DEPOSIT INSURANCE - AN ANSWER TO THE PROBLEM?

PRESENTED BY

DEBBIE A. FRASER
ATTORNEY-AT-LAW
MYERS, FLETCHER & GORDON
21 EAST STREET
KINGSTON

AT
NORMAN MANLEY LAW SCHOOL
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INTRODUCTION

In 1994 we began to see the fall of a number of financial institutions in Jamaica. To say that we were unprepared to deal with this situation is an understatement. The government was faced with the dilemma of whether to allow the institutions to fail and the depositors to lose their deposits or to intervene by way of saving the institution or the depositors.

The negative impact which the failure of the various financial institutions had on our economy is still being felt and as a result of the failure of these institutions, various solutions were considered in an attempt to prepare for any future problems. One such solution was a Deposit Insurance Scheme.

1. WHAT IS DEPOSIT INSURANCE?

Deposit Insurance is a form of protection for depositors and in particular small depositors. It is an attempt to ensure that if one financial institution fails it will not undermine the public's confidence in the financial sector generally and lead to a "run" on other financial institutions. It is done by the government primarily for two main reasons namely:

(1) a sense of responsibility to depositors; and

(2) protection of the financial sector to maintain financial stability.

2. The formation of a deposit insurance scheme usually arises out of a fear of or the occurrence of a "bank run". Depositors may become aware or may speculate that

a deposit taking institution is experiencing financial difficulties. The fear that the institution may not be able to return the depositors' deposits leads to the depositor's rush to withdraw funds from the institution. If the institution is insolvent or has a serious cash flow problem, the depositors who get to the institution first are more likely to receive full payment while the later depositors receive next to nothing or nothing. Deposit insurance is aimed at making these circumstances more equitable as all depositors are treated on an equal basis and their likelihood of receiving payments is not solely dependent on when they became aware of the difficulties which the institution was experiencing. It does not avoid the problem since depositors who get to an institution before it fails are still more likely to get all of their deposits. The problem is however modified since depositors are guaranteed the return of at least a part of their deposits after the institution has failed.

3. The role that the government should play in the circumstances has been the subject of much discussion. Is the government responsible to depositors when a bank fails? The view has been expressed that the government is obliged to fully reimburse a depositor on the failure of a bank since its regulatory arm should have realized that the financial institution was in trouble before the problem worsened. The opposing view to this argument is that risk is inherent in deposit taking and a depositor in making a decision to invest in an institution which offers high returns on the investment should also face the consequences in the event that the institution is unable to return the funds. These views are at either end of the spectrum and most

countries try to find a middle ground.

4. What is true is that a form of implicit deposit insurance has taken place between 1994-1998 since the government has undertaken the deposit liabilities of a number of financial institutions.

5. **THE JAMAICA DEPOSIT INSURANCE CORPORATION**

In March 1998 the Deposit Insurance Act 1998 ("the Act") came into effect and following the passing of the Act the Jamaica Deposit Insurance Corporation ("the Corporation") began operations on August 31, 1998. The objects of the Corporation are stated to be to establish and manage a scheme for the insurance of deposits against the risk of loss. In carrying out its objectives the Corporation also has the aim of ensuring that there is the least possible exposure of the Corporation to loss. It is one thing if a financial institution fails but it is another if the Corporation which insures that institution is also insolvent. The Corporation is basically a Government body corporate which is operated as a private company but is controlled by the government. The Corporation is funded primarily from premiums paid by financial institutions to receive insurance coverage and it has the general functions of:

1. Insuring deposits;
2. Managing and administrating the funds and other income which the Corporation may receive and generally to levy premiums for the fund.

6. The only other English speaking Caribbean territory which has a Deposit Insurance Scheme is Trinidad & Tobago and that country's scheme operates similarly to ours.

7. Section 5 of the Act provides that the Corporation's functions are as follows:

"(1) *The functions of the Corporation shall be to carry out such activities as may be necessary to give effect to the objects specified in section 4, and without limiting the generality of the foregoing such functions shall include the duty-*

(a) to provide, in accordance with the provisions of this Act, insurance against the loss of deposits;
(b) to manage and administer the Fund or any other income of the Corporation;
(c) to levy premiums for the Fund and fees or other amounts payable in accordance with the provisions of this Act.

