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Financial Consumer Protection

An Overview of Deposit Insurance[1] Regulations in Vietnam

Introduction

The ongoing global liquidity crisis which started with the subprime mortgage meltdown in the US since 2008 has brought to the fore once again a discussion on appropriate policy responses to handle financial crises. Banking activities are always accompanied with sensitiveness and hidden risks, therefore, government provision of a financial safety net for banks and other financial institutions has been a key element of the policy response to the current financial crisis.

In the process, the design of many safety net elements, such as deposit insurance, has been redrawn in many jurisdictions to stop or avoid widespread bank runs. Deposit insurance began its operation after the world financial crisis in 1928-1933. The first organisation was established in the US. After more than 70 years, there have been more than 100 countries that have deposited insurances[2] in its financial system. The Deposit Insurance of Vietnam was established in 1999[3] in order to create a mechanism to protect small depositors in the economy.

This issue of economic update will examine experiences of selected countries in the world using banking guarantees and then the status of Vietnam's current mechanism of deposit insurance to find out whether it is a solid tool to protect consumers when the banking system encounters a crisis.

Experiences of selected countries using blanket guarantee

In the wake of the global financial crisis, national and international efforts to strengthen consumer protection policies have intensified in order to promote financial stability. Among many safety set elements that governments design, deposit insurance has been one option that is utilised to restore confidence and protect depositors. During the 20th century, the world witnessed some severe financial and economic crisis which affected many countries.

Table 1 summarises experiences of selected countries in the period since 1990 and later to find out how different countries used the blanket banking guarantees to restore customer confidence. In most cases, guarantees were used when a systemic banking crisis was already unfolding, while in others it was used as soon as pressures were felt.

In terms of coverage, the blanket guarantee is usually comprehensive – including foreign and domestic currency liabilities – but it commonly excludes subordinated debt (except the recent case of Ireland which includes dated subordinated debt) and liabilities to related parties. In some cases it was in place for as little as 11 months, while in others for over 8 years or the blanket guarantee was preceded by an announcement of partial coverage of liabilities, such as Thailand, Korea, and Nicaragua. In other instances, the guarantee had been extended only for a specific institution or set of institutions, whenever bank runs had been contained within a segment of the system.[4]

Effectiveness of blanket guarantee[5]

The benefits of a blanket guarantee lie in its impact on public confidence by eliminating incentives to withdraw deposits. It is to be expected that if a blanket guarantee is successful, deposit withdrawals should subside and liquidity pressures at banks decrease, which would result in a decline or at least slowdown in banks' demand for liquidity support from the central bank.

Figures available in the Table 1 suggest that the evolution of liquidity support did decrease or slow down following the announcement of a blanket guarantee. Cases where the pattern was exactly what one would expect include Malaysia, Honduras, Mexico, Finland, Sweden, and Turkey. In some countries, liquidity support did not decline but decelerated significantly and/or leveled off immediately after the announcement, which may be interpreted as signs of success of the blanket guarantee. Thailand and Nicaragua were in that group.

Deposit insurance in Vietnam

Deposit insurance in Vietnam which was established in 1999 and officially operated in 2000 does not work outside the general objectives. This is evident in the Decree of the Government on the deposit insurance policy,[6] "Deposit Insurance of Vietnam is a State financial institution, protects the lawful rights and interests of depositors, and contributes to maintaining stability of institutions participating in deposit insurance and the development of safe, soundness banking operations". Having been in effect for more than 10 years, it has made payments to depositors. At the end of 2011, the Draft Deposit Insurance Law has been submitted to the National Assembly and feedbacks are being collected to complete the new Bill.

