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DEPOSIT INSURANCE: A LEGAL ANALYSIS

By

RAKOTOKA ZAIRE

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in

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SUPERVISOR: PROFESSOR SAREL DU TOIT
Declaration

I Rakotoka Kenapeheri Kamaizemi Zaire hereby declare that this dissertation is my original work and all sources used are cited and acknowledged for.
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Table of Contents

Declaration ................................................................................................................... 2
Acknowledgements .................................................................................................... 3

CHAPTER ONE .......................................................................................................... 5
INTRODUCTION ........................................................................................................ 5
1.1 Primary Objective and Rationale ........................................................................ 5
1.2 Consumer Protection in the Banking Sector ..................................................... 7
1.2.1 Depositor ......................................................................................................... 8
1.2.2 Current policy environment in Namibian and South African Banking sectors .... 9
1.3 Theoretical framework ....................................................................................... 9
1.4 Problem statement and central question ........................................................... 10
1.5 Literature review .............................................................................................. 11
1.6 Significance of the research .............................................................................. 13

CHAPTER TWO ........................................................................................................ 15
Analysis of Bank Failure ........................................................................................ 15
2.1 Analysis of Bank Failure .................................................................................. 15
2.2 Bank failures in general .................................................................................... 15
2.3 Namibian SME Bank case study ....................................................................... 16
2.4 VBS Mutual Bank failure ................................................................................ 18
2.5 Conclusion ....................................................................................................... 19

CHAPTER THREE .................................................................................................... 20
Deposit Insurance Schemes ..................................................................................... 20
3.1 Introduction ....................................................................................................... 20
3.2 Deposit insurance in history [from the Great Depression (1929-1939) to the Global Financial Recession of 2008] ................................................................. 20
3.3 Countries with deposit insurance: a few examples .......................................... 22
3.3.1 United States of America ............................................................................. 22
3.3.2 Nigeria .......................................................................................................... 23
3.3.3 Zimbabwe ..................................................................................................... 24
3.3.4 Canada ......................................................................................................... 25
3.5 Conclusion ....................................................................................................... 26

CHAPTER FOUR ...................................................................................................... 27
Adoption of a Deposit Insurance Scheme ............................................................... 27
4.1 Introduction ....................................................................................................... 27
4.2 Arguments for the adoption of a deposit insurance scheme ............................ 28
4.3 Arguments against the adoption of a deposit insurance scheme ....................... 30
4.4 Overcoming arguments against the adoption of deposit insurance ................... 32
4.4 Conclusion ....................................................................................................... 33

CHAPTER FIVE ....................................................................................................... 34
Conclusion and Recommendations ......................................................................... 34
5.1 Conclusion ....................................................................................................... 34
5.2 Recommendations ......................................................................................... 35

BIBLIOGRAPHY ..................................................................................................... 36
CHAPTER ONE
INTRODUCTION

1.1 Primary Objective and Rationale
The aim of this research is to encourage Namibia and South Africa to develop an insurance deposit scheme, in order to protect depositors and investors in the event that a bank fails. This study argues for legislation to compensate bank depositors in cases of money losses, using bank closure as case study.

After the great depression, the period whereby the international financial system suffered a heart attack, many banks failed and some simply closed their doors due to financial difficulties.1 When a bank fails, for example, goes into bankruptcy and loses money, this means that depositors will lose their savings, their money.2 It is a life-changing event for the depositors, because all their future plans are washed away just in a second.3

In mid 2017, Namibia witnessed the failure of the Small Medium Enterprises (SME) Bank. The collapse of the SME bank that year is reportedly “the worst economic disaster in Namibia since Independence”.4 Depositors were only entitled to N$25,000.005 and enjoyed no preferential treatments beyond that amount, when compared with the banks non-deposit creditors.6 Namibia currently only has an implicit deposit insurance scheme by default, because the country has not adopted an explicit deposit insurance scheme which could have bailed out the depositors who have lost their money due to dubious investments made the Banks directors. However, Namibia having an implicit deposit scheme means that the government can compensate depositors with taxpayers’ money.

