**CHAPTER 16:**

**Managing Risk: Deposit Insurance**

**FOCUS OF THE CHAPTER**

This chapter is a discussion of the **necessity**, **importance,** and **consequences** of deposit insurance. The deposit insurance program in Canada is analyzed and compared to deposit insurance programs in some other countries. The chapter ends with a discussion of some **proposed improvements** to the Canadian deposit insurance program.

**Learning Objectives:**

1. Explain why deposit insurance is necessary, how it operates in Canada, and which levels of government offer deposit insurance
2. Explain how the Canada Deposit Insurance Corporation is structured, how it functions, how it interacts with other regulatory institutions, and how it deals with insolvent banks
3. Determine how deposit insurance works in other countries and whether the Canadian plan is relatively generous
4. List some common problems with insurance and describe the importance of moral hazard and adverse selection
5. List some of the public policy issues surrounding deposit insurance, analyze whether the present scheme can be improved, and describe any political factors that impede reforms

**SECTION SUMMARIES**

**Rationale for Deposit Insurance**

The failure of a single bank can lead to fears of the failure of other banks, thus creating the potential for a banking panic. Deposit insurance has been suggested as a means to prevent widespread banking crises and their social costs. But, whether deposit insurance does more harm than good in securing the safety and stability of the financial system has been a point of debate.

***Moral Hazard and Adverse Selection:*** Insurance always raises the difficulties of moral hazard and risk avoidance. The forms of deposit insurance in North America seem to be particularly problematic.

*Moral Hazard:* **Moral hazard** is a consequence of **asymmetric information**. Moral hazard refers to the tendency of insured institutions to take on more risks than they would in the absence of insurance. Insurance provides an incentive for some institutions to increase their exposure to risk, and thus increases the number of high-risk institutions in the financial system. **Co-insurance** (the injured party pays a fraction of any loss) and deductible insurance (a fixed amount is deducted from the loss claim) are two ways to mitigate the moral hazard problem.

*Adverse selection:* This problem also exists because of asymmetric information. If insurance companies are not able to precisely determine the risk for each would-be insurance purchaser, they have to assign risk categories to groups of individuals. Some of those insurance purchasers will have above average risk while others will have below average risk, but they will pay the same premiums for the coverage. Asymmetric information reveals to us that insurance purchasers are more likely to know whether they are above or below the average in terms of risk. Those individuals that know they have a risk factor that is below average will realize that they are paying too much for their insurance and are therefore likely to opt out of an insurance policy. That will leave those individuals with average or above average risk who, knowing that the premium understates their cost of insurance, are more willing to buy the policy. However, unless the insurance company raises its rates to reflect the greater concentration of higher risk individuals, it will lose. As it raise premiums, more of the low risk individuals opt out and the market deteriorates.

***The Role of Government in Deposit Insurance: Is There a Political Motive?*** Government involvement in providing deposit insurance is justified on the grounds of market failure. However, whether the government deposit insurance programs perform better than private deposit insurance is not clear from the historical record. Deposit insurance was created because it is a popular **entitlement program**, like health insurance and unemployment insurance.

**Deposit Insurance in Canada**

Deposit insurance is a form of insurance which compensates depositors for at least some of their loss resulting from the failure of a financial institution.

***The Mechanics:*** The **Canada Deposit Insurance Corporation** **(CDIC)** operates and supervises the deposit insurance system in Canada. All federally chartered banks, trust companies, and mortgage loan companies must be members. Provincially chartered institutions may also be members. Before 1999 each member paid a flat premium; in 1999 a risk-based premium was implemented. Four membership categories exist. As of 2005 eligible deposits are insured up to a maximum of $100,000 per deposit. But the coverage effectively may be increased since: 1) the limit applies to deposits held with a single member; 2) the joint deposits, RRSPs, RRIFs, and deposits held in trust are insured separately; and 3) the federal and provincial governments sometimes go beyond the coverage of the deposit-protection agency.

