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Deposit Insurance Scheme in Bangladesh:Searching For Prudent Framework

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Abstract:

Deposit Insurance Scheme *(DIS) can play a magnificent role to stabilize a sound regulatory financial system by making depositors indifferent to the all sizes of depository institutions and keeping members of DIS on the right track. DIS of Bangladesh under the Bangladesh Bank Deposit Insurance Act (BBDIA), 2000 has been found not comprehensive as compared to the international practices. Besides, present form of DIS of the country cannot be applied effectively to the present regulatory financial environment. The present study has been conducted aiming at evaluating the existing DIS of Bangladesh as compared to international practices with respect the structure, formation of scheme, funding of scheme, method of charging premium etc. The study has found different flaws with the present scheme such as ineffective formation of Deposit Insurance Trustee Board (DITB), flat rate method of premium, inadequate amount of coverage etc. These flaws are motivating banks to undertake non-judicious activities and thereby to jeopardize the financial system. This, in turn, has increased the risk of the depositors. The present study has come out with some prudent measures such as Mode of charging premium on risk adjusted basis, formation of representative DITB, increase in amount of coverage, funding of DIS etc.*

These measures are expected to bring about an expected change in the financial system by resolving moral hazard problem and providing an automatic financial protection to the depositors if depository institution fails.

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1.1 Statement of the Problem

Financial Industry is composed of depository and non-depository market, security market, and financial derivative market. Financial Industry has been experiencing substantial changes in structures-legal, organizational and managerial; policies and strategies; and mode of functional performance across the world. These changes have really posed a threat to the survival of members of financial industry. These paradigm shifts require the establishment of a sound financial ***system***. A sound financial system has three pillars such as effective legal system, good management, and strong & effective central bank (Chowdhury and Moral, 1999). The goal of such rules and regulations should not be to undermine the autonomy of bank financial institutions in conducting their normal financial activities instead; it should ensure that their lending operations do not cause systematic risk and thus pose a danger to the financial system (Hossain and Rashid, 2003).

The activities of bank/financial institutions are subject to both systematic and unsystematic risks. Among the activities, deposit activity is one the most fundamental activities of bank for mobilization of funds which give birth to risks for both banks and customers. This is likely to pose a real threat to the stability of financial system.

Banks perform a good number of financial functions such as capital formation through deposits, lending to individual and firms for growth among important activities, for the economic development. Any mismatch between these two activities makes banks vulnerable to illiquidity and insolvency.

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This situation is likely to shatter the confidence of depositors in the banks and precipitate the withdrawal of deposits in large scale and mounts the non-performing assets to a large extent. This, in turn, leads the concerned bank to the bankruptcy, which will have contagious effect on other banks and sectors of the economy.

A large number of countries in developing and developed economies have adopted or are considering the adoption of Deposit Insurance System (DIS) aiming at providing automatic financial protection of people's savings in case of bank's failure; and thereby contributing to the promotion of safety and soundness of banks and maintaining systematic stability like other countries-USA, Japan and India. Bangladesh Bank, the central bank of the country, had introduced Deposit Insurance System under the Deposit Insurance Ordinance, 1984 in Bangladesh.

It may be mentioned here that Deposit Insurance Ordinance, 1984 was repealed in 2000 and replaced by the Bangladesh Bank Deposit Insurance Act (BBDIA), 2000. Of late, Financial Market in Bangladesh is experiencing a phenomenal growth in banks in the private sectors and a shift in government nationalization policy-Denationalization of Nationalized Commercial Banks. This dramatic shift has resulted in severe competition among members of financial service industry to have a profitable niche. Consequently, banks are found to have a tendency to go beyond the track. For example, sufferings of depositors caused by the bankruptcy of BCIC , loan scandal of Oriental and First Security Banks, declaration of these banks as problem Banks and non-judicious baking activities have made the bank financial industry more vulnerable. Under this situation, the existing DIS under the BBDIA, 2000 has been found not precise and pragmatic with respect to the coverage, charges of premium, ceiling of deposit insurance fund, management of fund etc. Apart from this, DIS of Bangladesh differs substantially from that of other countries like Singapore, Japan, USA, UK, Canada, Korea etc.