Function of DIV

In each country, deposit insurance is established to perform specific function assigned by the government. In practice, there are three types of explicit deposit protection arrangements/ options, namely:

Table 1: Selected Blanket Guarantee Episodes			
Country	*Date of guarantee*	*Duration (months)*	*Coverage*
Denmark	October 08	unspecified	All bank deposits
Ecuador	December 98	37	All deposit liabilities (including offshore entitiesof the financial group and foreign trade credit lines of banks under restructuring
Finland	August 1992 (1st announced) February 1993 (passed in Parliament)	75	All liabilities, except for shareholders
Germany	October 08	unspecified	All private savings accounts
Honduras	September 99	48	All banking system deposits
Iceland	October 08	unspecified	All deposits in domestic commercial and savings banks and their branches in Iceland. "Deposit" refers to all deposits by general customers and companies which are covered by the Deposit Division of the Depositors' and Investors' Guarantee Fund.
Ireland	September/October 2008		
Japan	November 97	89	All deposits, including interbank deposits.
Korea	August 1997 (External liabilities)	37	All liabilities (excluding shareholders' capital and subordinated debt)
Malaysia	January 98		Deposits only of commercial banks, finance companies and merchant banks, including overseas branches of domestic banking institutions.
Mexico	December 1993 (1st announcement) December 1994 (2nd announcement)	109	All bank liabilities, including inter-bank deposits but excluding subordinated debt
Nicaragua	August 2000 (deposits of Interbank) January 2001 (all deposits)	18	All deposit liabilities except for related parties
Sweden	Sep-92	46	All liabilities, except for shareholders
Thailand	June 1997 (finance companies)August 1997 (extended to banks)	89	All deposits, contingent and foreign liabilities (excluding shareholders' capital and subordinated debt) of banks and finance companies. Deposits and/or claims of related parties were excluded unless proven that transactions were at arms' length
Turkey	May-94	66	All saving deposits
Turkey	December 00	43	All liabilities (including contingent) of domestically incorporated banks except for owners' deposits, deposits linked to criminal activities, subordinated debt, and equity

Source: International Monetary Fund

Box 1: An Example of Making Payments for Depositors in Bac Giang Province

People's Credit Fund agent in Tru Huu – Luc Ngan District – Bac Giang Province was established and had been operated since 1996. To the end of 2009, the fund's operation appeared to have many shortcomings, great loss of property due to the fund officers' moral hazard. On June 01, 2011, the Fund was forced to dissolve according to the Decision of the Chairman of Bac Giang province's People's Committee and the State Bank Governor.

On June 07, 2011, Deposit Insurance of Vietnam decided to stop deposit insurance of this agent and recalled the deposit insurance certificate, and quickly completed necessary documents to make payments for depositors. After the DIV Board approved the payment plan, DIV branch in the North cooperated with Agribank and BIDV branches in Bac Giang province to make payments for depositors. The total amount of 3,090 million VND was paid to 104 depositors.

Source: Deposit Insurance of Vietnam

i. Pay-box deposit insurance system: The main public policy objectives of these pay-box deposit insurance systems are to pay off depositors of failed insured institutions and to contribute to the stability of the financial system by protecting less financially sophisticated depositors. The main function of these systems is to reimburse depositors, in order to perform several public objectives, in which, the two most important objectives are: (i) to ensure government's commitments on state assurance through an explicit organisation and deposit insurance mechanism; and (ii) to protect small depositors through establishing redress mechanism.
ii. Risk-minimising deposit insurance system: With this model, along with the task of protecting depositors, the institute cooperates with government agencies and State bank in supervising, monitoring and assessing risks of banks and other financial institutes, contributes to ensuring safety and transparent operation of the financial system. The institution has the authority to determine their sources of fund, borrowing limits, etc. This model is considered as the most advanced model of deposit insurance organisations and it helps reduce risks in the banking system when the economy encounters difficulty.
iii. Pay-box deposit insurance system with extended powers: In addition to the primary roles of the pay-box deposit insurer (premium collection, fund management, and reimbursement of depositors), pay-box systems with extended powers are usually involved in failure resolution and responsible for bank liquidation, and co-monitor member banks. But the powers and authorities granted to systems in this category vary considerably.

The first model often exists in developing countries, where deposit insurance institutions are newly established and still have limited scope and financial capacity. The institution of Vietnam operates under the third model with the main function of making payments along with extended power. It supports participating members when they are insolvent; undertakes advocacy about deposit insurance to the public; organises training workshops and provides professional advices related to deposit insurance, etc.