(2) *For the purpose of the performance of its functions under this Act, and subject to the provisions of this Act, the Corporation may do anything and enter into any transaction which, in the opinion of the Corporation, is necessary or incidental to its functions, and in particular, and without limiting the generality of the foregoing the Corporation may-*

(a) make such enquiries of a policyholder as to the conduct of its affairs as may be prescribed;
(b) make recommendations to the Minister for action to be taken in accordance with the Banking Act, Bank of Jamaica Act, Building Societies Act or Financial Institutions Act, as the case may require, in respect of any policyholder which appears to the Corporation to be in financial distress[1]*;*
(c) in accordance with such rules as may be prescribed, act as receiver, liquidator, or judicial manager of any policyholder, or of its holding company or subsidiary which becomes insolvent, or appoint any person to act as such; and in acting in any such capacity may arrange for the restructuring of a policyholder whether by merger with or acquisition by another financial institution or otherwise [no rules have been prescribed to date];
(d) deduct from payments made to a depositor out of the Fund in respect of an insured deposit, arrears in respect of any credit facilities, deposits pledged as collateral, called-in guarantees and unsecured overdrafts due from the depositor

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1 A financial institution is in a state of financial distress if among other things, the institution has failed to satisfy prudential criteria and minimum solvency standards prescribed by or under the Banking Act, Bank of Jamaica Act, Building Societies Act or Financial Institutions Act.

to the policyholder in question."

8. The Corporation's functions are therefore extensive and seem to be primarily that of a watchdog with the power to take over the management of financial institutions in financial distress. It is left to be seen how the Corporation's power to act as receiver or liquidator will accommodate the powers of the Minister of Finance to assume temporary management of financial institutions when they fall into difficulties. It is possible that the Minister may exercise restraint in exercising his powers under the various financial legislation and that the Corporation will be allowed to assume the dominant role in the event of a crisis in a financial institution.

9. In a review of its financial status as at March 1999, the Corporation indicated as follows[2]:

"The Corporation commenced operation with an authorised capital of One Million Dollars ($1,000,000.00) subscribed by the Government. However, prior to the receipt of this amount, the Bank of Jamaica provided a loan of eleven million and sixty five thousand dollars ($11,065,000.00) to the Deposit Insurance (Promotional) Company Limited, the forerunner company to the JDIC, to facilitate start-up operations. The loan was extended at two percent above the Reverse Repurchase rate. Repayments are being made on a quarterly basis and should be completed by September 2000.

The bulk of JDIC's financial resources was generated from the initial insurance premiums paid by the thirty-five (35) policyholders in November 1998. These premiums which were calculated on the basis of 0.1 percent of the policyholders insurable deposit liabilities as at December 31, 1997 amounted to $134,196,297. However, only $55,915,124 was reflected in the accounts as the amount earned as premium income for the seven-month period to March 31, 1999. The financial statements show total expenditure of $19,760,544. The Corporation also earned income on its investment of $8,218,260, resulting in an excess of expenditure over

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2 See Executive Summary from the JDIC Annual Report at http://www.jdic.org/documents/overview.htm

income of $11,542,283. This led to a surplus in the Deposit Insurance Fund of $44,372,841 at the end of March 1999."

10. The Corporation needs to ensure the it has the funds to fulfill its obligations under the Act if the need arises.

11. **WHO AND WHAT IS COVERED**

Financial institutions such as commercial banks, merchant banks and building societies are required to become policyholders under the Corporation. This means that these institutions are required to insure their deposits with the Corporation. The depositors of the financial institutions are therefore the beneficiaries of the insurance coverage. For the purposes of this paper, I will describe financial institutions which have certificates of insurance with the Corporation as "policyholders". There are thirty-four (34) policyholders to date and this will be reduced when the Union Bank merger is completed. All thirty-four(34) policyholders are supervised by the Bank of Jamaica.

12. Funds of financial institutions subject to the Act which may be covered under the Act include: (1) savings and chequing accounts; (2) certificates of deposit; (3) time or fixed deposits; (4) managers' cheques, money orders and drafts (5) a share in a building society but not a capital share, a deferred share or a preference share. It should be noted that interbank deposits and deposits from a government company or statutory body are not subject to deposit insurance.

13. Policyholders are required to pay a premium to the Corporation of 0.1% of their total deposits. It is therefore intended that the policyholders will provide the funds necessary to make pay outs if needed and that this will not be at the expense of the public purse. Although the Corporation has the power to prescribe different percentages of insurable deposits and different methods of payments for different financial institutions,[3] the decision was taken to implement a flat rate at this time since presumably this was easier to manage. It is expected that in the future the Corporation will make a risk assessment of each policyholder and this may affect the premium which is required for a policyholder. The Corporation is required to work closely with the Bank of Jamaica to receive information on the safety and soundness of policyholders and to be able to identify at an early stage policyholders who are in financial difficulties. It is however not a regulator although it is entitled to receive copies of the various examination reports on policyholders which are prepared by the Bank of Jamaica.[4]