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2 Luke (n 1) 1.
3 Luke (n 1) 1.
4 Zongwe “Deposit insurance in Namibia and South Africa: pricing its necessity and design” 2018 ALBU 21.
5 The Namibian dollar is pegged one-to-one with the South African Rand.
6 Zongwe (n 4) 21.
Namibia and South Africa have a shared history, which encompasses similar legislation that was transferred by the South African apartheid government to Namibia when Namibia was a protectorate under South Africa after German colonial rule. Like Namibia, South Africa does not yet have an explicit deposit insurance scheme and therefore it is pivotal for this study to draw on the experiences in South Africa (such as the recent collapse of VBS). According to Zongwe, Namibia's reluctance or delay in deploying an explicit deposit insurance scheme may have been influenced by the position of South African authorities.\(^7\)

The central argument for regulation is that banks are special.\(^8\) When a bank fails there are knock on effects which may affect third-parties, as a consequence of liabilities coming in the form of money or very liquid assets.\(^9\) Therefore regulation should also be aimed at supervising and examining financial institutions for consumer protection, safety and soundness. The main objectives of banking regulation is to uphold financial stability, induce confidence in the banking industry, and provide a safe and sound banking sector that will protect depositors and promote good investment policies.\(^10\)

Secondly, consumers constitute the genesis of economic activities, and therefore their roles have always been valued by way of developing the economic market.\(^11\) As a consequence, a sufficient consumer protection system permits the financial industry to work through the consolidation of the rights of the citizens.\(^12\) The goal is to minimise the effect of bank failures on its consumers as well as the transmissible impact of bank failure on the financial sector as a whole.\(^13\)

The rationale for adopting a deposit insurance scheme is so that consumers can be compensated in the event of bank failure. Institutions that are prone to fail are usually the small medium ones and most people that bank there are those that are less

\(^{7}\) Zongwe (n 4) 22.  
\(^{9}\) Dionne (n 8) 11.  
\(^{10}\) Dionne (n 8) 11.  
\(^{12}\) Corradi (n 11) 1.  
sophisticated and failure of these institutions will definitely have a huge impact upon their lives and their families. In that regard, their deposits have to be insured.

1.2 Consumer Protection in the Banking Sector

The need to protect the banking customer first emanates from the contractual nature of the banker-customer relationship. Generally the concept of the “bank-customer relationship” refers to a relationship that commences when a customer opens and operates a bank account. Following a deposit into a bank account, a debtor and creditor relationship is founded between the customer and the bank respectively. The legal position suggests that the opening of an account is a vital element in establishing the bank-customer relationship.

The relationship between the bank and a consumer stems from a contractual agreement entered into by both the parties. In a leading judgment on banking law, as reported in *Standard Bank of SA v Oneanate Investment (Pty) Ltd*, Selikowitz J, with reference to South African and foreign legal authorities, stated:

“The law treats the relationship between banker and customer as a contractual one. The reciprocal rights and duties included in the contract are to a great extent based upon custom and usage. Although historically the original objective of a depositor was to ensure the safekeeping of his money, over time jurists have considered characterising and explaining the basic relationship as one of depositum, mutuum or agency. All of these approaches have an analysis proved to be inadequate. It is now accepted that the basic, albeit not sole, relationship between banker and customer of a current account is one of debtor and creditor.”

The relationship entails mutual obligations. When a consumer deposits money into the bank, the bank has a real right over the money and the consumer holds a personal claim against the bank for payment of a similar amount. In the case of *Absa Bank v Keet* it was stated that:

“In a real right we have the owner in direct relation to the thing he claims, but in a personal right the claimant must claim his right to a thing or act indirectly through an intermediate person called a

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16 Van Jaarsveld (n 28) 259.
17 *Pinto v First National Bank of Namibia Ltd* 2012 NAHCMD 43.
18 *Di Giulio v First National Bank of South Africa Ltd* 2002 ZAWCHC 33 par 17.
19 1995 (4) SA 510 (C).
20 *Absa Bank Limited v Keet* 2015 ZASCA 81 par 22.
debtor. The person who claims from his debtor money lent has no absolute right to particular coins, but he has the right of compelling his debtor to pay him what is due to him by virtue of the loan. The debtor is under a legal obligation to pay his creditor what is due to the latter."

