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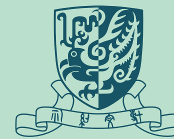

A Proposal for Deposit Insurance in Hong Kong

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Abstract

This paper examines the arguments for and against deposit insurance. It is found that, while most arguments against deposit insurance are valid, they can be mitigated by suitable arrangements. In particular, fractional deposit insurance together with vesting the responsibility of managing the insurance fund with the bank regulators will maintain a suitable degree of market discipline and ensure that banks will not invest excessively in risky ventures. It is pointed out that one major cause of bank failures is fraud and it is suggested that market discipline — in particular the "monitoring" activity of depositors — cannot effectively contain fraud. Monitoring by bank regulators is far more efficient because regulators have more expertise, can devote full time to the activity, and have wider legal powers to look into the affairs of individual banks. By reducing uncertainty and the cost of monitoring for depositors, deposit insurance achieves huge savings for society, helps bring about fairer competition among banks, and reduces disruption to economic activities in the event banks fail. It is proposed that Hong Kong adopt mandatory fractional deposit insurance on all Hong Kong dollar deposits which are redeemable on demand. Depositors should further have the option to buy additional coverage on other deposits and on the otherwise not-covered deposits by paying an appropriate, higher premium.

Introduction

The subject of deposit insurance[1] has always elicited much controversy. In the United States the idea of a federally backed deposit insurance drew much criticism and opposition when it was first proposed (Keeton, 1990:28), and it took virtually a collapse of the entire banking system to eventually crush the opposition and bring the idea to fruition. In early 1933, a banking panic spread throughout the country, but President Roosevelt was still staunchly opposed to the idea. It was feared that deposit insurance would encourage excessive risk-taking and would lead to the subsidization of poorly managed banks by sound banks. As

thousands of banks failed, however, a key opponent of deposit insurance, Senator Carter Glass, finally changed his mind, believing that deposit insurance would help bring about other necessary reforms. Thus it was in the midst of a great controversy that the Federal Deposit Insurance Corporation (FDIC) was founded. The enabling legislation, known as the Banking Act of 1933 or the Glass-Steagall Act, also brought in a range of far-reaching regulations aimed at preventing cut-throat competition and excessive risk-taking. Two years later a new Banking Act reorganized the Federal Reserve Banking System and gave bank regulators even more power. Throughout the post-depression years up till 1979 the number of bank failures stayed at an extremely low level, averaging some 12 per year as compared with about 600 per year during the 1920s. In the 1980s, however, the number of bank failures in the United States soared, and the FDIC was at risk of running out of funds. Criticisms against deposit insurance were heard again.

Interestingly, most of these criticisms are the same criticisms that were raised during the early days before the inception of deposit insurance. Here in Hong Kong we also hear the same criticisms. Thus, these criticisms have survived the test of both space and time. As expected, these criticisms are mostly valid. Yet the fact that they are valid is not a sufficient reason to reject the idea. In economics we always stress the need to compare costs and benefits, and in public policy we always stress the need to investigate the possibility of reform so as to reduce costs and increase benefits. It is with this spirit that I write this short monograph.

Policy Criteria

In general, a policy is worth undertaking if its benefits exceed its costs. Among a set of mutually exclusive worthwhile policy options that option which maximizes the excess of benefits over costs should be chosen. Thus any policy decision should be based on a careful comparison of costs and benefits among a number of options.

There are two criteria against which public policy is usually judged. These are equity and efficiency. In the public finance literature equity usually takes on one of two meanings: horizontal equity and vertical equity. Horizontal equity is the "equal treatment of equals." Thus horizontal equity holds that two individuals in similar circumstances should be treated equally. Vertical equity is the "appropriately differentiated treatment of differentiated individuals." In the tax literature this is usually taken to mean that those with higher ability to pay will bear more, perhaps even proportionately more, of the tax burden. In economics efficiency has a special meaning. It usually refers to "Pareto efficiency," which means a state such that it is not possible to improve the welfare of anyone without adversely affecting someone else. Any arrangement that improves the welfare of at least one individual without hurting anyone else is said to be a Pareto improvement. Naturally a rearrangement that is agreeable to all parties would be a Pareto improvement.

