

Interim Report by the Study Group on the Deposit Insurance Premium

The Study Group on the Deposit Insurance Premium, a private advisory body for the Governor of the DICJ, prepared and published the Interim Report on June 18. The DICJ made a provisional translation of the report for your information.

For further inquiries, please contact us at inter-info@dic.go.jp.

June 18, 2004

Interim Report by the Study Group on the Deposit Insurance Premium

I. Introduction

Japan's deposit insurance system was established in 1971. Under the scheme, the Deposit Insurance Corporation of Japan (DICJ) collects from financial institutions insurance premiums equal to a certain percentage of their insurable deposits, and, in the case of a financial institution's failure, reimburses depositors within a certain limit. This system was strengthened in 1986 when the DICJ obtained the power to provide those financial institutions, which would rescue a failed financial institution, with grants necessary for protecting depositors of the failed financial institution.

Until the end of the fiscal year 1995, the level of the liability reserves of the DICJ was positive because there had been few failures of financial institutions. Since the fiscal year 1996, measures had been in place to provide depositors with unlimited protection and a series of failures of financial institutions had taken place. In total, between the fiscal years 1971 and 2002, the DICJ provided grants of nearly 19 trillion yen. Despite the injection of public funds exceeding 10 trillion yen, the balance sheet of the DICJ shows deficits amounting to four trillion yen as of the end of fiscal 2002. Since then, however, the number of failures has declined substantially with only one failure of Ashikaga Bank.

Under these circumstances, the Governor of the DICJ decided on organizing a Study Group as a private advisory body to discuss an ideal system of deposit insurance premium from the medium- and long-term perspective. The Study Group held seven meetings from last October to June this year.

The following summarizes the discussion that took place at the Study Group meetings.

II. Bearing the Cost to Operate the Deposit Insurance System

Before taking up the issue of the ideal system of deposit insurance premium, the Study Group decided that it needed to discuss who should bear the operating costs of the deposit insurance system.

During the period of the “peacetime” when the financial sector is overall under a sound condition, it is considered appropriate that financial institutions (and their shareholders) should bear all the costs of running the deposit insurance system through the payment of insurance premiums since they enjoy the benefits of collecting deposits at lower costs than otherwise thanks to the deposit insurance system.

On the other hand, during the period when financial sector faces a “crisis”, members of the Study Group took the position that not only financial institutions but also the government should be obliged to bear the costs since there exists the public interest in maintaining the stability of the financial system.

It is not an easy task to decide on whether the particular situation be classified as “peacetime” or “crisis” from the viewpoint of determining who is to bear the cost to operate the deposit insurance. Such judgment would be even more difficult in those countries like Japan which experienced a large loss incurred on the deposit insurance fund with multiple failures of financial institutions for a couple of years, and then the number of such failures decreased significantly.

One criteria that can be considered as a watershed would be whether or not the insurance premium revenue collected without excessive burdens on financial institutions steadily manages to exceed the costs of bank resolutions for a given year.

The Study Group also emphasized that the stability of the financial system would be achieved by a combination of effective deposit insurance, prompt corrective actions and timely resolution of bank failures. The effective mobilization of the two latter measures is necessary to reduce the burden on

the deposit insurance system.

The cost of deposit insurance premium has a large effect on competitive conditions among financial institutions. From this viewpoint, due consideration should be given to the competitive position of those institutions paying the deposit insurance premium vis-à-vis the postal savings services currently outside the deposit insurance system, agricultural and fisheries cooperative-type financial institutions covered by their own savings insurance system, and financial institutions providing no depository services. Their international competitiveness also needs to be considered.

III. Ideal System of Deposit Insurance Premium

Deposit insurance premium systems in other countries largely fall into two types: i.e., flat and differential. Under a differential premium system, the level of an insurance premium paid by a financial institution takes into account a risk of loss which may be incurred on the deposit insurance system as a result of a failure of that financial institution. Differential premium system was introduced in the United States in 1993 after the review of the bank failures occurred in the 1980's. Since then, more and more countries have adopted differential premium system.

In Japan, the Financial System Council reported on this issue in 1999, "A variable insurance premium, where insurance premiums are determined in connection with the financial condition of individual insured institution, is adopted or under consideration in other countries. Such a risk-based insurance premium is, in principle, desirable in terms of supplementing market discipline." and said, "Although the framework of a risk-based insurance premium should be studied at an early opportunity, the application of the framework is not feasible at this juncture."

The Study Group has noted that the following advantages exist in differential premium system.