Because of the contractual nature of the relationship, banks have to be regulated in such a way that they conduct their business in a manner that is also in the best interest of the depositors. If the deposits by the customers are not well regulated, it means that when the bank fails all the customers’ savings will be lost. The contractual relationship between a bank and its customers’ entails that when the customer losses money due to a bank failure, the customer should be compensated as the bank has the duty to pay.

In this section the author will look at consumer protection most especially in the banking sector. Firstly, the definition of who a depositor is will be defined, this is necessary because when a deposit insurance scheme is set in place, it has to be made clear as to who the depositor is who needs the protection. The bank also makes deposits; does this mean that they are also entitled to be protected?

In terms of consumer protection, a deposit insurance scheme is designed to reduce or eradicate the risk that depositors placing funds with a bank will suffer a loss.

1.2.1 Depositor
A bank customer includes anyone who deals with the bank in the ordinary course of business, regardless if that person has a bank account with the bank or not. A depositor on the other hand is defined as a person or thing that deposits and that deposits, furthermore a person who deposits money in a bank or who has a bank account.

1.2.2 Current policy environment in Namibian and South African Banking sectors

Namibia and South Africa both don’t have explicit deposit insurance schemes, they however have implicit deposit insurance schemes.\textsuperscript{23} Namibia is in the process of developing a bill on deposit insurance.\textsuperscript{24} In South Africa, the Financial Sector Laws Amendment Bill was tabled in 2018, it introduces deposit insurance as part of the Twin Peaks legislation. The Bill is yet to be promulgated and will be discussed in more detail in chapter 4.

1.3 Theoretical framework

In general, two theoretical approaches exists which explain the conception and expansion of deposit insurance.\textsuperscript{25} Firstly, it is an economic approach and secondly a political one. Economically it is substantiated by the potential gains in efficiency from limiting bank runs, which is regarded as being the public interest motivation.\textsuperscript{26} Politically it is grounded in the rising influence of special interest groups that preferred insurance as a means to access subsidies, this is seen as being the private interest motivation.\textsuperscript{27}

Economic theories demonstrate how insuring deposits may improve the proficient management of the banking sector by reducing systemic liquidity risk.\textsuperscript{28} Deposit insurance that is funded by the government eliminates the incentive for depositors to run a bank in expectation of others doing so.\textsuperscript{29} According to economic theories the establishment of the deposit insurance is costly.\textsuperscript{30} According to Calomiris and Kahn,
the demandable debt contracts permit depositors to subject banks to “market discipline”, which punishes bad behaviour and rewards good.\textsuperscript{31} Due to the fact that insurance decreases the incentive for market discipline, it may fundamentally increase insolvency risk by bankers taking more conscious risk (moral hazard), or might also increase the number of incompetent bank managers.\textsuperscript{32}

According to Stigler,\textsuperscript{33} political bargaining models recognise conditions under which the interests of specific groups within society may triumph in securing its passage, even though liability insurance may be ineffective.\textsuperscript{34} Political models aim to elucidate why deposit insurance might favour specific groups in society, even when it inflicts high costs on society in the form of increased systemic risk for banks.\textsuperscript{35} In this setting, deposit insurance has to be understood as part of an equilibrium political bargain attained by a winning political coalition.\textsuperscript{36} Therefore, the function of deposit insurance may differ from country to country, as a result of the difference in political functions are at play in different regimes and circumstances.\textsuperscript{37}

1.4 Problem statement and central question

Namibia and South Africa’s economies are heavily dependent on foreign direct investment, and when financial institutions cannot meet their obligations, this can lead to a dramatic downturn in the economy, in that investors will not want to invest in an economy which is failing. When such institutions fail, the current laws that are in place are outdated and therefore depositors do not have adequate protection in the event of bank failure. As a result, consumers also lose confidence in the financial sector, which in turn has a negative impact on the economy.