It has been proven that in the absence of marginal technological externalities perfect competition will lead to cost minimization, implying the greatest output for any given resource (production efficiency); production in accordance to consumers' choice (consumers' sovereignty); and the greatest consumption value for the produced output (consumption efficiency). Depending on the initial distribution of ownership of the factors of production, the market will result in a different Pareto-efficient state.

In recent years the concept of Pareto-efficient income redistribution has come to be accepted as plausible (Hochman and Rogers, 1969). If in a pure redistribution of income, those giving up some of their incomes actually felt happier at the knowledge that others had become better-off the redistribution can be a Pareto improvement.

More recently, Ho (1981) advanced the concept of Pareto risk-efficiency. Suppose some members, say 1 per cent, of a population will suffer a significant loss of their incomes by the end of the current period while the rest of the population will reap an equivalent total benefit. At the end of the period, then, there are some unlucky ones mourning over their loss, while others congratulate themselves for being lucky. A redistribution of income, at this point, from the lucky ones to help the unlucky ones will likely be opposed by the lucky ones. If so, this cannot be a Pareto improvement. However, if the risks are recurrent, everybody may prefer a state where the risk of arbitrary redistribution never takes

place. An arrangement whereby the arbitrary redistribution is avoided can be said to be Pareto risk-efficient, in the sense that *ex ante*, everyone prefers the arrangement. The concept obviously carries over to cases where the population as a whole loses some income because of a natural disaster or unfortunate event. This concept of Pareto risk-efficiency as well as the Hochman-Rogers concept of redistributive efficiency will be useful in the discussion of deposit insurance to follow.

The Changing Regulatory Environment

Historically deposit insurance was introduced to stem bank panics. According to Chari (1989), there were seven instances of system-wide runs on banks between 1864 and 1933, but since the onset of deposit insurance there has never been a single system-wide bank panic. With deposit insurance, particularly one that effectively provides the assurance that depositors will not suffer any loss, there is no longer a compelling reason to withdraw funds from the banking system when individual banks get into trouble. On the other hand, in the absence of deposit insurance a domino effect may be set off, which may eventually lead to a momentous contraction in credit. This is widely regarded as a key contributing factor to the seriousness of the Great Depression.

Over the years the art of bank regulation and central banking has been improved — albeit with lots of ups and downs. In the United States the recent surge in bank failures and problems in the thrift industry have been blamed on incorrect deregulation and deregulation that went ahead of deposit insurance reform (Davis, 1990, 1991; Kareken, 1990; Benston, 1983). On the other hand, some of the earlier regulations have been found to contribute to, rather than ameliorate, banking crises. In particular, certain regulations on the assets side were found to have prevented depository institutions from diversifying their risks; other regulations on the liabilities side, on the other hand, had contributed to the phenomenon of "deposit disintermediation" whereby depositors in one class of deposit taking institutions (namely savings and loans associations) were given the incentive to withdraw funds in favour of higher-yielding instruments and avenues, when market interest rates rose

above rates that the regulated institutions were allowed to pay (Buynak, 1986). In practice, banking regulations represent a clear case of learning by doing (Ho, 1989). In Hong Kong, the Banking Ordinance of 1986 — a major landmark in banking regulation in the territory — was a consequence of the wave of banking crises that rocked the banking system throughout the early 1980s. Following the discovery of widespread fraud in the savings and loans and banking industry during the 1980s, the United States has recently introduced the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (Sessions, 1990). This act closed a loophole resulting from the Right to Financial Privacy Act and significantly strengthened the ability of the FBI in investigating financial institution fraud and laying charges. The FDIC was also reported to be in the process of establishing new rules aimed at preventing bank officers and directors from abusing their banks' resources for personal gain (*South China Morning Post*, August 1, 1991).

Internationally, the globalization of financial markets led to the formation of the Basle Committee of Supervisors in 1975, which eventually brought about the convergence of supervisory practice among leading industrial nations. Today there is still a debate over several aspects of the Basle agreement, particularly over the definitions of components constituting the key risk asset ratio, but the Basle initiative is widely regarded as a major step towards an internationally consistent standard in the prudential supervision of banks (Hall, 1990).[2]

Given the advance achieved in banking regulation, deposit insurance has, over the years, become less important as a means of protecting the banking system against panics. However, given the understanding that no banking regulation can completely eliminate bank failures (OECD, 1987:127), the case for deposit insurance on grounds of equity and efficiency is still very strong.