14. **PAYMENT OUT OF THE FUND**

The Corporation is required to make payments in satisfaction of the sums due from a policyholder up to a maximum of J$200,000.00 to each depositor. A Task Force which was established in 1995 to make recommendations for the Deposit Insurance Scheme, recommended the sum of $200,000.00 per depositor since this was

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3 See Section 14(6) of the Act

4 See Section 7 of the Act

determined to be just over two (2) times Jamaica's per capita gross domestic product. They indicated that that sum would satisfy the conventional maxim which is that coverage should be about twice a country's per capita income. Payments under the Act should be made in any of the following instances:

1. the policyholder's licence is revoked by the Minister;
2. a winding up order has been made against the policyholder;
3. the policyholder is unable by reason of an order of the court or a decision made by the Minister to make payments in respect of deposits;
4. the policyholder'spolicy of deposit insurance has been cancelled subsequent to the making of a deposit which is insured. (If the depositor made the deposit after the policy was cancelled, that deposit is not insured.)

15. The Corporation must start to make payments to depositors no later than 3 months after the occurrence of one of the above events. If the Corporation fails to start making payment within that specified period of time, the Corporation is liable to pay interest on the payments at the average rate of interest payable by commercial banks on savings accounts on the date when the liability to pay interest begins.

16. The Act provides that where a depositor holds more than one deposit in a policyholder:

(a) In different capacities and with different rights in relation to that deposit, each deposit is treated as a separate deposit for the purposes of calculating the

$200,000.00 coverage.

(b) In the same capacity and with the same rights all such deposits shall be treated as a single deposit for the purpose of calculating coverage.

17. If for example, a depositor has three accounts at a commercial bank but each account is held at a different branch of the bank and for instance that depositor has $20,000.00 in branch A, $20,000.00 in branch B and $300,000.00 at branch C, the depositor's coverage in the event that the bank fails is $200,000.00 and not $340,000. The depositor is therefore uninsured for $140,000.00 of his deposits.

18. In other jurisdictions which also have deposit insurance, one of the most common issues relate to joint accounts. The total amount of insurance on multiple joint accounts owned by the same persons cannot exceed $200,000.00. So for instance, A, B and C have three separate joint accounts in a commercial bank which has failed. A, B and C are only entitled to a coverage of $200,000.00 and not $200,000.00 per account or per person. Once the holders of that joint account are the same as the holders of the other joint accounts then coverage is a maximum of $200,000.00. If a depositor has more than one deposit in a policyholder but these deposits are held along with different individuals, each deposit is treated as a separate deposit for insurance purposes. Funds are apportioned equally among joint account depositors in the absence of some proof from the depositors that they should be apportioned otherwise. Depositors have 18 months after the date on

which the Corporation's obligation arises within which to make claims for payment out of the funds.

19. I have seen numerous instances where in relation to failed institutions, deposits were held in the names of certain individuals but they indicated that they were holding the funds on trust and that the account was really for the benefit of someone else. When a situation like this arises the Corporation has the power to accept some form of affidavit evidence confirming that the funds should be paid to another person . If there is some dispute as to the true owners of an account, I expect that the Corporation may require a court order to direct it as to how the payment should be made.

20. Attorneys-at-law, in particular should ensure that accounts in financial institutions are clearly identified to indicate the nature of the account whether they be personal or trust. Trust accounts should be clearly described to identify the beneficiaries of the trust to avoid any disputes with the Corporation as to who is the beneficiary of an account. In the event that trust funds (even though the beneficiaries may be different) are lumped into one account described as a "trust account", the Corporation will pay out $200,000 for that account in the absence of directions from the court to do otherwise. If however, separate accounts are opened for each beneficiary and these accounts clearly indicate that they are trust accounts and the beneficiaries are identified, each account will be insured for a maximum of

$200,000.00. If there are different accounts with the same trustee and the same beneficiary, coverage will be for $200,000.

21. In instances where a depositor is uninsured for a part of its deposits, this does not mean that the depositor has necessarily lost its funds in its entirety. For instance, if a depositor has a deposit of say $400,000.00 in a failed policyholder then the Corporation will pay out $200,000.00 to that depositor and a certificate will be issued by the Corporation for the excess i.e. $200,000.00. That depositor is therefore entitled to prove in any liquidation proceedings which may be taken against the failed policyholder so there may be a chance of recovering all or some of the remaining $200,000.00 if funds are available after the sale of the assets of the failed policyholder. This means that it will take a much longer time for the depositor to recover any additional funds over the maximum coverage. I have been advised by the Corporation that they are now working on regulations to be made under the Act which will address the following:

1. Joint and Trust Accounts;
2. Amalgamating Policyholders;
3. Developing a pay out methodology.

22. Deposit insurance has its advantages and disadvantages. The advantages can be seen as follows:

1. It provides some certainty to depositors since there should no longer be a need for speculation as to whether or not the Government will "bail out" the depositors of a failed financial institution;

2. It reduces the political pressure on the Government of the day in relation to demand by its voters for immediate redress when an institution fails;

3. It creates another "watch dog" for licenced financial institutions since the Corporation, in addition to the regulatory arm of the Bank of Jamaica should also be critical of its policyholders in order to reduce the likelihood of a failed financial institution.

