

# Deposit Guarantee Scheme in Nigeria

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#### INTRODUCTION

The role of the banking sector, the financial safety net, and other financial institutions that accept deposits from the public are important in the economy because of their involvement in the payments system, their role as intermediaries between depositors and borrowers, and their function as agents for the transmission of monetary policy. By their nature, banks are vulnerable to liquidity and solvency problems, among other things, because they transform short-term liquid deposits into longer-term, less-liquid loans and investments.

Financial safety net is usually made up of three components: prudential regulation & supervision, a lender of last resort and deposit protection scheme. The distribution of powers and responsibilities between the financial safety-net participants is a matter of public-policy choice and individual country circumstances.



#### **Concept of Deposit Insurance**

Based on its role and focus in the financial system, a deposit insurance scheme has been defined as a financial guarantee to protect depositors in the event of a bank failure and also to offer a measure of safety for the banking system (Ebhodaghe 1997). In most economies where the scheme exists, it serves as one of the complementary supervisory agencies employed by the monetary authorities for effective management and orderly resolution of problems associated with both failed and failing depository institutions. In addition, the scheme also offers some form of deposit guarantee to depositors such that their confidence in the banking system is not eroded in situations where deposit-taking financial institutions fail. The scheme also provides government with a framework for intervention and sterilization of disruptive effects on the economy following the failure of deposit- taking institutions.



# **Concept of Deposit Insurance**

Moral hazard can be mitigated by creating and promoting appropriate incentives through good corporate governance and sound risk management of individual banks, effective market discipline and frameworks for strong prudential regulation, supervision and laws. Specific deposit insurance design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; using certain forms of coinsurance; implementing differential or riskadjusted premium assessment systems; minimising the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts.

Many of the methods used to mitigate moral hazard require certain conditions to be in place. For example, differential or risk-adjusted differential premium assessment systems may be difficult to design and implement in new systems and in emerging or transitional



#### Mandates, powers and structure

A mandate is a set of official instructions or statement of purpose. There is no single mandate or set of mandates suitable for all deposit insurers. Existing deposit insurers have mandates ranging from narrow, so-called paybox systems to those with broader powers and responsibilities, such as risk-minimisation, with a variety of combinations in between. Whatever the mandate selected, it is critical that there be consistency between the stated objectives and the powers and responsibilities given to the deposit insurer. Paybox systems largely are confined to paying the claims of depositors after a bank has been closed. Accordingly, they normally do not have prudential regulatory or supervisory responsibilities or intervention powers. Nevertheless, a paybox system requires appropriate authority, as well as access to deposit information and adequate funding, for the timely and efficient reimbursement of depositors when banks fail.



## **Ownership and Management**

Fundamentally, the ownership of a DIS takes three forms. There is the purely public sector ownership in which the equity is held entirely by the government and/or its agency. An alternative arrangement is the purely private ownership of the scheme. Under this arrangement, the decision to establish a DIS may be that of the government which enacts the necessary legislation to enable the privately-owned banks to establish and manage the DIS. Another alternative arrangement is where the DIS is jointly owned by the public and private sectors. Under this type, the equity shares are held in specific ratio and the board is made up of representative of both parties.



### **Membership**

(i) Compulsory Membership

In general, membership should be compulsory to avoid adverse selection. There are some cases, however, where a strong commitment of banks to participate in a deposit protection system can be observed and broad participation of banks may be achieved without a legal obligation. This can occur if depositors are aware of and sensitive to the existence of deposit insurance, thus creating strong incentives for banks to be part of a system. In other cases, if depositors are less concerned about deposit insurance or are not aware that coverage is limited to certain banks, then the stronger banks may opt out. Further, in a voluntary system strong banks may opt out if the cost of failures is high and this may affect the financial solvency and the effectiveness of a deposit insurance system.

There are two circumstances that may require different approaches to granting membership to banks. First, when a deposit insurance system is established and second, when membership is granted to new banks in an existing system. When a deposit insurance system is created, policymakers are faced with the challenge of minimising the risks to the deposit insurer, while granting extensive membership. Generally, two options are available: automatic membership or requiring banks to apply for entry.

Automatic membership for all banks may be the simplest option in the short term. However, the deposit insurer may then be faced with the difficult task of having to accept banks that create an immediate financial risk or that pose other adverse

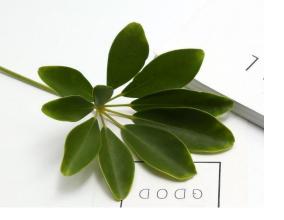


### **Membership**

(ii) Coverage Scope and Level

Insurable deposit should be defined clearly in law or by private contract. In doing so, the relative importance of different deposit instruments, including foreigncurrency deposits and the deposits of non-residents in relation to the public-policy objectives of the system should be considered. Once the relevant deposits are selected, exclusions of specific deposits and/or depositors can be determined. Many deposit insurance systems exclude deposits held by depositors who are deemed capable of ascertaining the financial condition of a bank and exerting market discipline. Examples include deposits held by banks, government bodies, professional investors such as mutual funds, and deposits held by bank directors and officers. In some cases, deposits held by individuals who bear responsibility for the financial well-being of a bank are excluded from reimbursement. Also, deposits with extremely high yields are sometimes excluded from coverage; or reimbursement may be limited to the principal owed, with a lower rate of interest applied.

Once the scope is determined, the level of coverage can be set. This can be done through an examination of relevant data, such as statistical information describing the size distribution of deposits held in banks. This gives policymakers an objective measure, such as the fraction of depositors covered, with which the



# Deposit insurance assessments: Flat-rate versus risk-adjusted differential premium systems

Countries have a choice between adopting a flat-rate premium system or a premium system that is differentiated on the basis of individual-bank risk profiles. The primary advantage of a flat-rate premium system is the relative ease with which assessments can be calculated and administered. However, in a flat-rate system, low-risk banks effectively pay for part of the deposit insurance benefit received by high-risk banks.

Most newly established systems initially adopt a flat-rate system given the difficulties associated with designing and implementing a risk-adjusted differential premium system. However, because flat-rate premiums do not reflect the level of risk that a bank poses to the deposit insurance system, banks can increase the risk profile of their portfolios without incurring additional deposit insurance costs. As a result, flat-rate premiums may be perceived as encouraging excessive risk taking by some banks, unless there is a mechanism to impose financial sanctions or penalties.

Risk-adjusted differential premium systems can mitigate such criticisms and may encourage more prudent risk-management practices at member banks. When the information required to implement a risk-adjusted differential premium system is available, relating premiums to the risk a bank poses to the deposit insurer is preferable.



#### **Public awareness**

In order for a deposit insurance system to be effective, it is essential that the public be informed about its benefits and limitations. Experience has shown that the characteristics of a deposit insurance system need to be publicised regularly so that its credibility can be maintained and strengthened.

A well-designed public-awareness program can achieve several goals, including the dissemination of information that promotes and facilitates an understanding of the deposit insurance system and its main features. Also, a public-awareness program can build or help restore confidence in the banking sector. Additionally, such a program can help to disseminate vital information when failures occur, such as guidance regarding how to file alaima and kaasiya kaimbukaamanta



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