On equity grounds, depositors under similar circumstances should be treated similarly. If a depositor is compensated or protected in one case but not in another case through no deserving action of his own a *prima facie* case of horizontal inequity can be established. A formal system of deposit insurance will lay out the ground rules clearly so that everyone will be subject to the same rules.

In general, lower income people are less able to diversify their

portfolios. They are therefore more likely to have a larger percentage of their wealth put away in the form of bank deposits. A bank failure is likely to hurt them proportionately more than richer people, contributing to a case of vertical inequity. Deposit insurance thus protects people least able to protect themselves. In the wake of the Bank of Commerce and Credit Hong Kong (BCCHK) debacle many people expressed sympathy over the plight of the victims. There is, therefore, a case on efficiency grounds, à la Hochman/Rogers, to introduce deposit insurance.

Because the failure of a larger bank has more widespread repercussions than that of a smaller bank the government may be under pressure to bail out the former while allowing the latter to go under. This discrimination on the basis of size has been widely noted in the literature (Benston, 1983; Ho, 1989; Keeton, 1990) and found to lead to unfair competition in favour of the larger banks. Deposit insurance effectively puts all banks on the same footing, thus contributing to fairer competition.

Evidence that *de facto* deposit insurance exists for the major banks but not for the minor ones in Hong Kong surfaced recently. In response to queries by victims of the BCCHK debacle in 1991 as to why a rescue action was not taken, the Hong Kong government stated that the Exchange Fund was obliged by law not to utilize its resources except in defence of the exchange value of the Hong Kong dollar.[3] As there was no sign the Hong Kong dollar had weakened in the wake of the BCCHK incident, any chance for a rescue action was ruled out. The implication, of course, is that if the BCCHK had been a major bank leading to a confidence crisis in the banking system a rescue action would probably have been taken.

From the efficiency point of view a deposit insurance scheme, by enhancing competition in the banking industry, will lead to better products and services, and will even force banks to lower costs.[4] There is certainly no *a priori* reason why banking costs will be higher with deposit insurance. In particular, deposit insurance saves the cost of monitoring banks for millions of depositors. Telling unsound banks from sound ones is widely acknowledged to be no easy feat. Even very knowledgeable depositors can only rely on published data and their own ears to learn what is actually going on in their banks. This is costly in

terms of time and unreliable because both published information and rumours are hard to verify. By contrast, bank regulators generally have greater expertise and authority to find out facts about banks. For many depositors, paying a premium for deposit insurance is far less costly than monitoring their banks by themselves. Given the sheer number of depositors in society, the aggregate social savings achieved by vesting the responsibility of deposit insurance in bank regulators must be huge.

To the extent that depositors prefer and are willing to pay for the cost deposit insurance can be said to result in a Pareto risk-efficiency improvement. To the extent that deposit insurance is demanded by depositors its establishment can be regarded as a market response and a case of respect for consumers' sovereignty.[5] If deposit insurance were available on a voluntary basis these two points would certainly be valid. If deposit insurance were mandatory the case on these grounds would be weaker and has to be established empirically. Finally, if the responsibility of deposit insurance is vested in bank regulators, bank regulators will have greater incentive to monitor the behaviour of banks.

Objections Against Deposit Insurance

The more serious objections against deposit insurance are three:[6]

- that it removes the incentives of depositors to monitoring the banks and thus blunts the effectiveness of "market discipline" in straightening out bankers' behaviour;
- that it results in unfair cross-subsidization of poorly run, poorly managed banks by well-run, well-managed ones;
- that it can be costly to depositors and even to taxpayers who must underwrite the risks whenever the accumulated fund becomes inadequate to repay depositors in the event of widespread bank failures.

The first two objections are dated from the very beginning when deposit insurance was first proposed.[7] The third objection is now heard more often, mainly as a result of the mounting financial problems facing the FDIC in recent years. Notwithstanding multiple increases in premiums in 1990 and 1991, taxpayers are expected to shoulder