The core research question is: How should the banking sector protect bank depositors from money losses caused by bank failures? Other research questions that deserve investigation include: Can a depositor recover money they’ve lost due to bank failure?

\textsuperscript{31} Calomiris and Kahn “The role of demandable debt in structuring optimal banking arrangements” 1991 American Economic Review 81/3 500.
\textsuperscript{32} Calomiris and Kahn (n 19) 500.
\textsuperscript{34} Calomiris and Kahn (n 31) 500.
\textsuperscript{35} Calomiris and Kahn (n 31) 500.
\textsuperscript{36} Calomiris and Kahn (n 31) 500.
\textsuperscript{37} Calomiris and Kahn (n 31) 500.
Why is there a need for depositor protection legislation in the banking sector? And lastly, to what extent are depositors protected by deposit insurance from losses caused by bank failures?

1.5 Literature review

This section will focus on concepts of deposit insurance from a few writers, whom I find as being prominent writers on deposit insurance. According to Demirgüç-Kunt and Kane, a country's safety net encompasses a pool of disruption-mitigating financial policies. These policies comprise of explicit and implicit deposit insurance, set-out measures for examining and solving bank insolvencies, strategic measures for regulating and administering banks, lender-of-last-resort services at the central bank, and emergency services for accessing aid from multinational organisations such as the World Bank.

Among safety net policies, this study will focus on the implementation of explicit deposit insurance which has increased in prominence in recent years. Garcia, states that when a system of explicit deposit insurance has been established, the guarantees that it brings forth have become a primary part of policy guidance on financial structure that foreign experts give to developing nations.

Deposit insurance is a part of the greater financial safety net and crisis resolution tools for banks, it can therefore not be considered in isolation. Explicit protection normally has the positive effect that the taxpayers do not end up having to carry the financial burden of failed banks. There are no rules given for implicit schemes, in regards to the amount of coverage, the funding of guarantees, and the eligibility of bank

38 Demirgüç-Kunt and Kane “Deposit insurance around the globe: where does it work?” 2001 Journal of Economic Perspectives 16/8493 175.
42 Demirgüç-Kunt and Kane (n 38) 176.
43 Gerhardt and Lanno “Options for reforming deposit protection schemes in the EU” 2011 ECRI 4 2.
44 Gerhardt and Lanno (n 43) 2.
liabilities.\textsuperscript{45} When a bank is experiencing problems under an implicit scheme, the government usually steps in to provide protection for depositors, however it could also let the bank fail.\textsuperscript{46} An implicit scheme has the negative effect of reduced monitoring of banks.\textsuperscript{47}

In most of the economies which have adopted deposit insurance, it operates as one of the regulatory organisations deployed by financial authorities for successful management and systematic resolution of troubles related to depository institutions which have failed and are failing.\textsuperscript{48} Deposit insurance also offers a system of guarantee to depositors, which in turn instils confidence in the banking sector and prevents such confidence from being diminished in situations where banks fail, it also provides the state with a system for intervention and resolution of unsettling effects on the financial sector after the failure of banks.\textsuperscript{49}

Legislators have the choice in deciding how to protect depositors. Some countries, such as Namibia, only have implicit protection which kicks-in when both creditors and depositors, expect some form of protection in the occurrence of the failure of a bank.\textsuperscript{50} This expectation normally occurs as a result of the previous statements and behaviour by state officials.\textsuperscript{51}

