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For discussion on
3 October 2003

Bills Committee on
Deposit Protection Scheme Bill

Indexing Coverage Limit

Background

At the meeting of the Committee held on 17 September 2003, Members requested the Administration to provide a paper on the pros and cons of linking the coverage limit to inflation as is being considered in the U.S.

The U.S. proposal

2. In 2001, the Federal Deposit Insurance Corporation (FDIC) conducted a review of the deposit insurance system in the U.S. It is proposed, among other things, that the present system of ad hoc adjustments of the coverage limit be replaced by an indexing system, so that the coverage limit would be adjusted automatically in line with inflation. Since then, the proposals arising from the review have been translated into draft legislation, which is currently under the scrutiny of the U.S. Congress.

3. The main features of the indexing system being considered by the U.S. are:-

(i) the coverage limit would be adjusted in accordance with the Personal Consumption Expenditures Chain-Type Index (a commonly used index to measure inflation);

(ii) an adjustment would be made every five years;

(iii) any adjustment which would result in a decrease of the coverage limit would be ignored; and

(iv) the adjusted coverage limit would be rounded to the nearest US$10,000.

Pros and cons of an indexing system

4. The FDIC's proposal to index the coverage limit to inflation has aroused considerable controversy in the U.S. The arguments in support of this proposal are mainly two-fold:-

(i) The proposed system would prevent erosion of the coverage limit by inflation, which would undermine the effectiveness of the deposit insurance system; and

(ii) An automatic adjustment system would obviate the need for legislative amendment each time the coverage limit is revised.

5. On the other hand, the following arguments are cited by the opponents of this proposal:-

(i) Coverage limit is the most important design feature of a deposit insurance system. It affects not only the effectiveness of the system but also its costs and the level of moral hazard associated with it. For this reason, it is important that any adjustment of the limit should be debated thoroughly and extensively;

(ii) Setting a rule that automatically adjusts the coverage level makes sense only if there is a reliable index that will keep the actual coverage level close to its appropriate level. In practice, however, it is extremely difficult, if at all possible, to formulate such an index. This being the case, an automatic adjustment mechanism could be worse than the present system of ad hoc adjustments;

(iii) In relation to the preceding point, some economists have pointed out that inflation alone is not the right index. Other factors such as growth in real GDP, change in savings behaviour, as well as the pace of financial innovation (which has a bearing on how households allocate their wealth between deposits vis-à-vis other financial assets) should also be taken into account. However, some of these factors are difficult to quantify, let alone being reduced into intelligible language in the legislation; and

(iv) An automatic adjustment mechanism could create uncertainty for both the banking industry and depositors. Banks would find it more difficult to carry out financial planning. On the other hand, depositors might be confused as to what the prevailing coverage limit is.

6. Given the many difficulties in implementing a robust indexing system, it is not surprising that very few countries[1] have so far adopted such a system. In its paper entitled *"Deposit Insurance: Actual and Good Practices"*, the International Monetary Fund (IMF) also notes that indexing coverage limit may not be a good practice. According to the IMF, the ideal situation is one where a country has low inflation, so that it can keep the limit constant for a relatively long period of time. In this way, the public would know the coverage limit with certainty and the limit remains appropriate in terms of the number of depositors and the value of deposits covered by the scheme.

The Administration's view

7. The Administration shares the view of the IMF (i.e. adjustment of the coverage limit should be infrequent and discretionary). Given the importance of the coverage limit to a deposit protection scheme (DPS), it is more appropriate for any adjustment of the limit to be subject to extensive public debate. The discussion in the previous section also shows that the appropriate coverage limit is affected by a number of factors and that an automatic adjustment mechanism has its own problems. In view of the limited overseas experience in this area, it is not advisable for Hong Kong to introduce an indexing system when the public have yet to familiarise themselves with the structure of the proposed DPS in Hong Kong.

Hong Kong Monetary Authority
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[1] For example, Romania and El Salvador. Most of these countries are experiencing or have previously experienced periods of high inflation.

References

1. *Deposit Insurance - Actual and Good Practices, Occasional Paper 197,* International Monetary Fund, Gillian G.H. Garcia, 2000

2. *A Guide to Deposit Insurance Reform, Economic Review,* Federal Reserve Bank of Kansas City, Third Quarter, Antoine Martin

3. *Guidance for Developing Effective Deposit Insurance Systems,* Financial Stability Forum, September 2001

4. *Keeping the Promise: Recommendations for Deposit Insurance Reform,* Federal Deposit Insurance Corporation, April 2001