In view of this, the present study has been undertaken aiming at critically evaluating the present DIS of Bangladesh on the basis of prevailing situation as well as best practices of DIS in other countries.

1.2 Objectives of the Study

The principal objective of the study is to evaluate the present deposit insurance system in Bangladesh. To accomplish this objective, following specific objectives have been covered:

I. To evaluate the existing Deposit Insurance Scheme of Bangladesh

II. To identify the scope of improvement in the existing DIS on the basis of opinions and practices in other countries

III. To suggest a prudent framework of DIS for application in Bangladesh

1.3 Scope of the Study

The study has been confined to the analysis of DIS under Bangladesh Bank Deposit Insurance Act, 2000. It has also covered the opinions of banking professionals, officials of regulators, and academicians engaged in research in the field of banking.

1.4 Methodology of the Study

The study is both theoretical and empirical one. Both primary and secondary data have been used in the present study.

1.4.1 Collection of Primary Data

The primary data has been collected by interviewing the concerned respondents with the help of pre-structured guides. In this case, researchers have followed direct approach to the collection of primary data. An effort was made to interview 60 respondents. Finally it was possible to successfully interview 39 professionals: 23 bank professionals, 8 officials of regulators, and 8 academicians. The opinions of these sample respondents have reflected the true practice of DIS in banking industry, and thereby enabled researcher to accomplish the objective of the present study.

1.4.2 Collection of Secondary Data

The questionnaire was prepared on the basis of survey of existing literature, research journals, rules and regulations, practices of DIS in other countries.

Besides, the existing information extracted from survey of literature has also been used to have a comparative look.

1.4.3 Analysis of Data

The data thus collected have been tabulated first manually. Then, these have been analyzed by employing simple financial technique- percentage.

1.5 Organization of the study

The study has been organized into three sections. First section has covered statement of the problem, Objective and Methodology of the Study. The second section deals with comparative scenario over the practices of DIS in Bangladesh and the same in other countries. The final section covers summary of the findings and policy implications thereof.

2.0 Findings and their Analyses

2.1 Theoretical Arguments for and against the Deposit Insurance Scheme

DIS is required to be introduced if financial market is found volatile and depositors are not well protected from the loss of deposits in case of bank failure.
There are arguments for and against the implementation of DIS. Arguments for the DIS are as follows:

I. DIS enhances stability of the financial system by making depositors less sensitive and maintaining their confidence in the safety of deposits

II. DIS exerts a positive influence among depositors to perform a regular job- savings and withdrawing and thereby enabling individual bank to honor the obligation to pay

III. DIS allows banks irrespective of sizes to operate freely and efficiently by eliminating the Depositor's concerns about bank failure and mitigating competitive barriers

IV. DIS provides automatic financial protection to small investors who are likely to be exploited by problem banks offering higher interest rates

V. DIS reduces the financial obligation of Government and thereby minimizes the tax payer's burden

However, some economists have argued that deposit insurance can be socially counter productive if the system is not appropriately structured and supported by adequate regulatory environment (Cull et al. 2001). DIS like any other insurance scheme creates the incentives for moral hazard.

Existence of DIS not only reduces incentives for depositors to select banks and monitor their activities, but also encourages banks to undertake riskier activities for making higher amount of profits. Consequently, DIS cannot prevent bank from being failure. By and large, a well-designed and well-understood DIS can contribute to the stability of a country's financial system by reducing the incentives for depositors to withdraw their deposits following a loss of confidence in their depository institutions or financial system (WCCUI, 2003).