According to Goodhart, deposit insurance makes it easier for public authorities to shut down failed banks: the liquidation of an institution becomes more acceptable politically when social hardship is reduced, due to there being consumer protection.\textsuperscript{52} In support of this view is the idea that the taxpayer and consumer should never be the bearers of this cost, it should rather fall on the financial sector.\textsuperscript{53}

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\textsuperscript{45} “Core principles for effective deposit insurance systems” 2009 International Association of Deposit Insurers 6.
\textsuperscript{46} “Core principles for effective deposit insurance systems” (n 45) 6.
\textsuperscript{47} “Core principles for effective deposit insurance systems” (n 45) 6.
\textsuperscript{49} “Deposit insurance” (n 37) 3.
\textsuperscript{50} “Guidance for developing effective deposit insurance systems” 2001 Financial Stability Forum 12.
\textsuperscript{51} “Deposit insurance” (n 48) 1.
\textsuperscript{52} Gerhardt and Lannoo (n 43) 3.
\textsuperscript{53} Gerhardt and Lannoo (n 43) 3.
1.6 Significance of the research

During the 1930-1932 Great Depression, a lot of banks failed; the initial wave of failures caused depositors to withdraw their deposits from other banks, fearing that the failures would spread. These actions actually caused more banks to fail. If deposit insurance had been made available, depositors might not have removed their deposits and some bank failures might have been avoided.54

When a financial catastrophe exceeds the realm of the banking industry, it initiates a widespread financial crisis.55 An example of this is the crises in Turkey in the late 90’s where fragilities in the banking sector set-off a crisis of confidence in other local financial establishments and led to a wide spread flight of foreign investments and a damaging currency crisis.56 Policymakers in every nation deploy a financial safety net in the hopes of limiting the chance of systemic breakdowns, as well as the disturbance fiscal costs and disturbance created when the occur .57

A sound, competitive banking sector is integral to a country’s economic vitality; banks have a hand in funding economic growth.58 Generally banks play a dominant role in a nations’ settlement and payment systems, they’re also an important component in the management of monetary policy, which operates through financial markets and institutions to affect the economy.59 Given the special roles played by banks, states with the policy goal of promoting economic growth and financial stability, set-up a financial safety-net which comprises of deposit insurance.60

A deposit insurance scheme provides a system which ensures a protection which is planned ahead of time, in an orderly and efficient manner, as opposed to an impromptu scrambling for finances and hit-or-miss policy decisions made under pressure, and/or decisions which are not transparent and lead to unorganised compensation

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55 Demirgüç-Kunt and Kane (n 38) 2.
56 Demirgüç-Kunt and Kane (n 38) 2.
57 Demirgüç-Kunt and Kane (n 38) 2.
58 Ketcha “Deposit insurance system design and considerations” 1991 Bank for International Settlements Information 221.
59 Ketcha (n 58) 221.
60 Ketcha (n 58) 221.
provisions. Similar to a personal financial safety net, a deposit insurance scheme starts with saving for a time of need, it forms part of the financial sectors safety net that should help it remain resilient in trying times, such as a personal financial safety net would in times of trouble or significant change (such as retrenchment). During good times the financial sector should put mechanisms and buffers in place to be able to defuse any disruptions and costs associated with unexpected failures.

In conclusion, the significance of this paper is mainly to show the importance of adopting a DIS and how it will be beneficial to the depositors. The findings of this paper will then be useful to the legislative bodies of the Republic of Namibia and the Republic of South Africa, their respective reserve banks, bank managers, consumers, lawmakers, politician’s, lectures, students and the general public at large.

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62 “Designing a deposit insurance scheme for South Africa “a discussion paper” (n 61) 8.
63 “Designing a deposit insurance scheme for South Africa “a discussion paper” (n 61) 8.
CHAPTER TWO
Analysis of Bank Failure

2.1 Analysis of Bank Failure
Bank failures are common all around the world, especially if the country does not have effective regulations to monitor the banking sector.\(^{64}\) When a bank fails, depositors are the ones that suffer the greatest amount of loss. They can potentially lose all their life savings and there is a great chance that they might never be able to get their savings back, unless their country has a mechanism in place to compensate depositors. Bank failures result in consumers not having confidence in the banking sector which in turn can lead to the country losing current and potential investors. Necessary regulations have to be put in place to avoid such failures. The author in this chapter will be examining bank failures in general and case studies of failed banks.

