The Role of Deposit Insurance in a Market-oriented Banking System in Cuba
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Introduction

Deposit Insurance was an integral part of the Cuban banking system prior to the confiscation of the private banks. Under Law Decree 384 of September 9, 1952, deposit accounts were insured up to 10,000 pesos for each individual by the *Fondo de Seg uros de Depósitos*, an autonomous legal agency of the government. The Fondo had an operating capital of 10 million pesos and it was funded by annual contributions of 1 million pesos by the Banco Nacional de Cuba and 100 thousand pesos by the me mber banks. While similar to the F.D.I.C. in the United States, it did not have the supervisory and enforcement powers of the American counterpart, although it participated in decisions having to do with closing or liquidating private banks.

Opponents of Deposit Insurance argue that it reduces the incentive for depositors to put their money in safe institutions and this in turn encourages banks into risky lending and investments. In fact, there is historical evidence to that effect in A rgentina and in several other countries in Latin America, that have experienced banking crises in the last ten to fifteen years. A bank running into trouble, as was the case of Banco de Intercambio Regional in Argentina some years ago, can very easily cov er its liquidity problems by paying a premium for its deposits, and depositors will readily flock to such an institution because the risk is basically the same as that of another institution paying much lower interest rates. On the other hand, if there i s no deposit insurance of any kind, the evidence suggests that governments will generally not allow their institutions to fail due to political repercussions, or else, only the biggest banks are protected while the smaller ones are allowed to flounder. Th is is the "too big to fail" theory that has prevailed in the U.S. until recently. Therefore, those systems become one in which the government essentially guarantees everyone 100 per cent without charging a premium for it, i.e, a de facto insurance system without the controls to implement it, and without the charges to finance it. Given the historical experiences in selected countries in Latin America, we recommend the establishment of a deposit insurance scheme as soon as circumstances are permissible. There are a few principles that should characterize such deposit insurance system in order for it to be successful:

1. Available to all institutions (foreign and local).
2. Full government backing.
3. Full accountability.
4. Decision-making power.
5. Risk-based premiums
6. Safety and soundness.

In addition to the above minimum standards, one should consider a cost structure to the banks that will take into consideration the safety and soundness of the institutions being insured. This can be easily done by a formula based on the rating of th e bank, or based on the capitalization ratio of the institution. In addition, the deposit insurance fund may be used as an instrument initially to foster the creation and growth of "Cuban" banking institutions as opposed to foreign bank branches, agencie s, or wholly-owned subsidiaries of major international banks.

The DIF should also consider the recommendations of the U.S. Treasury Department in its study entitled, "Modernizing the Financial System," with respect to possibly limiting the amount of insurance available to an individual within a given banking sy stem. As we all know, the U.S. system, with its plethora of banks and loopholes, permits a depositor or company to have virtually unlimited insurance on its deposits when the original intent was to protect small savers. Of course, CD brokers can efficien tly explode large concentrations of funds into numerous CDs or viceversa, thereby making deposit insurance readily available to large depositors.

I. General Description

Deposit insurance is used throughout the world to enhance the financial stability of the banking system in any one country.

The FDIC in the US was established in 1933 and is the longest-running system in operation. In addition, at least 28 other countries offer depositors some type of protection program. At least 12 of those countries are not considered to be industrial ized countries.

Many countries that have recently instituted coverage schemes still rely primarily on central bank funding and cash infusions from other, healthy institutions in order to handle troubled banks, with the deposit insurance system itself often playing a relatively minor (as compared with the FDIC) role. This reliance on coalitions involving the private sector and fashioned by the central bank imparts a more informal nature to the process. However, the US Government has had to provide significant fundi ng to the FDIC to meets its needs during the recent banking crisis, and in other countries, such as Chile, the industry has received full central government support to avoid a financial crisis.

The ability and willingness of governments to marshal public and private resources quickly and decisively has been a relatively new development and one of the most important features in preventing the disorderly collapse of important financial insti tutions. Examples in which depositors, in the presence or absence of explicit coverage, have been hurt are rare, and are usually limited to those who have an additional relationship, such as shareholder, with the bank.