- a) To counter the moral hazard effect that the deposit insurance would

bring to the management of financial institutions, and to induce those institutions to strengthen their financial positions. As a result, the stability of the financial system would increase; losses on the deposit insurance funds would be curbed; and burden on the taxpayers would be minimized;

- b) To enhance the financial institutions' recognition that insurance premium burden is fairly distributed among them; and,
- c) To increase the effectiveness of capital adequacy regulations and other regulatory measures.

On the other hand, concern was noted that the introduction of differential premium system at the time when the financial system is unstable would result in charging a higher premium on financial institutions in weaker positions than others, further eroding their financial soundness.

Considering these points, many members of the Study Group took the position that an element of differential premium system should be incorporated into the deposit insurance system.

IV. Possibility of Introducing Differential Premium System in Japan

Examples of differential premium systems in other countries show that there is no identical system in the calculation method of premium rates and the rate structure; instead, each country has adopted its own differential premium system in accordance with its circumstances.

The Study Group discussed what options would be available when the condition of the financial system is stabilized and the time comes to Japan to consider the introduction of differential premium system.

i) Methods of Calculating Premium Rates

One possible method of calculating premium rates would be to estimate for each institution the amount of expected loss that the deposit insurance may incur from its failure in accordance with a statistical model which is based on

its share price, its yield of subordinated debts, and its rating by rating agencies; however, this approach involves a number of problems, such as difficulties of exact estimation, limited availability of appropriate numerical data for each institution. In view of these difficulties, many countries have adopted an approach to group financial institutions based on financial quantitative data such as capital adequacy ratios, etc., and then apply differential rates to each group of financial institutions. Still many others take into account qualitative information such as examination ratings in grouping financial institutions, in addition to quantitative data above.

Many members of the Study Group expressed the view that it would be desirable to group financial institutions mainly on the basis of published quantitative data from the viewpoint of transparency; however, there were other opinions that a combination of quantitative and qualitative information should be considered.

In order to determine what specific quantitative data should be selected in applying the rates, it is necessary to carry out an analysis of the past failures of financial institutions and find a set of quantitative variables which are significant in estimating the expected default frequencies and the loss given default.

ii) Rate Structure

The number of differential premium rate categories and the configuration of rate curves are different across countries. At the initial stage of introducing the differential premium rates, one option would be to have only two or three premium categories and keep the spread small between those categories so that a drastic change in financial institutions' burden of premium payments would be avoided, ensuring their support for a new premium rates structure.

In Japan, *shinkin banks*¹, credit cooperatives and *labor banks*² have

¹ Shinkin Banks are cooperative type financial institutions with strong ties to the local community, whose members are small companies and local residents.

² Labor banks are cooperative type financial institutions with the aim of raising laborers' living standards, whose members are labor unions, their members, consumer cooperatives and other labor-related entities.

established, within the respective sectors, an arrangement to mutually provide peer institutions in need with financing. These mutual support arrangements, if they work effectively, might prevent a failure from occurring and reduce losses to deposit insurance funds. In this connection, a further study is necessary on whether it is possible to incorporate such function of these arrangements into the structure of differential premium rates.

iii) Application of Differential Premium Rates to Individual Financial Institutions

Other countries have established a procedure for a financial institution dissatisfied with the applied premium rate to file a complaint with the deposit insurance authorities; it is considered necessary in Japan to have a similar procedure in place.

With respect to public disclosure of rates applied to individual financial institutions, there is an opinion that it can enhance market discipline. On the other hand, if the information is used for business promotion purposes, it is feared that reputation risk would become a significant threat. This reputation risk would not arise if premium rates are calculated solely on the basis of published quantitative data; however, it could become serious if the rates are applied on the combination of both quantitative data and qualitative information such as examination ratings. Most countries impose confidentiality requirement on the deposit insurance authorities as well as financial institutions in this respect. Sufficient attention needs to be paid to this issue in Japan, as well.

iv) Needs of Providing for Preparatory Period or Transitional Measures

Prior to the introduction of differential premium rates, most countries have set up a preparatory period for financial institutions to strengthen their management or a transitional measure to prevent drastic changes in the level of their insurance premium charges. In Japan, it is also desirable to consider the needs of similar measures, depending upon the feature of differential insurance premium rates to be introduced.

v) Needs of Periodical Review of the Rates Structure

In case differential premium system is to be introduced, it is desirable to carry out periodical review of the rate structures, keeping in mind the changes in financial environment and other circumstances.