2.2 Analysis of Financial Environment in the Financial System of Bangladesh

Financial system of Bangladesh has ample opportunities to grow in all directions. Banking Industry being an important integral part of financial system is characterized by large scale loan default and lack of good governance. It has threatened the existence of the banking system at this moment (Alam and Jahan, 1999). The present study has depicted opinions of 39 respondents to know whether the present bank financial system is volatile or not. 34 (87.18%) out of 39 respondents are of the opinion that bank financial system has been volatile for different reasons which have been identified as follows:

Table 1: Reasons Rendering Bank Financial System Volatile

Reasons for Volatility	No.of Respon.	Percentage of Respondents
I. Frequent Changes in Regulation	16	47.06
II. Unanticipated Changes in Interest Rates	34	100
III. Weak Monitoring System	34	100
IV. Weak Controlling Activities	32	94.11
V. Exercise of Political Muscle power	27	79.41
VI. Bureaucratic Complicacy	21	61.76
VII. Behavior of Large Commercial Banks	28	82.35
VIII. Behavior of Depositors-Switching Banks	18	52.94
IX. Financial Insolvency of Government	29	85.30
X. Abnormalities of other Wings of Financial System	26	76.47

A perusal of above table –1 indicates that volatility in financial system of Bangladesh can be attributed principally to the following reasons:

a) Weak Monitoring and Controlling Activities;
b) Unanticipated Changes in Interest Rates;
c) Financial Insolvency of Government;
d) Behavior of Large Commercial Banks; and
e) Exercise of Political Muscle power.

The identified reasons for volatility also substantiates the present features of banking environment- higher interest rates to attract deposits, huge amount of non-performing assets, loan scandals, uneven and unfair competition between large and small commercial banks, increase in number of problem banks etc.
Besides, most private banks face liquidity crisis and are about to fail to meet current financial obligations because of mismatch between risks weighted assets and liabilities. Somehow they meet financial obligations recoursing to call money loan and loan from sister branch. This situation calls for sound regulatory environment first and then, implementation of a comprehensive DIS. As per Government Gazette Notification, there are more than 40 laws for regulating the activities of banks and financial institutions.

Effective enforcement of these regulations is expected to create a sound regulatory environment, which facilitates the environment for implementation of DIS. The accepted wisdom is that DIS accompanied by sound regulatory environment have a positive effect on financial development and economic growth (Cull et al. 2001).

2.3 Evaluation of DIS under Bank Deposit Insurance Act, 2000 with Reference to the International Practices of DIS

Many countries either have already implemented DIS or are currently looking at establishing DIS for depository institutions. DIS differs substantially from country to country with respect to structure, governance, financial implications, coverage-implicit and explicit etc.(WOCCU, 2003).

Of course, these variations might have been caused by their different regulatory structure such as financial structure, management pattern, investment policy etc.

2.3.1 Main Features of Deposit Insurance Scheme under the Bank Deposit Insurance Act, 2000:

a) The DIS is being executed under the direct supervision of Deposit Insurance Trustee Board (DITB) of Bangladesh Bank for protecting Depositors of scheduled Banks only to the extent of Tk.100,000(Equivalent to US$1400) per deposit account if Depository Institution fails.

b) Every insured bank shall pay to the Bangladesh Bank a premium on deposits as may be determined by the Bangladesh Bank at the rate of Tk. 0.04 per Tk.100 per annum.

c) In case of default on payment of premium in time, Bangladesh Bank recovers the premium by debiting the account of the defaulting bank maintained with the Bangladesh Bank.

d) Bangladesh Bank maintains a fund account called ‘Bangladesh Bank Deposit Insurance Trust Fund’. This fund is credited with source like premium on deposits, income from investment of Deposit Insurance Trust Fund, residual value from liquidated bank and income from other sources.

e) DITB can invest the fund in treasury bills and treasury bonds having duration of 5 years and above.

f) This fund can be used for payment of obligations to Depositors and related expenditure for managing the Scheme

g) DITB can borrow at bank rate either from Government or Bangladesh Bank if deposited money of liquidated bank is less than payable obligations to Depositors

h) Membership of DIS is often automatic and compulsory for all scheduled banks

2.3.2 Analysis of Present Practices of DIS and Opinion Survey over Prudent Framework:

Depositor classes or surplus units are found sensitive to the changes in market environment as well as to the likely impending failure of Depository Institutions arising from strategic operational and managerial inefficiency. They respond accordingly to the risk of bank failure by shifting deposits from risky bank to the well-managed banks and thereby accelerating the process of failure for the risky bank.