II. Structure and Organization

Essential differences in the structure of insurance systems include the following:-

> Whether membership is voluntary or compulsory,-
> Whether they are administered by a government agency, private industry or through a joint public and private arrangement,-
> The methods by which they are funded and,-
> The amounts and types of deposits covered.

III. Membership and Administration

Table 1 attached presents data for the 29 nations offering some form of deposit insurance. There are 31 systems listed, as Germany maintains separate funds for savings banks and credit cooperatives. Membership in nine countries is on a wholly volunt ary basis; some systems demand that particular institutions join, and those not so required may opt to belong at their own discretion. In Germany, commercial banks must join the Deposit Security Fund, but savings banks and credit cooperatives may decline membership in their respective systems. Japan and the UK both require institutions to participate in the insurance programs.

Eleven systems, including the UK's, are officially sponsored and administered by the government. In the UK, the fund is run by a board consisting of three members of the Bank of England, as well as other members appointed by the Governor of the cent ral bank. However, these administrators have no other bank supervisory role.

Seven systems, including the Japanese system, are collectively operated by the public and private sector, and twelve are private industry arrangements. All three of Germany's funds are among this latter group. One possible advantage of direct gover nment administration is the greater degree of credibility inherent in the guarantee. Market participants must have faith in the insurance scheme for it to be effective, and the government's promise is generally considered to be more trustworthy. However , most authorities suggest that depositors commonly believe that the government will not permit a private insurance scheme to fail.

IV. Methods of Funding

Table 2 attached provides information on the financing procedures for the various programs.

Two primary means of funding insurance systems exist: in the first, premiums are assessed regularly to maintain the fund, while in the second levies are imposed only following bank failures.

Those nations using the latter method, referred to as ex post funding, include Austria, Chile, Italy, The Netherlands, Switzerland, and France. Under these arrangements, there is no "fund" per se, and money is collected to repay depositors as needed after a failure. In France, assessments are made based on the size of the bank's deposits. If necessary, the Association of French Banks, which administers the system, can require contributions from the preceding two years, as well as advances on the n ext two years. The Chilean system is funded by its treasury Department directly from the budget. No premiums are assessed on banks or depositors. As such, it becomes immaterial whether membership is voluntary or compulsory. Nineteen systems, including the Japanese and all German programs, are financed through a regular assessment of premiums. The particular rates vary widely, as do the bases upon which the payments are charge. These include:-

total deposits-
domestic deposits,-
insured deposits,-
total assets, and-
required reserves on deposits.

The UK levies a premium on its banks on the basis of deposits; the minimum contribution is L10,000, and the maximum is L300,000. Additional contributions may be required if the fund is stressed, but the total payment of one bank may not exceed 0.3 p ercent of the deposit base.

Norway assesses payments equal to 0.015 percent of total assets, but only until the paid-up capital of the fund is a full 2 percent of the bank's aggregate deposits from non-bank customers. The Spanish system's premiums are 0.2 % of deposits, and th e Bank of Spain contributes an annual amount equal to the aggregate contribution of the banks. Furthermore, the central bank may also advance up to 4 times its yearly contribution to the fund if it becomes necessary.

A similar procedure exists in the German fund for commercial banks, where the stated annual premium level is 0.03 percent of the total (non-bank) deposit liabilities. However, these premiums may be doubled if it is required.

Changes in premium rates and structures occur regularly. Systems that are funded by ex post assessments do not charge premiums, but could alter the payment structure according to the risk of a bank's portfolio. Finally, some funds do have access to alternative means of financing, such as the central bank or government treasury.

At the present time no system is currently using risk-based premiums. This is probably because only recently was agreement reached by the banking regulators of the industrialized world on risk based measurements. In view of the recent emphasis in r isk-based measurements, coupled with the fact that the risk is in the assets and not in the liabilities, it is anticipated that some countries will move to some form of risk-based premiums in the future.

V. Coverage Limits

Table 2 also shows the various coverage limits in terms of the domestic currency and the US. dollar equivalent.