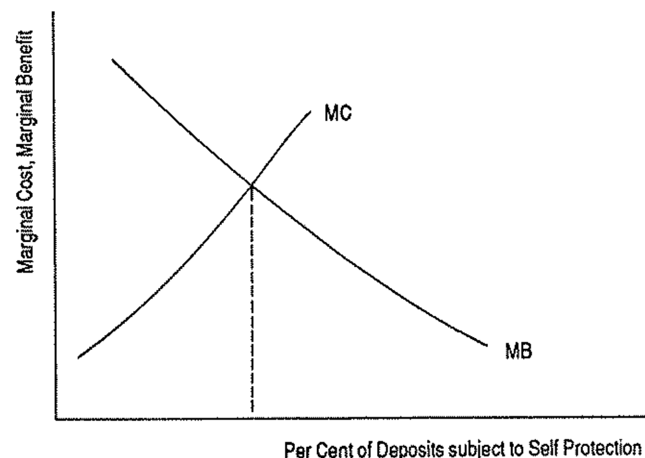
hundreds of billions of dollars in bank rescue operations and payouts (Davis, 1991).

As argued above, relying on "market discipline" to straighten out the behaviour of banks is extremely costly.[8] Depositors know that no matter how hard they try there is a chance that their banks would fail. To minimize the risks and save the cost of monitoring they may place their deposits in the major banks which they understand will not be allowed to fail because of their sheer size, and they may diversify their holdings in a number of different banks. The former course of action is costly to society because it leads to unfair and even inadequate competition. The latter course of action is costly in terms of higher transactions cost. Moreover, whenever banks fail, well-run but unfortunate businesses may go under. This is also costly to society.

According to Sessions (1990), "insider abuse is a major factor in almost all investigations involving failed financial institutions." "Even though fraud is often a contributing factor in bank failure, it was an economic downturn that surfaced the fraud."(p.58) Thus legitimate, excessive risk-taking is far less important as a contributing factor behind bank failures than fraud. There are few reasons and little evidence to suggest that market discipline can satisfactorily contain fraud, as perpetrators of banking fraud can resort to a number of ingenious ways to maintain the appearance of adequate net worth. By nature, bank regulators are in a far better position to prevent and uncover fraud. Depositors certainly have every incentive to pay bank regulators to protect their interests. In order to be fully accountable to the depositors, however, bank regulators should indemnify at least part of the losses resulting from bank failures occurring under their direct supervision. Thus vesting the responsibility of deposit insurance in bank regulators is a logical way of keeping them "on their toes." In the same spirit Benston (1983) argued that "The agency with the principal interest in supervising financial institutions should be the one that must bear the cost of their failure — the insuring agency."

The so-called moral hazard problem is common to all kinds of insurance. Purchasers of theft insurance may be less vigilant. Purchasers of comprehensive car insurance may also be less careful in preventing vandalism and minor accidents. Insurance reduces the benefit of self-protection. Given a positive marginal cost of self-protection measures and given that insurance reduces the marginal benefit of self-protection, self-protection effort will decline. This in itself is not sufficient to prove that insurance is socially undesirable (Jao, 1982:22). In any case neither deposit insurance nor market discipline is meant to be a substitute for the prudential supervision of banks (Jao, 1982:25). A recent survey of empirical studies by Gilbert (1990) concluded that there is no evidence market discipline is more effective in reducing bank failures than bank regulation. In principle, zero insurance puts the whole burden of self-protection on depositors while full insurance puts the whole burden of protection of depositors' interest on the insurer. Whether these extreme cases or some intermediate arrangement is desirable depends on a comparison of marginal costs and marginal benefits of self-protection (Figure 1).

Figure 1 The Optimal Degree of Self Protection



Marginal costs (MC) include cost of monitoring and diversification of deposits and assets resulting from a lack of official protection;
Marginal Benefits (MB) include the benefit of greater security, improved market discipline on the behaviour of banks, reduction in otherwise-needed regulation that may distort bankers' behaviour, etc.

The argument that mandatory deposit insurance may lead to the subsidization of weak and badly managed banks by strong, well-managed banks is valid, but must be qualified. This "unfair cross-subsidization" problem would indeed be serious if the supervision of banks is ineffective, but it becomes a rather minor problem as far as the supervision of banks is effective in ensuring that banks are sound and honest. In the extreme case, bank supervisors do a perfect job, and banks never fail. Insurance premiums will keep falling, approaching zero over an indefinite length of time.[9] There is no cross-subsidization. In a less extreme case some banks fail, but if there is no telling which banks are more likely to fail beforehand the allegation of unfair cross-subsidization does not really stand. Finally, if deposit insurance is not mandatory but is purchased voluntarily by depositors the claim that deposit insurance leads to the subsidization of weak banks by strong ones cannot even be made.