***The CDIC:*** The board of directors of the CDIC includes the governor of the Bank of Canada, the deputy minister of finance, and the superintendent of financial institutions. Four Board members including the chair are representatives from the private sector. The CDIC has wide powers a) to acquire assets from a member; b) to make loans or deposits without any collateral; c) to borrow from the federal government or to issue debt instruments to raise funds; d) to act as a liquidator; and e) to assume the costs of winding-up operations. The financial turbulence of the 1980s led to a review of CDIC roles and functions, which led eventually to a change in the CDIC mandate to focus on the promotion of the stability of the financial system. In the event of a failure, the CDIC

can take one or more of the following steps:

1) pay off the depositors and close the bank.

2) merge with a solvent bank

3) transfer deposits to another institution, which receives funds necessary to assume the liabilities, and wind up the insolvent bank

4) bail out the insolvent bank.

The review of the CDIC’s functions in 1993 and 1994 led to a clarification of the functions of the CDIC and to the creation of the Office of the **Superintendent of Financial Institutions** **(OSFI).**

 Canadian financial history has been one of avoiding bank failures. Between 1967 and 1989, the CDIC was called on to act in 23 instances. Since 1984, there has been a string of failures. The two largest failures occurred in 1991 (Standard Trust) and in 1992 (Central Guarantee Trust Co.). Since the end of the 1990s the financial position of the CDIC has improved. The growth of off-balance sheet items has been an important development in the financial industry over the last two decades or so.

**Deposit Insurance in Other Countries**

The first country to provide deposit insurance was the United States, where state-sponsored schemes can be traced back to the 1820s. A government agency named the **Federal Deposit Insurance Corporation** **(FDIC)** handles deposit insurance in the United States. The FDIC maintains two funds, one for commercial and savings banks, and the other for savings and loan institutions. Insurance is provided to a maximum of $100,000. Other industrialized countries also have deposit insurance schemes. Many programs in countries other than the United States, Great Britain, and Canada, are financed privately by the institutions themselves and administered by an association of members, without the help of an officially sanctioned agency.

**How Could Deposit Insurance Be Improved?**

Is Canada’s deposit insurance program too generous? What kinds of reforms in deposit insurance would best serve the nation? Why are banks and trusts insured against losses while other institutions have separate investor protection programs? These are a few of the questions which have been raised about Canada’s deposit insurance program. Guaranteeing equal competition would mean insuring all types of institutions or none at all. Nobel laureate **James Tobin** has suggested that only pure chequing account balances be insured. Others have argued that only accounts paying relatively low interest rates be insured. Although there are many possible practical problems, an important reform would be to let the premiums on deposit insurance fully reflect the risks undertaken by the depository institutions. Raising the capital requirement (i.e., the equity-to-assets ratio); making the CDIC more accountable to the institutions that pay the premiums and are best able to assess risk; and making membership in the CDIC voluntary have been suggested as improvements.

 The 1998 Task Force on financial reforms recommended clarification of the responsibilities of the CDIC and OSFI. This clarification might be accomplished by transferring responsibility for determining what is sound banking practice to the OSFI. Other helpful reforms might include requiring the CDIC to disclose its ratings of member institutions or providing incentives to the private sector to provide information about the soundness of institutions. A proposed reform which would require the banks to issue junior or subordinated debt has also been widely discussed.

 **MULTIPLE**-**CHOICE QUESTIONS**

1. Deposit insurance is a form of insurance against

a) losses arising from changes in the market prices of financial assets.

b) foreign exchange risk.

c) systematic risk

d) losses arising from the failure of a financial institution.

2. The deposit insurance system in Canada is operated by

a) the Bank of Canada.

b) the Canadian Payments Association.

c) the Canada Deposit Insurance Corporation.

d) the Office of the Superintendent of Financial Institutions.

3. Under the current deposit insurance program in Canada, eligible deposits are insured

a) to a minimum of $6000 per deposit.

b) to a maximum of $60,000 per deposit.

c) to a maximum of $100,000 per deposit.

d) one hundred percent (100%).

4. The Board of Directors of the CDIC includes all of the following except

a) the minister of finance.

b) the governor of the Bank of Canada.

c) the deputy minister of finance.

d) the superintendent of financial institutions.