Funding for DIV

Currently, an *ex-ante* funding method is utilized for the deposit insurance system in Vietnam. An ex ante funding system is said to have more advantages than an *ex post* one. It requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure actually occurring. It is funded by its members through contributions, insurance premiums and other means. An *ex-ante* system is more rule-based and offers greater certainty than other systems – the funds are intended to be in place before they are needed.[7] This helps to minimise the risk of sudden withdrawals and the escalation of withdrawals to a bank run.

In addition, the *ex-ante* also has the advantage of being more equitable than an *ex-post* one because all member institutions, including those that fail, will have helped to support the system financially through payments into the fund. This funding system spreads the cost of insurance losses over time, since insurance premiums are collected taking into account expected losses over the long run.

With this funding method, Deposit Insurance of Vietnam is collecting premiums from members at 0.15 percent of the average insured deposit balance at the participating institutes. This premium is paid to DIV on a quarterly basis, and the deadline is on the day 20th of the first month of each quarter. The rate of 0.15 percent is applied to all members regardless of size, ownership or legal form of participating organisations. It is said that the flat-rate premium is easy to apply in newly established deposit insurance system in developing countries. Another kind of collecting premium is risk-based or differential premium. When applying risk-based model, deposit insurance entity is collecting premiums that reflect how prudently banks behave when investing their customers' deposits.

Having been operated for more than 10 years, however, the deposit insurance system still has limited funding to ensure the banking system safety. International practice has shown that the rate between deposit insurance funding over the total insured deposit balance is usually at 2.5 percent-3 percent, meanwhile, that rate in Vietnam is decreasing over time and it is nearly one percent at the moment. And the available funding of the deposit insurance system to the end of 2010 was more than 6,500 billion VND. It is considered quite low compared to that of other countries and compared to the current size of the banking system. It is not enough to cover the insolvency or bankruptcy of two medium-sized banks in Vietnam.[8] And it may not ensure the safety of the banking system when the latter encounters a severe crisis.

Coverage limit paid to depositors

Another controversial issue in the Vietnamese deposit insurance system is related to the coverage that the system pays for depositors when participating members go bankrupt or become insolvent. The current maximum coverage for depositors is limited at 50 million VND. It is about twice as much as the average gross domestic product (GDP) per capita of Vietnam. This limit has been applied since 2005. However, with current trends of increasing inflation and the scope of economic growth, this limit is said to be out-of-date (Son, 2011).

In a recent meeting on the Draft Insurance Deposit Law of the National Assembly, representatives felt the need to increase this limit. It should be based on specific average GDP per capita in each period. And the coverage should be equal to four to five times of average GDP per capita. Or differential coverage may be applied with the possible limits of 50, 100 and 150 million VND based on specific deposit balances (Diep, 2011). Several countries in the world have practiced the coverage equal to 100 percent of the balanced deposits in particular circumstances to face with crisis in the banking system like Thailand, Indonesia, Malaysia, etc.

In the US, German, and Hong Kong, the coverage is US$250,000; €100,000 and HKD 500,000 respectively. According to the Draft Law, this limit would be decided by the Prime Minister. The coverage is considered to be flexible and reflect the changing economic conditions.

Types of insured property in deposit insurance

Consumers also pay attention to the insured currency and types of assets in the insurance system. In the current legislation and the draft law, it regulates that only coverage for individual deposits in VND is paid, not for deposits in USD, other currencies or gold. And DIV would also not pay coverage for organisational deposits. It is said that those individuals make deposits in foreign currencies or gold, they have anticipated risks themselves (Giau, 2011).

The decision to pay coverage for domestic currency deposits reflects the government's perspective that citizens should use domestic currency like in many other countries in the world. Moreover, when the Draft law was submitted to the National Assembly, the State Bank of Vietnam did not list gold, foreign currency deposits in the insured deposits. The National Assembly's Economic Commission also agrees with this idea and says that tightening gold and foreign currency deposit insurance is in line with international practice. In addition, this also conforms to foreign management policy in Vietnam that prohibits using, selling and purchasing and hoarding foreign currency.[9]

Conclusion and Recommendations

Having existed for 10 years, Deposit Insurance of Vietnam has gained certain achievements, contributed to the stability of the banking system. Until now, there has been no significant solvency of commercial banks in Vietnam. Nevertheless, this does not mean that such a pessimistic outlook would not happen in an unpredictable condition today. The economic crisis in the US and the EU are alarming to other parts of the world about a potential contagion. The current scope and activities of DIV has shown that it is not strong enough to protect all small depositors when there is a severe crisis in the banking system.