Limits may be constrained in practice, however, either by provisions in the law or by the resources available. In Norway the fund's Board of Directors determines in each separate case the amount, type, and conditions of any support that may be forth coming. Even in some countries having a stated ceiling, actual coverage may be at the mercy of the fund's resources (in Belgium deposits are insured to B.F. 500,000, but only if sufficient money is available). In Germany, disbursements may be restricted by the fund's resources, and decisions concerning the payout are made on a bank-by-bank basis.

The concept of co-insurance (i.e., some stated percentage of deposits is covered) is used in five countries, but only Ireland and the UK have no lower limit below which deposits are 100 percent insured. In the UK only 75 percent of deposits up to L1 0,000 are insured (and above this level they are entirely uninsured). Under such a system, even the very small saver is at risk, and every depositor has an incentive to run on a troubled bank.

A unique insurance scheme is found in Germany's Deposit Security Fund for commercial banks. The coverage limit is 30% of the bank's stated equity capital, based upon the last quarterly report. This implies that coverage will decline as the level of capital diminishes. Thus, depositors have a strong incentive to remove funds from a suspect bank whose capital, and so coverage levels, are decaying. Naturally, the withdrawals themselves will exacerbate the bank's problems. An alternative to this may be prompt regulatory intervention in the event of a drop in capital below predetermined levels. This would prevent a run on a bank (perhaps on the entire financial system) and allow time to work out the problems in an orderly fashion.

VI. Types of Deposits Covered

Table 3 enclosed provides data concerning the types of deposits covered by the various systems.

Seven of the 23 countries for which information is available insure interbank deposits. Deposits held by nonresidents are covered by every system. In part, this may be to remain competitive in the international market, for without this insurance a f light of foreign capital could ensue. None of the sources surveyed indicated any statutory difference in coverage between residents and nonresidents.

Ten of the 22 countries, for which there is information, cover deposits denominated in foreign currency. Eleven do not, and the coverage in Ireland is provisional. Again, roughly half, or nine of 16 countries cover deposits in domestic branches of f oreign banks, while the remaining seven do not. Note that the U.S. is listed as yes, but there is no coverage for deposit of foreign agencies. Only 5 of 17 systems explicitly cover deposits in foreign branches of domestic banks. However, insurance of t hese deposits may be implicit, as it is usually larger banks which maintain foreign branches. There are several proposals now being considered in the U.S., which advocate charging domestic banks insurance premiums based upon the level of foreign deposits .

All of the systems surveyed insure a deposit's accumulated interest.

Virtually every major industrialized country now has some system of national deposit insurance, although there are exceptions (i.e. Australia and New Zealand). Luxembourg, Greece, and Portugal have neither a system of insurance, nor any movement tow ard implementing one.

VII. Handling Distressed Banks

In the United States, when the need to handle a distressed institution arises, the FDIC is generally a key figure in the operation. This is not the case in other countries, where the action taken by authorities often involves a joint endeavor of pub lic and private entities. Frequently, the central bank is the dominant player, providing liquidity directly and arranging for emergency injections of cash, sometimes from other, healthy institutions in the system.

With the exception of Spain, the FDIC is alone in its authority to extend de facto coverage by arranging purchase and assumption transactions, financially assisted mergers, or to provide direct aid to banks deemed "essential" to their communities. By contrast, other countries' deposit insurance agencies are more peripherally involved in the resolution process; crises are generally handled by the central bank, operating in conjunction with a consortia of private sector financial institutions.

It is not simply the lesser role of the insurance programs in countries other than the US. that provides a noteworthy contrast to the U.S. system. It is of interest that the central banks can, in fact, so readily and successfully organize a support group composed of private sector institutions. Losses, which in the US would be incurred by the insurance fund, are generally absorbed by the central banks and private institutions abroad. This may be due to history and tradition: that is, it has been d one that way for many decades. Furthermore, in nations where a handful of banks dominate the banking system, that handful may feel more directly threatened by potential dangers of a systemic nature than do institutions in the U.S. Finally, the need to c oordinate agreement among such a small number of institutions greatly reduces the task facing the central bank.