5. Which of the following is not an option for the CDIC in the case of a bank failure?

a) Close the bank without paying off the depositors

b) Merge the bank with a solvent bank

c) Transfer the deposits to another institution

d) Bail out the bank to continue its operations

6. The deposit insurance program in the United States

a) is the best example of a privately managed deposit insurance program.

b) is handled by the Federal Reserve.

c) is handled by a government agency called the Federal Deposit Insurance Corporation.

d) is a jointly managed program by the government and the private sector.

7. The tendency of financial institutions to take on more risk in the presence of deposit insurance is referred to as

a) risk-loving behaviour.

b) moral hazard.

c) adverse selection.

d) the asymmetric information problem.

8. The problem that the mere existence of insurance increases the likelihood that high risk individuals will more actively seek insurance

a) is called self-selection.

b) is called adverse selection.

c) is called moral hazard.

d) is called the paradox of insurance.

9. Nobel laureate James Tobin has suggested that

a) all types of deposits at all financial institutions be insured.

b) only the time and savings deposits of a nation be insured.

c) none of the deposits at depository institutions be insured.

d) only the transactions balances of a nation be insured.

10. The historical experiences of deposit insurance programs in the industrialized countries

a) clearly indicate that private programs outperform public (government) programs.

b) clearly indicate that public programs outperform private programs.

c) do not indicate clearly whether public programs are better than private programs.

d) show that both private and government programs failed completely in the 1980s.

## PROBLEMS

## 1. What is deposit insurance? Why are programs of deposit insurance necessary?

2. Why do people argue that deposit insurance does more harm than good in securing the safety and stability of the financial system?

3. Why are governments involved in deposit insurance?

4. What is the moral hazard problem and how does it help is understand problems arising out of deposit insurance and the solutions to those problems?

5. What is the adverse selection problem and how does it help is understand problems arising out of deposit insurance and the solutions to those problems?

**ANSWER SECTION**

**Answers to multiple-choice questions:**

1. d (see page 314)
2. c (see page 314)
3. c (see page 315)
4. a (see page 316)
5. a (see pages 316-317)
6. c (see page 318)
7. b (see page 312)
8. b (see page 312)
9. d (see page 319)
10. c (see page 318)

**Answers to problems:**

1. Deposit insurance is a form of insurance designed to compensate depositors for at least some of their loss resulting from the failure of a financial institution. Deposit insurance programs are necessary to ensure the safety of small investors who are not in a position to judge the soundness of the financial institution in which they have invested their savings. The failure of one depository institution can lead to fears that the whole system of banks might fail, thus creating bank panics. Therefore, deposit insurance programs are necessary to prevent or reduce the potential for such situations.

2. Insurance always raises the difficulties of moral hazard and risk avoidance. Some argue that deposit insurance does more harm than good in securing the safety and stability of the financial system. Moral hazard is the tendency of insured institutions to take on more risks than they would in the absence of insurance. With deposit insurance, moral hazard provides an incentive for some institutions to increase their exposure to risk, and thus increases the number of high-risk institutions in the financial system. Adverse selection refers to the problem that the mere existence of insurance increases the probability that a particular event will take place. In the presence of deposit insurance, adverse selection implies that depositors will be less concerned about the riskiness of a particular investment.

3.Deposit insurance can be considered a popular entitlement program, like health insurance and unemployment insurance. It has been argued that government involvement in deposit insurance is due mainly to political motives, though there may be valid economic reasons as well.

4. Insurance shifts the financial burden from the insured person to the insurance provider. This reduces the financial incentive to minimize exposure to risk. In the context of deposit insurance, moral hazard may induce financial intermediaries to undertake higher risk and potentially more profitable investments knowing that it will not significantly raise its borrowing costs. This is because depositors will not be worried about the security of their deposits and will not, therefore, demand risk premiums. Solutions to this problem will involve risk adjusted premiums which offer to intermediaries a financial assessment to not unduly assume risk.

5. The adverse selection problem arises because higher risk financial intermediaries are more likely to seek deposit insurance. This problem can be minimized by making deposit insurance compulsory and also by setting risk adjusted premiums that more accurately reflect each institutions risk category.