

DEPOSIT INSURANCE 101 : The Essentials We Need to Know

Author:

Sharifah Adlina Syed Abdullah

Email:

sadlina.sabdullah@mof.gov.my

Abstract: This book is to help understand the basics of deposit insurance. DEPOSIT INSURANCE 101 : The Essentials We Need to Know is a book packed with funfilled facts about deposit insurance. It would be imperative for you to know how deposit insurance works in protecting your deposits in the banks. This understanding will help you to avoid panic behaviour to withdraw your deposits unnecessarily if there are rumours about the state of health of your banks. In actuality your deposit insurer or government; so you do not need to rush to the bank and be in the long queue in the first place. As much as I would say there is one design feature of deposit insurance that fits all, however this is not the case. As we live in different countries, our government's policy decisions on deposit insurance differ. This book helps you to be aware of the main design features of deposit insurance. By knowing some of these design features it will help you to plan and making an informed decision to ensure safety of ypur deposits in the banks. For instance, you must know where to put your money and in how many accounts or banks you should put them to secure full protection of your hard-earned savings.

Keywords: Deposit, insurance, bank, imperative, policy

Deposit Insurance



The Essentials
We Need to Know



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We Need to Know

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Website: <http://penerbit.uthm.edu.my>

E-mail: pt@uthm.edu.my

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PRAISE FOR THE BOOK



"It is my pleasure to know Dr. Sharifah Adlina since 2010 in a friendship that has grown from a supervisor-supervisee friendship to a closed-friend. Both through my research collaborations with the author as well as reading of the chapters, "Deposit Insurance 101: The Essentials We Need to Know" is indeed a well-researched and excellent work on why does the national deposit insurance matter. The book reveals all the essential elements of financial and banking theories associated with deposit insurance as well as its history and implementation in Malaysia. Notably, it is an extension of her doctoral thesis, as well as based on her years of working experience in the financial sector. Hence, the content is very factual, accurate, and practical for not just students but also academicians, policymakers and practitioners. Undoubtedly, everything about the book is so amazing especially the way how she uses colourful, animated and eye-catching infographics to augment written text. This suits the young millennials very well. They make the book easy to read and understand as well as visually interesting for college and university students."

*-Professor Dr. Rubi Ahmad
Faculty of Business and Accountancy
Universiti Malaya Kuala Lumpur.*

"Dr. Sharifah Adlina's book offers an essential introduction to the important topics of deposit insurance and bank stability."

*-Professor Jens Hagedorff
University of Edinburgh, United Kingdom.*

"I enjoyed reading it and learned a lot. I really liked the informal style of writing, which makes a (to be honest) kind of dull topic much more interesting and accessible."

*-Richard Record
Economist.*

"I find the book is good and easily understandable for the man on the street. Informative."

*-Mohd Muazzam Mohamed
Bank Islam Malaysia.*



PREFACE

Dear reader,

You may ask why I am writing this book as I have not even written a single page of a book before in my entire life, until now. What more, my first book is about deposit insurance which is a finance technical area. Conveying a technical subject matter in the simplest way with careful thoughts on the book pictures, illustrations and arrangements is an ecstatic experience for me. At times, I do struggle with writer's block but I persevere because all these efforts are worth because they permit me to fulfil my aspiration to share my knowledge about deposit insurance with you.

My aim is to help you to understand the basics of deposit insurance. Deposit Insurance 101: The Essentials We Need To Know is a book packed with fulfilled facts about deposit insurance. It would be imperative for you to know how deposit insurance works in protecting your deposits in the banks. This understanding will help you to avoid panic behaviour to withdraw your deposits unnecessarily if there are rumours about the state of health of your banks. In actuality your deposits are safely protected and guaranteed by a deposit insurer or government; so you do not need to rush to the bank and be in the long queue in the first place.

As much as I would like to say that there is one design feature of deposit insurance that fits all, however this is not the case. As we live in different countries, our government's policy decisions on deposit insurance differ. This book helps you to be aware of the main design features of deposit insurance. By knowing some of these design features it will help you to plan and making an informed decision to ensure safety of your deposits in the banks. For instance, you must know where to put your money and in how many accounts or banks you should put them to secure full protection of your hard-earned savings.



I caution you in the book about the rise of the moral hazard problem with the banks in the form of banks' excessive risk-taking that comes with deposit insurance protection. On the one hand, deposit insurance protects depositors like us. But on the other hand, deposit insurance may lead to banks increasing their risk appetite in financing activities. So, if you noticed deposit insurance as a double-edged sword, you are not alone. Nevertheless, I also explain in the book that a risk-based deposit insurance premium should be able to mitigate our banks' rogue behaviour.