Do these differences translate into a different method of treating the depositors of a failed institution? The answer is not to a great degree. As in the U.S., perhaps the most decisive element in the decision process is apprehension over systemic risk, ant this is a fear that non U.S. banks may feel more acutely than their U.S. counterparts. In most of the recent bank failures throughout the world the central bank and private institutions lost a great deal of money, while depositors (who were not also shareholders) did not. There are also other factors that motivate the protection of depositors. Canada and the UK both have acted as they did partially because the federal governments had publicly encouraged individuals not to withdraw their funds . Hence, the governments believe they had assumed a moral obligation to provide protection.

In the cases of Chile and Brazil, the central banks and the treasury have backed up the various financial institutions experiencing difficulty, be it because of internal problems or international disruptions, with little if any losses being experienc ed by individual depositors. Additional liquidity, mergers or assumptions were taken in the above cases to continue banking activities of the institutions involved.

This is not to say that depositor and creditor protection has been absolute. Up to 1994, the Herstatt was the classic example of severe depositor loss. Italian authorities permitted creditors of Banco

Ambrosiano's Luxembourg affiliate to suffer lo sses, while domestic depositors of the parent bank in Milan were protected to a much greater degree. But depositor protection is not absolute in the U.S. either, although the recent financial crisis was so severe that the Government provided the necessar y funding to substantially fund all depositors, including the "too large to fail" concept, where every effort is made to assure the safety of depositor funds.

The concept of "too-large-to-fail" was not followed by the Venezuelan authorities in the well publicized case of Banco Latino. The run on Banco Latino coincided with a change in government, and the authorities did not act decisively to limit the dam age to the industry. Instead, the Government's reaction was perceived as standoffish. The insurance coverage of Bs 1 million (approx. US$9,000 at the time) was deemed inadequate by the public and the run on deposits spread to other banks. Rather than as suring depositors, the Government chose to pump in additional capital into the institutions under strain without gaining effective control of these institutions. After months of indecision, the Government increased the insurance coverage to Bs. 4 million . It took Banco Latino's small depositors almost three months to be able to have access to their funds. It is believed that the cost of the financial crisis to the Venezuelan treasury has reached U.S.$3 billion and continues to mount.

The indecisive action of the Government of Venezuela can be contrasted with that of other countries such as Chile or Colombia. The authorities in these two countries, when faced with an incipient financial crisis, stepped in to shore-up its financi al institutions. Today, they have two of the strongest economies in Latin America.

To sum it all, although the resolution process is more formal and legalistic in nature in the US than elsewhere, the net results are often very similar. With the exceptions of the Herstatt failure in 1974 and Banco Latino in 1994, authorities have n ot been willing to permit the sudden and disorderly failure of important banks.

VIII. Summary

It is evident that the present trend is towards the establishment of Deposit Insurance funds. However, we see that the majority of the countries employ a combination of central bank, national treasury and established institutions to deal with problem institutions.

Opponents of Deposit Insurance argue that it reduces the incentive for depositors to put their money in safe institutions and this in turn encourages banks into risky lending and investments. There is historical evidence to that effect in Argentina, several other countries in Latin America and specially in the recent US's Savings and Loan crisis. Banks facing financial difficulties because of lack of liquidity and/or asset quality, can very easily cover its liquidity problems or continue a growth tr end by paying a premium for its deposits. Depositors will readily flock to such an institution because the risk is basically the same as that of another institution paying lower rates. On the other hand, if there is no deposit insurance of any kind, the evidence suggests that governments will generally not allow their institutions to fail. Those systems become one in which the government essentially guarantees deposits without charging a premium for it, i.e., a de facto insurance system without the con trols to implement it, and without the charges to finance it.

Others view deposit insurance in the context of an indirect form of taxation on the business of banking. Since a free Cuba will not have local established financial institutions to provide part of the safety net, and it would take years to fund a d eposit insurance fund with assessments on the newly established banks, it would be totally up to the national treasury to provide any insurance deposit protection to the banking industry.