To protect the bank from being failure by making depositors less sensitive to withdraw deposits, different measures under the umbrella of DIS can be taken. Different measures in quest of prudent DIS have been discussed in the following paragraphs:

I. Measure for Protection of Deposit

All respondents are for the establishment of a prudent DIS. There are six different measures (Cull, R., et. al. 2001). Any one of these can be implemented for protection of depositors from the loss of deposits arising from the failure of depository institutions.

Table 2: Measures for Deposit Protection

Measures	Percentage of Respondent
1. An Explicit Protection and Full Reliance on Transparency and Market Discipline	48.71
	5.13
2. Legal Priority for the Claim of Depositors over other Claimants	0.00
3. Ambiguity Regarding Coverage	23.08
4. An Implicit Guarantee	5.13
5. Explicit Limited Coverage	17.95
6. A Full Explicit Guarantee	
Total	100.00

Note: Data have been compiled by Researchers

The most common objective of deposit protection is to protect the financial system from the impact of bank failure. The analysis of above table indicates that 48.71% of the respondents are in favor of establishing DIS by offering 'An Explicit Protection and Full Reliance on Transparency and Market Discipline'. This would facilitate good governance in financial system and provide safety net to depositors. Meanwhile 23.08% of the respondents are in favor of establishing DIS by offering 'an implicit guarantee to the depositors which is not based on exposure of bank to the risk of bankruptcy.

II. Formation of Deposit Insurance(DI) System

DIS differs from country to country. In Bangladesh, DITB belonging to Bangladesh Bank is performing DI jobs as government agency.

Table 3: Formation of Deposit Insurance System

Alternatives	Percentage of Respondent
1. Present – Bangladesh Bank as Government Agency 2. Public Limited Company 3. An Independent Agency 4. Non-Capital Base Special Agency 5. Private Limited Company	35.30 23.53 29.41 0.00 11.76
Total	100.00

Note: Data have been compiled by Researchers

It appears from the above table that there are many alternatives to the formation of DIS. Analysis of above table indicates that majority respondents(35.3%) are of the opinion that present form of DIS is found better. This finding is consistent and very accurate to the existing regulatory and financial environment of the country. This is because; most of the depositors feel safe by vesting responsibility in the government or government agency like Bangladesh Bank. This practice is similar to the practice adopted in India, Srilanka and UK.

III. Membership of DIS

Generally Banks deal with the deposits and thereby form capital for lending. DIS is implemented aiming at providing a safety net to the depositors if Depository Institution fails.

Table 4: Membership of Deposit Insurance System

Membership Options	Percentage of Respondent
• Present – All Depository Institutions • Compulsory For all Depository and Financial Institutions • Voluntary Basis – Scheduled and Non-Scheduled Institutions	5.88 64.70 29.42
Total	100.00

Note: Data have been compiled by Researchers

Presently all depository institutions or Scheduled Commercial Banks are required to be members of DIS. A perusal of the above table indicates that 64.70% of the respondents are of the opinion that membership should be made compulsory for all depository and financial institutions (FIs). Introduction of this provision to the present DIS would eliminate the problem of FIs to collect deposits on rigid terms and conditions. This will provide depository institutions and financial institutions a level playing field in the competitive market.

Meanwhile, 29.42% of the respondents are for membership on voluntary basis. This would be better for well managed and blue-chip bank/financial institutions. With this, they can minimize cost and maximize profit by the extent of premium. Of course, DITB can also decide on onsite and offsite inspection whether depository institution should be member of DIS or not.