The objection that deposit insurance will eventually burden the taxpayer arose recently as a result of problems afflicting the FDIC in the United States. The recent United States experience, however, is far from typical among the scores of countries with deposit insurance. Actually, for more than half a century since its inception, the FDIC had been running a profit. Annual rebates to insured institutions had been made since 1962 through the early 1980s (Cooper and Fraser, 1986:156). The premium charged on deposits was also reduced. It stood at 1/14 of one per cent in 1983 and 1/13 of one per cent in 1984, as compared with the 1/12 of one per cent which had prevailed since the 1930s.

The massive bank failures and problems with the savings and loans associations (S&Ls) in the 1980s in the United States are the result of serious loopholes that allowed S&Ls "to pile risky loans atop others" and permitted banks to lend developers with "next to no equity" (Davis, 1991:51).[10] "Backed by federal deposit insurance, the S&Ls paid high interest rates for big, insured deposits, which the S&Ls lent interest-free to their developer friends. The loans frequently were padded with stiff loan fees and interest charges (that are never paid) .... The phony incomes produced wildly exaggerated profits that wound up as dividends in the pockets of some S&L owners .... In Texas, ... loans could exceed the purchase price of property" (Apcar, 1987). There is no doubt that mandatory, full deposit insurance combined with lax supervision will lead to disastrous consequences (Kareken, 1990). But deposit insurance can be fractional and can combine with close supervision and regulation to protect depositors' interests.

According to Chari (1989), "the obvious argument against close regulation is that unfettered markets can allocate resources better than bureaucrats can."(p.3) Thus, "the benefits of deposit insurance must be balanced against the costs of distorting bank decisions." This argument is again valid but may not carry much weight. Given that banks and other deposit taking institutions are the custodians of huge stocks of liquid wealth entrusted by a large section of the population, the temptation for fraud and abuse of trust is strong (Davis, 1991:49). Today prudential regulation of banks is universally regarded as necessary, indicating that the world is placing greater value on deposit security than on "efficiency." Moreover, a high incidence of bank failures resulting from lax regulations must also hurt efficiency. This loss of efficiency may be worse than the loss of efficiency arising from close regulation.

Still, one could argue that there should be a range of differentially regulated deposit taking institutions, with some more closely supervised and better insured that others. Depositors are then free to choose between deposit security and higher returns or other objectives. Each depositor will hold a portfolio of deposits reflecting his unique needs and aspirations.

Design of Deposit Insurance

The following questions must be answered in designing deposit insurance:

1. Should deposit insurance be compulsory or voluntary?
2. Should the concept of coinsurance be adopted? That is, should coverage be limited to a pre-determined percentage of deposits?
3. Should there be an upper limit to the payout in the event a bank fails?
4. Should banks or depositors be responsible for paying the premiums?

5. How should the premiums be calculated?
6. Should deposit insurance be restricted to demand deposits, or be extended to cover time deposits?
7. Should deposit insurance be restricted to Hong Kong dollar deposits, or be extended to cover foreign currency deposits?
8. Who should be responsible for running the deposit insurance scheme?

I shall examine each of these issues in turn. The first two questions, however, can be discussed together.

First, I contend that there should be mandatory deposit insurance for 60 per cent to 80 per cent of all demand deposits, with additional coverage available on a voluntary basis for the rest of demand deposits and for time deposits. The idea is that a bank failure will cause the most disruption on economic activities when demand deposits are not protected. A suspension of payment will almost certainly set off a chain effect that could cause multiple business failures. The deposit insurance fund should provide immediate liquidity to demand deposit account holders when a bank is unable to honour its obligations so as to minimize economic disruptions. When I say "60 per cent to 80 per cent" I mean some banks can opt for 60 per cent compulsory coverage while others can opt for 80 per cent coverage. The former kind of banks are subject to less stringent regulations than the latter. The idea is to allow greater choice in investment strategy and banking services while mandating basic protection to depositors. This idea is really not foreign to Hong Kong, where the three-tier system of deposit accepting institutions has been in existence since 1981, except of course that presently restricted licenced banks and deposit taking companies are not allowed to accept demand deposits. The implication, of course, is that if they continue not to be allowed to accept demand deposits they should not be covered by the mandatory deposit insurance, even though depositors should be eligible for subscribing to insurance on a voluntary basis.