Many feel that a form of deposit insurance or similar Government guarantee is essential to develop locally-owned financial institutions in a free Cuba in order to help in the country's economic recovery, as well as for the extended future. The assum ption being that locally-owned financial institutions could not compete against well established foreign financial institutions without some form of deposit insurance or similar Government guarantee.

Many experts agree that financial institutions should bear their fair share of the costs of such protection. It is clear that risk-based premiums are the fairest of all the methods to allocate the cost of insurance coverage. This would reward the m ore conservative institutions and penalize those more aggressive.

Notwithstanding the above, risk-based insurance premiums are not enough to prevent excesses. It would take a strong supervisory role by the Central Bank or appropriate regulator to prevent a difficult financial situation in a institution from deteri orating to a point where significant losses may be incurred or the system become imperiled.

IX. Recommendations

Given the historical perspective outlined above, our recommendations are as follows:

A. Offer Deposit Insurance

We recommend the establishment of a deposit insurance scheme. Some of the principles that should characterize such insurance system are:

(1)All institutions with the same characteristics should be able to offer the same deposit protection to its clients.

(2)The fund should enjoy the full financial backing from the government and be adequately funded from the onset.

(3)Its finances should be transparent with clear accounting and disclosure of revenues and expenses.

(4)It should have decision-making authority, either independently or in conjunction with the Banco Central de Cuba.

(5)Coverage to be offered should take in consideration the goals of safety and soundness of the system, as well as national economic objectives, limits, if any, on the types of accounts and the monetary limits to be covered, etc. (i.e., some systems provide virtually unlimited insurance on its deposits while others tend to limit insurance to a certain level owned by each depositor).

(6)The cost structure should take into consideration the safety and soundness of the institution being insured, their risk profile, capitalization, composite regulatory rating, etc.

B. Timing of Commencement of Insurance Protection

Deposit insurance should be offered in conjunction with the establishment of private financial institutions in a free Cuba.

Given the circumstances of a new banking industry, a new market driven economy, lack of local established financial institutions, etc., it is evident that the only alternative is for some type of Government institution, which would offer the insuranc e backed by the full faith and credit of the National Treasury.

C. Institution that will operate the Deposit Insurance Fund (DIF)

Given the fact that the initial funding for the DIF will have to come from the State, this institution should be a Government owned/controlled entity (as opposed to a private or mixed capital (part private/part government owned).

Questions as to whether this entity should be a segment of a Central Bank, or a separate organization, its supervisory powers, etc., are to be determined based on considerations outside the scope of this study..

D. Source of Funds for the DIF

At inception, it is essential that its initial funding come from the State. Other future sources are:

1.Periodic premiums. Such premiums should be based on the risk profile of each and every institution. That is, the more solid, well capitalized and administered institutions should pay less premiums than the riskier institutions.

2.An allocation of the amounts paid for initial banking licenses and renewals.

E. Membership

We recommend that all financial institutions offering local banking products to Cuban nationals be required to participate in the DIF.

Membership by other financial institutions may be required or prohibited based on other factors, such as the nationality of its depositors, the type of investments and/or loans allowed/required, the location of its borrowers, the currencies in which such deposits and/or assets are stated, etc.

We believe that the currency in which the transactions are denominated do not determine whether or not the deposit is subject to insurance or not. A local commercial bank may be allowed to hold deposits for Cuban nationals in a foreign currency. On the other hand, a foreign bank may establish a bank in Cuba to conduct offshore operations. The controlling factors on the availability of insurance coverage should be considerations such as those discussed in the preceding paragraph.

References

The source for the tables and some of the sections included in the historical perspective is a report on the U.S. federal deposit insurance system prepared by the U.S. Treasury Department entitled *"Modernizing the Financial System: Recommendations for Safer, More Competitive Banks"*, printed by CCH, Inc. The difficulty of modernizing the state should not be an excuse for avoiding action, as an efficient state is required to achieve the full benefits of a liberal economic order.