IV. Coverage

Study of different literature indicates the different forms of coverage in different countries. They are shown in the following table:

Table 5: Deposit Insurance Coverage

Options	Percentage of Respondent
1. Present – All Deposit of both Individual and Institutions 2. All Deposits of Individual Depositors 3. Only Fixed Deposits 4. Only Current and Savings Deposits 5. Only Savings and Fixed Deposits	64.70 35.30 0.00 0.00 0.00
Total	100.00

Note: Data have been compiled by Researchers

A perusal of the above table indicates that majority respondents (64.70%) are in favor of existing coverage provision. This covers all deposits of individuals as well as institutions.
But 35.30% respondents are of the opinion that only deposits of individual depositors should be covered. It implies that small individual depositors should be protected.

V. Funding of Scheme

DIF is funded from different sources-premium on deposits, income from investment, residuals from liquidated institutions and income from other sources.

The study has identified four alternative options for funding on the basis of Deposit Insurance Act, 2000 and survey of different existing literatures.

Table 6: Funding of Deposit Insurance Scheme

Funding Options	Percentage of Respondent
▪ Present – Premium Paid by Depository Institutions	47.06
▪ Premium (Levies) to be paid by Insured Institutions for Funding and Management Cost of Scheme	17.64
▪ Donation From Government, Bank and Other Financial Institutions	11.76
▪ Insurance Premium From Protected Institutions and Contribution From Governments	23.54
Total	100.00

Note: Data have been compiled by Researchers

It has been observed from the analysis of above table that majority (47.60%) respondents are in favor of present provision. On the other hand, 23.54% respondents are of the opinion that DIF should be funded by premium on deposit from depository institutions and contribution form government.
This provision would increase the burden of tax payers. In such a case, existing provision will produce productivity as well as efficiency.

VI. Management of Scheme

DIS should be led by a professional team. Present Management – DITB is composed of Directors who are also on the Board of Directors of Bangladesh Bank.

Table 7: Management of Deposit Insurance Scheme

Management Scheme	Percentage of Respondent
▪ Present – Board of Trustee of Bangladesh Bank	17.64
▪ Board Representing Bangladesh Bank and Financial Experts From Outside	41.18
▪ Board is Composed of representatives of BB, Industry Professional and Selected Depositors	41.18
Total	100.00

Note: Data have been compiled by Researchers

It has been found from the analysis of above table that equal number of respondents (41.18%) favors formation of DITB incorporating Directors from Bangladesh Bank, financial industry, and Selected Depositors. This practice is found in USA, UK, Japan and Korea etc.

VII. Premium Method

At present DITB is charging premium @ Tk. 0.04 per TK.100 per annum irrespective of banks financial institutions. It implies that it follows a flat rate method.

Table 8: Premium Method in Deposit Insurance Scheme

Premium Payment Options	Percentage of Respondent
1. Present – Flat Rate @Tk0.04 per Tk100 of all Deposits	23.53
2. Flat Rate of Savings and Fixed Deposits	5.88
3. Risk Adjusted Premium System	58.82
4. Different Rate For Different Deposits Then __% of Regular Deposit; __% of Term Deposits	11.77
Total	100.00

Note: Data have been compiled by Researchers

The present flat rate method of premium is found demotivating for well-managed banks. Analysis of above table indicates that majority respondents (58.82%) are in favor of charging premium on deposits on risk adjusted premium system. This implies that the depository institutions exposing to high default risk are to pay higher premium and vice-versa. In other words, depository institutions have to pay premium at different rates depending on risk associated with the quality of advances and other assets, and types of deposits and borrowings.

VIII. Ceiling of Funding Scheme

Presently, there is no ceiling of funding scheme. Every depository institution is required to pay Tk.0.04 per Tk.100 per annum.