A special bonus for you especially if you are a researcher, is a teaser of my research article on deposit insurance that I wrote in the year 2020. The article can be found in Chapter 5 in the book. Briefly, this is an empirical study that demonstrates how deposit insurance protects us — as depositors, in minimising moral hazard or excessive risk-taking behaviour among our banks. I hope this teaser will provide you with some insights in the application of deposit insurance in the "real world" particularly in the case of Malaysia. Chapter 6 concludes the book with a summary in infographics. So, let's start reading and enjoy the read!

Yours truly,
Sharifah Adlina Syed Abdullah, PhD
30 December 2020



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Above all, to the ONE and ONLY for the blessings and strengths bestowed on me and my loved ones, ALHAMDULILLAH.

Many have praised the hard work that I have put in to make my first book a reality. I feel truly blessed to publish a single-author book for my first book publication.

My special thanks and dedication to my eldest son Mior Shazryl Afiq who gave constructive comments and thoughts on the book. His creative ideas made the book more intriguing.

I just want to say Thank You to: my husband, sons, daughter and parents for their enduring love, patience and prayers;
the memory of my grandmother Che Mah;
the memory of my father-in-law M.Bashah;
everyone else, whose names I didn't mention;

... my publisher for believing in me. Their encouragement kept me on my toes and made me more determined to complete this book.

... having the best people in my life which has made a tremendous difference!

"Intellectual growth should commence at birth and cease only at death." -Albert Einstein-

Deposit Insurance



The Essentials
We Need to Know

PART I

WHAT IS DEPOSIT INSURANCE?



CHAPTER ONE
The Big Idea



An Overview

As some of us have observed, banking crises are a recurrent phenomenon in the history of international finance. Bank crisis management and responses differ from those extended to corporates in other industries. When confronted with failed or failing banks, governments have at their disposal: (1) the lender of last resort role of the central bank; (2) deposit insurance; (3) government policies of implicit protection of depositors, banks (the ‘too-big-to-fail doctrine’) or the payment system and other preventive measures including supervision by central banks and deposit insurers. In a way, our money as tax payers will be funding the bank rescue.