The idea of fractional, rather than full, mandatory deposit insurance is mainly to give banks an incentive to compete for deposits on the basis of soundness, rather than to urge depositors into monitoring the behaviour of banks. As argued before, the cost of monitoring banks may be prohibitively high for many depositors. The psychological pressure on

banks, however, will serve to induce a more healthy portfolio of investments.

Today, fractional deposit insurance is widely accepted as a far better approach than full deposit insurance. The American Bankers' Association (1990), representing the industry as a whole, recently proposed that there be a "hair-cut" of between 5 and 15 per cent off deposits reclaimed whenever a payout is necessary.

In addition to the mandatory fractional deposit insurance that should apply to all demand deposits, we argue that supplementary coverage should be available on a voluntary subscription basis for time and foreign currency deposits as well as for the remainder of the demand deposits that is not covered by the mandatory scheme. To the extent that some depositors may prefer security to income and are willing to pay the necessary premium to obtain coverage efficiency considerations suggest that coverage should be available as long as the premiums collected can cover the cost of the scheme over the long run. In general, premiums on the supplementary coverage should be higher, because the risks associated with protecting additional funds rise rapidly. The premiums on foreign currency deposits and time deposits should also be calculated on a commercial basis and should be collected in the currency in which the deposits are denominated. Because time deposits and foreign currency deposits are not covered under the compulsory scheme, banks still have a high incentive to maintain an image of being prudent in their investment decisions.

In many countries there is an upper limit to the amount depositors are repaid. This limit is intended to help conserve the insurance fund and lower the required premiums. However, in practice depositors often can resort to various ways to achieve full protection, including diversifying deposits among several banks and even using different names to open accounts (Miller and Pulsinelli, 1985:191). Given this behaviour the upper limit to payout may not significantly reduce the burden to the deposit insurance system as a whole, while the behaviour to take advantage of the loopholes absorbs real resources and thus is socially wasteful. Accordingly we conclude that a payout ceiling is both unfair and inefficient.

With respect to the question of who should bear the cost of insurance

there are potentially three candidates: depositors, banks, and taxpayers. Because of the ability of banks to pass the costs to depositors there is probably no material difference in the outcome to requiring depositors or banks to pay for the cost of compulsory insurance. By nature, the voluntary part of deposit insurance is completely borne by those depositors who have opted for the additional insurance. Requiring taxpayers to subsidize the cost of deposit insurance seems to be at odds with the spirit of a free market economy with its emphasis on entrepreneurship and "no-free-ride." Actually, having taxpayers fund part of the cost of deposit insurance is not totally unwarranted, to the extent that deposit insurance produces external benefits and that large taxpayers are probably also large depositors. Nevertheless, there is little doubt that any scheme should be mainly funded by its direct beneficiaries.

I have already argued that any additional insurance above the mandatory level should be financed by premiums charged on depositors. I have also pointed out that all premiums on the supplementary insurance should be charged at a higher rate than the basic premiums, because, as coverage increases, the risk that there is not enough asset backing the covered deposits increases. Naturally, the appropriate premium would depend on the incidence of bank failures, and the latter would depend on the efficacy of the system of prudential supervision of banks. If the bank regulators have great confidence in their ability to track down impending problems and take precautionary measures, premiums should be lower. On the other hand, if the bank regulators have very little confidence the premiums should be higher. Thus bank regulators are in a better position than anyone else in calculating the risk premiums. As mentioned earlier the FDIC in the United States used to run a profit with its low annual charge at 1/12 of one per cent on deposits. Its current cash shortfall is a recent phenomonen and is really unique to the United States situation. As the Hong Kong government has expressed great confidence in the soundness of Hong Kong's banking system and as our recommendation is for a fractional insurance system it is unlikely that the insurance premiums would be higher than the United States rate of around 0.2 per cent per year. The claim sometimes heard that even if a deposit insurance scheme had existed in Hong Kong the premiums collected would have been inadequate to bail out BCCHK depositors is unwarranted because we do

not expect one bank failure per year. The fact that a deposit insurance scheme would only provide protection to a fraction of Hong Kong's bank deposits is not sufficient to discredit such a scheme. If it allowed those who desired security to opt for greater protection, say, by limiting their holdings in foreign currency and time deposits, it would have achieved much of its intended purpose.