Table 9: Ceiling of Funding of Deposit Insurance Scheme

Funding Options	Percentage of Respondent
1. Present – No Ceiling or Limit of Contribution	47.06
2. Limited to a designated reserve ratio. 1% or 2% or 3% or 4% of Total Deposits	23.53
3. Charging Premium when Bank Fails to meet Obligations	29.41
Total	100.00

Note: Data have been compiled by Researchers

It has been observed that 47.06% respondents are in favor of present provision. But majority (52.94%) respondents are against the present provision. Although, their opinions have been bifurcated into provision (b) and (c). The DITB can determine a ceiling of fund on the basis of total market risk beyond which it would charge premium if additional fund for compensation is really required.

IX. Ceiling of Compensation

The great problem associated with DIS is moral hazard if DIS provides a blanket or full explicit guarantee to the depositors.

Table 10: Ceiling of Compensation of Deposit Insurance Scheme

Ceiling of Compensation	Percentage of Respondent
1. Present – Compensation not exceeding Tk	11.76
1,00,000 without prior approval of the	
government	23.52
2. Blanket Guarantee (Full Insurable under	64.70
any circumstances)	0.00
3. 100% of the Deposit of The Depositors	0.00
4. __% of Current Deposits; __% of	0.00
Savings;___% of Fixed Deposits	
5. Principal and Interest Up to Taka ______	
6. Deposit(Principal) up to Taka _________	
Total	100.00

Note: Data have been compiled by Researchers

At present, DITB compensates each depositor in the case of bank failure to the limit of TK. 100,000(US$1400) through the respective commercial bank. Although, majority respondents (64.70%) are of the opinion that DITB should compensate depositors 100% of their deposits irrespective of types of accounts. This would certainly increase moral hazard and therefore, is likely to destabilize the financial system of the country.

X. Penalties for Default in Payment of Premium

Presently depository institutions have to pay @TK. 0.07 per TK.100 per annum at the end of six months. DITB either recovers outstanding premium from the account of defaulting banks maintained with the Bangladesh Bank or directs the defaulting bank not to receive deposits from depositors till clearance.

Table 11: Penalties for Default on Payment

Penalties	Percentage of Respondent
a) Present –	
i) Deduction from concerned Bank Account of Bank with Bangladesh Bank	23.53
ii) Direction to the Bank for not receiving Deposits From Depositors Till Clearance	
b)Proposed –	23.53
i) Revoking License of Defaulting Banks	23.53
ii) Withdrawal of Protection	29.41
iii) Stop Financial Lending to Banks	
Total	100.00

Note: Data have been compiled by Researchers

Analysis of observation from the above table indicates that 23.53% respondents are for present system and the remaining are for other measures- Revoking license of defaulting banks, withdrawal of protection and stop lending to Banks. However, the present provision of imposing penalties for default has been found better workable.

3. Policy Implication and Conclusion

It is evident from the above analysis that present DIS under BB Deposit Insurance Act, 2000 is not comprehensive and can’t be applied to the changing scenario of the financial service industry effectively. In order to make DIS under BBDIA 2000 more prudent and workable to the changing scenario in the financial industry, following policy measures are suggested for incorporation into the BBDIA Act 2000:

I. The BB Deposit Insurance Fund should provide an explicit guarantee of the maximum Tk. 200,000 (equivalent to US $2800) to the depositor for an account.

II. Membership should be made compulsory for all banks and FIs eligible for collecting deposits according to Laws/Acts.

III. The DITB should be composed of directors of representing banks, financial industry and depositor class. This composition is expected to contribute to the efficient management of DIS fund.

IV. Premium on deposits should be charged on risk adjusted basis.

V. There should have been a limit of DIS fund beyond which premiums be collected from Depository Institutions if additional funds are required.

Measures suggested above are expected to bring about a substantial positive change in the financial service industry as follows:

a) It would address the problem of moral hazard accurately keeping the depository institutions on the right track through different measures.
b) It would protect investor class on the one hand and prevent the business firms by hedging them from the loss of deposit s if depository institutions fail.
c) It would provide a level playing field to the all sizes of scheduled banks.
d) Finally, it would play a role to stabilize a sound financial system by protecting banks from being failure and encouraging them to be on the right track.

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