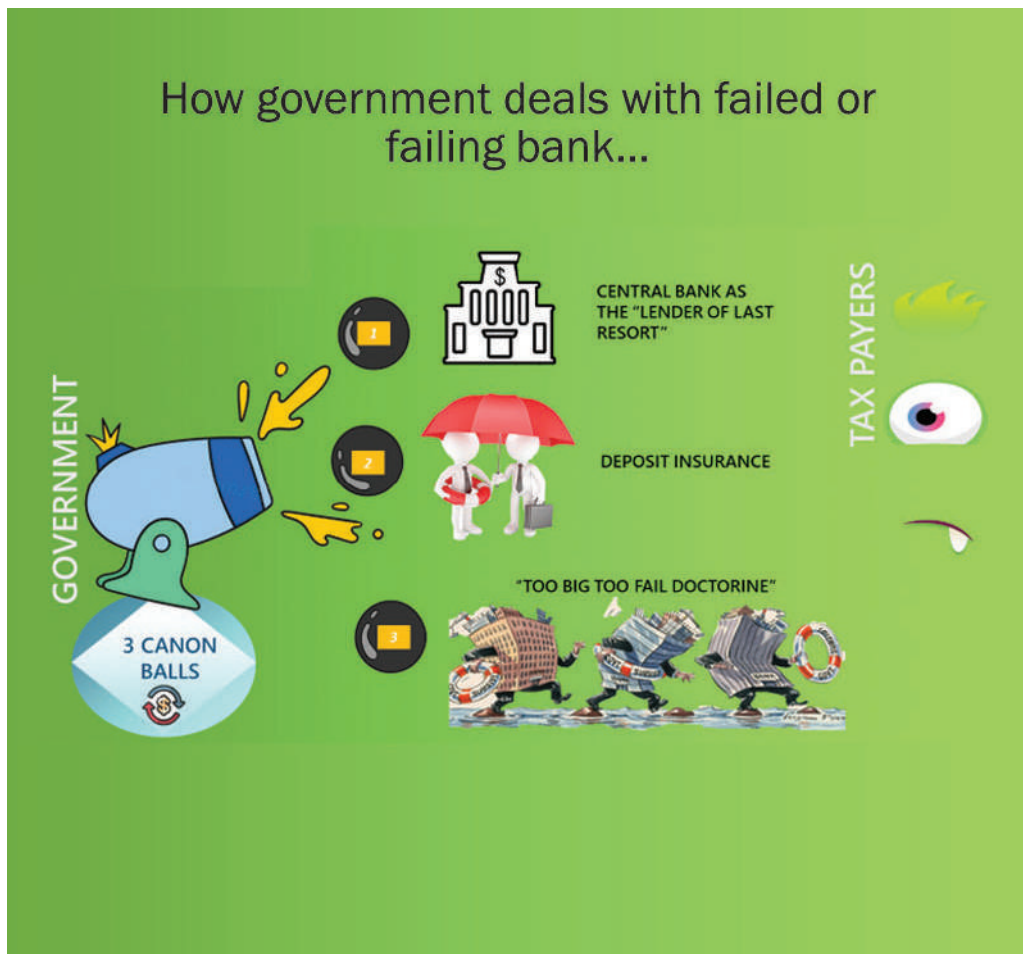


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CHAPTER TWO

History and Implementation





The Development of Deposit Insurance

At this point, we already know that deposit insurance is one of the broader aspects of financial safety net that not only protects households and businesses like us from contagious shocks but also bolsters our confidence in the banking system. Let us recall the gist of the previous chapter.



Image source: secret2anamazinglife.com

Our CONFIDENCE is the “magic pill” for banks...

To start with, the risk of severe banking crisis could be mitigated by having an appropriate financial safety net. If we do not have one, rumours spreading on the state of health of a banking institution could become contagious and turn the whole economy into a financial crisis.



CHAPTER THREE

Key Characteristics





Deposit Insurance: A Recap

We shall start by looking at three key takeaways about deposit insurance that we have learnt in the first two chapters. To recap firstly, we started off by describing deposit insurance and comparing it to a safety net catching the flying trapeze artists who are falling from a height. Secondly, we recognised that deposit insurance gives a boost to our confidence and that the power of our confidence is the “magic pill” for the banks. Finally, imagining an umbrella above our “piggy bank” is an image to describe deposit insurance protection on our deposits with banks.



Up till now we have also discussed the big idea on deposit insurance, its history and implementation around the world along with two selected countries, namely Malaysia and the United States.



CHAPTER FOUR The Moral Hazard Problem





Moral Hazard: The Deposit Insurance Problem

In theory, deposit insurance is clearly good in creating banking system stability. Sadly, deposit insurance can generate moral hazard and encourage banks to take excessive risk. The vital benefits of deposit insurance are the protection of small depositors, the maintenance of public confidence in the banking system and the minimisation of the broader economic consequences that could accompany bank failures.



Governments need to assess the benefits of deposit insurance against its costs

Deposit Insurance



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PART II

IN THE CASE OF MALAYSIA



From Chapter 1 to Chapter 4, I have basically familiarised you with the concepts and theories on deposit insurance that are essential for you to know. Let us now look at an empirical study that looks at the differences of risk taking between the conventional banks and Islamic banks before and after the introduction of deposit insurance. In the earlier chapters, I have also explained that the deposit insurance design features particularly the risk-based deposit insurance premium can help to mitigate the moral hazard problem of banks.

In this chapter I am sharing with you a teaser from my empirical study on how deposit insurance protects us as depositors particularly in minimising the moral hazard or excessive risk taking among our banks. The full article is accessible online for further reading at Syed Abdullah, S.A. (2020). *How Does Risk-based Deposit Insurance Premium Affect Bank Risk Taking? Islamic Bank vis a vis Conventional Bank*. *Journal of Technology Management and Business*, 7(2), 32-49. Retrieved from <https://publisher.uthm.edu.my/ojs/index.php/jtmb/article/view/7297>.

I hope this teaser will provide you with some insights on the application of deposit insurance in the “real world” particularly in the case of Malaysia. The diagram below summarise the scope and findings of the study in the article.



CHAPTER SIX

Final Thoughts



We have arrived at the end of the book and at the beginning of adjusting your future panic behaviour (in any case) of creating a bank run. Hopefully, this book will give you an idea of what deposit insurance is and how it protects your deposit in the banks. Further, as a result of what you have learned you are assured that your deposits are protected either in full or in part by your government either with an explicit deposit insurance or an implicit deposit insurance. I believe that it is right for me to say that this assurance would somehow boost your confidence in your banks which you have entrusted with your life savings.



The restoration of our confidence as depositors is crucial as it not only encourage us who are without prior banking arrangements to deposit money in a bank but also stretch the banks' size in the form of increased deposits. A guarantee of depositors' deposits, especially covering the majority of unsophisticated ones, would instill confidence and thus remove any incentive to participate in a bank run. When the majority of depositors like us are confident in our banks, panic withdrawal could be averted. Hence, by preventing bank runs, banking stability would also be enhanced for financial intermediation. In the short run, a deposit insurance system is a common antidote that reduces the occurrence of bank runs which would create banking system instability.

All in all, the prevention of banking crises as well as financial crises justifies the existence of financial safety nets like deposit insurance. Deposit insurance is needed to make better informed policy recommendations to mitigate the trade-off between protecting depositors while at the same time increasing bank risk taking. Mirroring this, deposit insurance serves as

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