDG, was done, first, to reiterate the government's commitment to exit the blanket guarantee by 31 December 2010. Second, it was to ensure that the public was fully informed about the exit and its related timelines as well as the enhanced deposit insurance arrangements well before the exit, to avoid unnecessary surprises. This provided certainty for depositors so that they would be better prepared, and provided MDIC with enough time to facilitate adjustments to the benefits of the enhanced package, ahead of the exit. Otherwise, if the public reacted negatively, this could culminate in financial instability in the form of bank runs and capital flight. This would seriously derail the exit plan. Third, an early announcement of the enhanced package also afforded MDIC a good opportunity to monitor public sentiment on the transition back to a limited guarantee.

The second strategy was to adopt a quick exit (a Big Bang approach) from the GDG. This was preferred over a gradual or staggered exit because of the long-run challenges, the distortions that might arise, as well as the moral hazard risks if the GDG was not removed quickly enough. Furthermore, Malaysia's strong economic fundamentals allowed a quick exit. Malaysia's economic environment, and the banking sector in particular, had ample liquidity and our deposit-taking members were well-capitalized. In addition, BNM's foreign exchange reserves were strong and the financial safety net framework was credible in the eyes of the public. However, it should be cautioned that a rushed exit, especially where it is not well explained and understood by the public in advance, could be very damaging.

That is why **the third strategy involved clear communication of the exit plan.** Essentially, this involved developing key messages to be conveyed to depositors during the transition, to ensure that the public fully understood and was well-informed of the Enhanced Financial Consumer Protection Package. This would guarantee greater public acceptance. MDIC is responsible for promoting public awareness about the deposit insurance program it administers, and the Corporation makes a great effort to reach out to the public. Understanding and acceptance by the public is the key to public confidence during the transition and after the exit date. The communications strategy adopted was to position the enhanced package as a "good news" story, with a strong emphasis on its benefits. This would create the perception of giving more, and not just taking away.

The public was encouraged to provide its views on the proposed enhanced deposit insurance limit and scope, as well as the proposed benefits to be protected under TIPS. This was achieved through our regular face-to-face meetings with depositors, holding focus group sessions across the country as well as communications with the public via our call center and website at info@pidm.gov.my. Various channels of communications were used, including media and print advertisements. These meetings and sessions greatly helped MDIC to understand the consumer psyche, in particular their concerns and expectations with respect to the transition. These have greatly facilitated MDIC in testing and managing public perceptions and fine-tuning the Enhanced Financial Consumer Protection Package and exit strategies.

The fourth strategy involved determining whether economic and financial conditions were conducive to supporting the transition back to the existing explicit limited deposit insurance system. To achieve a safe disengagement from the GDG, certain economic preconditions had to be met. BNM and MIDC remained vigilant to potential emerging financial risks and economic challenges throughout the GDG period, but more so during the run-up to the expiry of the GDG. BNM and MDIC closely monitored the economic and financial conditions, the public reaction to the proposed measures, and the movement of deposit liabilities in the financial system.

The last strategy was close collaboration and coordination with other safety net players. A smooth transition out of a GDG cannot be achieved solely by one safety net player but through the coordination and support of all safety net players. In Malaysia's case, the transitioning was made easier because MDIC had established a strong culture of collaboration with BNM and the Ministry of Finance. Close collaboration and coordination are important for the following reasons:

- Different safety net players were responsible for different tasks. In the case of Malaysia, while the design of the exit plan was MDIC's responsibility, its execution required teamwork from the other safety net players. The implementation of an exit plan works best when each player within the safety net understands their respective roles. When all players know who is to do what and when, this avoids unproductive overlaps and minimizes the likelihood of agencies sending out differing views, conflicting signals and messages, which would not only seriously erode public confidence, but, in turn, affect the credibility of the safety net players;

- In any crisis, it is vital to assure the public that the government is taking the situation seriously and is capable of dealing with such problems. Hence, it is important that the government speaks with a single voice;

- To ensure that the transition was carried out effectively, MDIC needed buy-in from the other safety net players to the exit plan. Hence, MDIC worked closely with the Ministry of Finance and BNM by keeping them informed of its exit plan and the execution strategies. With all the relevant safety net players taking part in the process, there was a greater likelihood that they would accept and support the goals and the strategies to move the plan forward. And the efforts of all agencies would be aligned towards the same goal.

Conclusion

Planning and executing an exit from a blanket guarantee can be complex. However, it can be successfully implemented with meticulous planning, an effective public awareness campaign and close collaboration with other safety net players, as the Malaysian experience has shown. Malaysia exited from the GDG successfully on 31 December 2010. And central to the successful execution of the exit plan by MDIC was a credible and well-received transition package, which mitigated public concerns about the expiry of the GDG and maintained public confidence. The successful execution of the exit from the GDG further advanced the visibility and credibility of MDIC as a key component of the financial safety net.