At the same time, the legal infrastructure governing the operation of deposit insurance does not commensurate with its functions and tasks (without deposit insurance law) and it is not consistent with the legislation governing banking activities (Law on the State Bank and Law on Credit Institutions of Vietnam). In order to actively ensure the safety net for the banking system when it encounters crisis or in case of solvency, there should be a comprehensive legal framework to enable an effective implementation of deposit insurance.

Firstly, the Law on Deposit Insurance should be enacted. The new Law should take into considerations the following issues:

- The maximum coverage needs changing to reflect real situation of the economy. In the draft law, it is the Prime Minister who decides the coverage level, this creates flexibilities in case there are fluctuations in the market. The coverage may be aligned according to the GDP growth or specific economic conditions. However, the decision-making process should be shortened to enable speed reaction to changing situation;
- At the moment, the deposit insurance system only pays coverage for individuals' deposit in domestic currency. Nevertheless, in the long term, other types of ownership like deposits from small enterprises or organisations and deposits in gold and foreign currencies should be taken into considerations as well. This would create a fair treatment to different deposits and various consumers;
- In terms of funding for deposit insurance, the available fund needs increasing by pushing up the rate between deposit insurance funding over the total insured deposit balance. When the rate is raised up, it would create a more stable condition for the banking system and therefore for the economy in case of solvency as available funding affects directly ability to make payments of the system. Furthermore, a risk-based premium system should be applied instead of the current flat-rate premium in order to create fairness among participating members. Higher-risk institutions have to pay higher fees than better-managed financial agencies;
- When DIV has developed, the appropriate model should be an autonomous entity that contributes to risk reduction of the financial system like in the case of Japan, Korea or Hong Kong. Along with making payments for deposits, this entity also cooperates with the State Bank, the government to ensure the stability for commercial banks and other financial agencies. This agency is also the one to supervise activities of financial institutions to ensure the safety net in the whole system. It also acts independently to invest in other sectors so that it can increase the funding for operation to reduce gradually its dependency in the state budget.

Regulations on dealing with bankruptcy and solvency should be included so that it would be effectively enforced in the future. Along with the speeding up of issuing Deposit Insurance Law, the government should also promulgate decisions/ decrees that guide the implementation of this law to related authorities. Moreover, public relation would also be an important function of deposit insurance system. Consumers' awareness and confidence are the targets that it forwards to. The awareness can be raised up by diversifying means of communication to create and maintain good relationship with the public. DIV also needs to upgrade its website in a more interactive, user-friendly approach to help citizens informed about their activities.

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Endnotes

1. Protection provided usually by a government agency to depositors against risk of loss arising from failure of a bank or other depository institution. Deposit insurance is mandatory, and pays claims from a pool of funds to which every depository institution regularly contributes. However, it covers only a fixed maximum amount per account holder. Also called depository insurance.
2. Public objectives of the deposit insurance activities for each country depending on the time making its different decisions, but overall progress has three main target groups: (i) contribution to stabilizing the financial system, (ii) protection of people with small deposits amount, (iii) other objectives such as promoting healthy competition in the financial sector, reducing the impact of economic recession, economic growth, innovation and reforming to meet the stable financial system maintenance.
3. DIV was established according to Decision No. 218/1999/QD-TTG dated on November 09, 1999 by the Prime Minister and has officially operated since July 07, 2000
4. Laeven, L., & Valencia, F., 2008, *The use of blanket guarantees in banking crisis*, International Monetary Fund
5. *Ibid*
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9. Minh, Tue & Anh, Hong, 2011, *Deposit insurance only paid for individuals with deposits in Vietnam Dong*, Vnexpress.

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