Questions 6, 7, and 8 have all been answered in the above. The main idea is that mandatory fractional deposit insurance should apply only to Hong Kong dollar demand deposits and that the bank regulatory agency should also be responsible for administration of the compulsory scheme. The government should encourage the private sector to offer supplementary coverage on a commercial basis, if it finds this too cumbersome to administer.

Conclusions

Those who oppose introducing deposit insurance in Hong Kong point out that Hong Kong has an excellent regulatory framework, and that the banking system as it stands is already sound. Introducing deposit insurance is regarded as another step away from a free market economy towards greater government intervention. This view is most unfortunate. No matter how well the regulatory machinery is designed, bank regulators are human and are susceptible to errors and temptation. The Bank of Commerce and Credit International debacle is of course not a home-made problem, and there is no evidence that our bank regulators have erred. Without implicating our bank regulators, the truth is that bank failures cannot be legislated away or eliminated by bank regulators. That the Hong Kong banking system is sound does not mean that deposit insurance is unnecessary. For those who have lost their life savings and are ruined financially the fact that the banking system is sound does not help. For them the incident is as bad as a serious depression.

Rather than steering the economy away from free enterprise and the free market, deposit insurance actually strengthens the free market. The mandatory, fractional deposit insurance on demand deposits as proposed helps competition by blunting the inherent advantage enjoyed by banks

that have become "too big to fail." By providing instant liquidity to demand deposit account holders, deposit insurance "lubricates" the market and minimizes the disruptions that will occur when banks fail. By providing protection to more than half of the demand deposits, deposit insurance reduces the uncertainty that businesses face. They are then free to devote their resources to where their comparative advantages lie rather than be forced into taking self-protection measures that can be costly and unreliable. By providing supplementary deposit insurance on a voluntary basis, depositors have a way of protecting themselves more fully while sound banks commanding greater confidence should be able to convince depositors that the supplementary insurance is not necessary. As Hong Kong dollar-denominated demand and savings deposits amount to just over 17 per cent of total deposits in the banking system "market discipline" will continue to be effective (see Table 1).

Table 1 Structure of Deposits in Hong Kong 1990 ($ Billion)

	Licenced Banks	Restricted Licence Banks	Deposit Taking Companies	Total
HK $ Demand and Savings Deposits	213	N.A.	N.A	213
HK$ Time Deposits	276	11	20	307
Total HK$ Deposits	490	11	20	520
Foreign Currency Deposits	666	33	13	711
Total	1156	44	32	1231

Source: *Annual Report 1990*, Commissioner of Banking, Hong Kong.
Note: Rounding caused minor discrepancies in totals.

Some people argue that if deposit insurance offers only limited protection to a fraction of total deposits then it is really not offering much protection to depositors. This argument fails to recognize the importance of the "limited protection." The protection of say up to 80 per cent of total demand deposits is sufficient to eliminate any major disruption to business transactions, and gives depositors the option to trade interest income for security. It would give protection to those who need it the most.

Will a requirement for fuller disclosure of information absolve the need for deposit insurance and improve the effectiveness of market discipline on banking behaviour?[11] If such a requirement is effective it certainly will improve the effectiveness of market discipline, but it does nothing to reduce the need for deposit insurance. The simple reason is that regulators, not to speak of depositors, can never be completely sure they have all the relevant information about the health of a bank, and that bank failures can never be legislated away. We have to ask ourselves which is more socially costly, government-backed, regulator-managed deposit protection, or self-protection by the millions of depositors.

It is sometimes suggested that money market funds and other short-term instruments can be developed or brought into greater use. As these are traded freely and are like unit trusts in that they are bound by law to invest in specific types of securities, they do not depend on the soundness of individual banks and institutions. Savers can take advantage of these instruments, and thus free themselves from the risks of individual financial institutions. There is indeed scope for an increasing role of these instruments in Hong Kong. In principle, there is nothing in the nature of money market funds that prevents the writing of cheques against them.[12] But progress in this direction is likely to meet with an opposition from the major banks at least as strong as that lodged against deposit insurance schemes.[13]

There are those who argue for deregulation and no deposit insurance. Chari (1989) argued in favour of central bank policy rather than deposit insurance to stem bank runs, stating that monitoring by depositors rather than by regulators would allow greater diversity in risk-taking among banks. Undoubtedly deregulation is helping the creation of new financial products and can enable depositors to earn higher interests. The empirical question is: do depositors prefer higher interest earnings or do they prefer greater security? Supporters of greater reliance on market discipline may have underestimated the extent of information cost which may have prevented risk-averse depositors to protect themsel-

ves effectively.