4. Depositors should now be better able to identify sound financial institutions and with that knowledge be able to be more selective in making their investments. Depositors should only do business with policyholders or face the risk of losing all their funds by investing with an institution which is not covered by the Corporation. Policyholders are issued Certificates of Insurance and depositors will therefore be able to identify the institutions which are covered.

23. The following could be seen as disadvantages of deposit insurance:

(1) Deposit insurance has been the subject of much international debate recently, largely as a result of the poor performances of many of the larger and generally perceived "sound banks" in countries which have deposit insurance. The view has been expressed that deposit insurance only serves to protect failing banks and to encourage banks generally to take risks which they would not take if there was no deposit insurance or if they believed that the government would not come to their assistance if they were about to collapse. This view is known as the "Moral Hazard Theory". This theory basically means that if you protect someone from the serious and harsh consequences of taking a risk, that person will have less incentive to avoid risky situations. The general experience of countries with deposit insurance is that it fosters high risk investments by financial institutions. Risk adjusted insurance premiums is seen as one method of avoiding the moral hazard theory.

(2) It is left to be seen whether the Government will maintain its position of not bailing out institutions which are not covered by the Corporation or whether the Government will provide 100% coverage for depositors of policyholders. In other jurisdictions it is a tendency for governments to protect failed institutions as a result of their insolvency even though they are not covered by any form of deposit insurance or to provide depositors with the full return of their deposits even though this may exceed the maximum coverage under the deposit insurance scheme.

(3) One of the advantages may also be considered a disadvantage since although the Corporation will be primarily concerned with the risk assessment of its policyholders, it can exercise some amount of monitoring control on those policyholders and there is therefore the possibility that there may be some duplication of effort between the Corporation and the Bank of Jamaica.

24. **OBLIGATIONS OF THE DEPOSITORS**

I hope that the days of depositors placing funds with financial institutions without enquiring as to their soundness or feeling that once the funds are with a licenced financial institution that they are protected are gone. Depositors in this environment need to ensure that the financial institutions in which they choose to invest are covered by the Corporation and have a Certificate of Insurance. In addition to this depositors must also become more receptive to information relating to financial institutions and they should also continue to monitor these financial institutions. A financial institution which has failed does not fail overnight. It is usually done over a period of probably months or even years and depositors need to be more conscious about where they place their funds.

25. It is also advisable to spread out investments among policyholders since if all your investments are kept with one policyholder and it fails, you would have lost most of your investment. Although the Corporation also has the added responsibility to

provide ongoing information on policyholders, with that added information depositors should therefore ensure that they make the right decisions in relation to where they place their investments. Depositors however cannot forget that depositing with a financial institution is a risk and therefore has its consequences. This is especially relevant to depositors with large deposits since the coverage is limited to $200,000.

CONCLUSION

26. Deposit insurance provides some confidence in a country's financial market since depositors are given a sense of security that they will be able to recover even a portion of their deposits in the event that a financial institution fails. With the implementation of a deposit insurance scheme in Jamaica another government body is created which intends to work closely with the BOJ to supervise and control financial institutions. Many complain that our financial system is over- regulatory and this hinders the smooth running of a free market economy and stifles competition. In light of what has occurred over the last few years, the general mood is more one of conservatism than liberalism.

27. The Corporation needs to grow and develop in a manner which ensures that there is continuing communication between depositors and the Corporation. Depositors should feel free to make complaints to the Corporation about policyholders and they should be able to obtain information quickly from the Corporation on the risk status

of a policyholder. Confidence in the banking sector will only come when depositors feel that they have accurate information on the status of a policyholder and that the Corporation will be able to make the necessary payouts if ever there is a need.

28. What is clear is that deposit insurance by itself will not reduce our exposure to a run on a bank and neither will merely providing for regulations to supervise these institutions. There must be some active supervision by the relevant institutions. Depositors also need to be mindful of where they invest their funds and although in an ideal world we may believe that the government has a duty to protect us from unsafe banking practices, the fact is that this is not an ideal world. THE ECONOMIST April 27th - May 3rd 1996 states "Like safe sex, safe banking requires effective precautions". This means precautions by bankers, regulators of the financial market and also by depositors themselves.

Debbie A. Fraser
Attorney-at-law
Myers, Fletcher & Gordon
21 East Street
Kingston