In conclusion, as long as banks exist to take deposits and that they may fail there is a market demand for deposit insurance and there does not seem to be a viable substitute to deposit insurance. To minimize potential disruption to economic activities caused by bank failures, I recommend mandatory fractional deposit insurance on all Hong Kong dollar-denominated demand deposits. I also recommend providing additional supplementary insurance to depositors who are willing to pay a commercial rate to obtain the coverage.

Notes

1. For a survey of the deposit insurance systems among OECD countries, see OECD (1987), Annex XII.

2. Hong Kong fully implemented the Basle framework of capital adequacy requirements on December 1989.

3. See statement by Joseph Yam, Director of the Office of the Exchange Fund, in *Hong Kong Economic Journal*, August 2, 1991.

4. According to OECD (1987), "a comprehensive deposit protection scheme may contribute to improving competitive equality by reducing the competitive advantages enjoyed in the perception of the market place by certain classes of banks, due to their size or legal status, which need not be necessarily the most efficient." (p.134)

5. In some countries, regulatory constraints may prevent the setting up of deposit insurance. The inability of insurance agents to look into the books of banks is yet another barrier to setting up deposit insurance in the market place.

6. See the section "Some unpleasant effects of deposit insurance" in Kane (1985), pp.13-15 and pp.17-20.

7. According to Kane (1985), "the basic difficulties were clearly foreseen in the debate that preceded the establishment of the federal deposit insurance system. Deposit insurance occupied a place on the national agenda for roughly a century before its adoption in 1933." (p.18)

8. OECD (1987) noted that "As a first prerequisite, market discipline requires a very broad access by market participants to detailed information regarding a bank's situation." Even if market participants had the skills to analyse a bank's balance sheets Hong Kong is still a place that permits the setting aside of "inner reserves," while to whom a bank lends is always treated as another secret.

9. In Sweden, while the savings banks have a common "deposit insurance fund," for many years they have not considered it necessary to make contributions to this fund (see OECD, 1987:274).

10. According to Davis (1991:51), mainly as a result of deregulation in the early 1980s banks poured in some $350 billion in commercial real estate. "A staggering 32 per cent of all the existing office space in America was built in the 1980s." By 1990, some regions of the country had an estimated ten-year oversupply of office space.

11. Richard Ho recently called for "full disclosure of information" so that depositors can assess the risks involved in depositing with financial institutions (Ho, 1991).

12. Cooper and Fraser (1986) noted that the money market funds in the United States have over time offered many attractive services to savers, including the ability to write cheques against the value of the account. Competition from money market funds was an important reason why banks were forced into offering interest-earning chequable accounts (pp.6-7).

13. Another consideration is that the prevalence of HK$-denominated money market funds is conditional on the availability of sufficient quantities of short-term, high-quality money market instruments that are denominated in Hong Kong dollars. This may require a much larger issue of government securities than is currently available.

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對香港實行存款保險制度的一個建議

何濼生著

（中文摘要）

本文對存款保險的利弊進行了深入的分析。結論是：雖然有關存款保險的批評大致上均屬正確，適當的安排卻可大大減少存款保險的副作用。本文特別指出，實行分數式存款保險、再向銀行監察部門委以管理存款保險基金的責任，將可達致一定的「市場紀律」、促使銀行不致進行過高風險的投資。本文同時指出，歷來銀行倒閉的一個主因是欺詐行為，而「市場紀律」一般不足以制約此等行為。原因是存戶及大眾並不容易掌握正確和充份的資料。由政府委任的銀行監察部門卻有專業和全職的人才和法定的權力去索取一切必需的資料。適當的存款保險制度為廣大的存戶減低風險和監察成本，做成巨大的社會資源的節省、促進銀行業內更公平的競爭、並減低一旦有銀行出事時所造成的對經濟活動的干擾。本文建議香港對所有港元活期及來往戶口的存款實行強制性、分數式的存款保險。同時存戶應可選擇性地付出較高的保費為其他存款購買額外的保險。