2.2 Bank failures in general
A bank fails economically when its assets are worth less than its liabilities.\(^{65}\) At such a time the bank is unable to pay all of its depositors in full and on time.\(^{66}\) In such an instance, the bank should be declared as insolvent and close down as quickly as possible so that they are able to pay back all its consumers and creditors fairly and prevent a bank run by consumers holding short-dated and demand deposits.\(^{67}\) If the insolvent bank is allowed to continue to operate for a much longer time it will result in, informed depositors withdrawing their deposits at par value, as well as effectively stripping the bank of its valuable assets.\(^{68}\) The less informed depositors and holders of longer-dated deposits will then have to bear the entire loss.\(^{69}\) Bank failures are perceived to be more important than failures of other types of business entities, they are considered to have greater adverse effects on the economy.\(^{70}\) Bank failures are viewed as causing more damage than other failures due to the fear that they have the

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\(^{65}\) “how do banks become insolvent and the importance of deposit insurance” 2 https://positivemoney.org/how-money-works/advanced/how-do-banks-become-insolvent/ (13-8-2019)

\(^{66}\) “how do banks become insolvent and the importance of deposit insurance” (n 65) 1.


\(^{68}\) Kaufman (n 67) 2.

\(^{69}\) Kaufman (n 67) 2.

\(^{70}\) Kaufman (n 67) 2.
potential to spread and have a knock-on effect throughout the banking system, affecting other banks (solvent and insolvent). As a result, failures by banks have always been a major public policy concern in most nations and a major reason for the rigorous regulation of banks in comparison to other institutions.

2.3 Namibian SME Bank case study
Bank failure is not common or known in Namibia as the country has never experienced bank failures prior to the recent case of the SME Bank.

SME Bank is a company and banking institution, registered and incorporated in accordance with the applicable laws of the Republic of Namibia and with its registered address located at 172 Jan Joker Road, Windhoek, Namibia. The bank was granted authorization to conduct business as a banking institution in Namibia with effect from 30 November 2012 by the Bank of Namibia. The shareholders of SME Bank are:

1. The government of the Republic of Namibia, through Namibia Financing Trust (Proprietary) Limited, which holds 65%.
2. Metropolitan Bank of Zimbabwe, which holds 35% shareholding.
3. World Eagle Properties (Proprietary) Limited, holding 5% shares.

At inception, SME Bank’s business model was based on pursuing a niche competitive strategy, targeting the Small and Medium Size Enterprise (SME) segment, and thus providing banking services for previously disadvantaged individuals (PDI’s), micro enterprises and communities in rural areas, which had at the time of its licensing been underserved in the country.

During August 2016, SME Bank’s external auditors, BDO Namibia, brought to the attention of the Bank’s Banking Supervision Department, it intention of disclosing information regarding certain investments made by the SME Bank.

The SME Bank Namibia invested nearly N$200 million with troubled bank South African Bank, Venda Building Society (VBS) Mutual Bank and as well into a cash

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71 Kaufman (n 67) 2.
73 Zongwe “Deposit insurance in Namibia and South Africa: pricing its necessity and design” 2019 ALBU 38-39.
management firm, called Mamepe Capital. According to the New Era Newspaper, in less than two months after the money was deposited, between August 12th and November 12th 2016, there were major disinvestments, and money was emptied out of these companies and bank accounts.\textsuperscript{74}

After it was discovered that the SME Bank lost about N$200 million, the Bank of Namibia launched an urgent application in the High Court seeking the winding-up of the SME Bank Limited.\textsuperscript{75} The Bank was found to be insolvent as contemplated by section 1 read together with section 58 of the Bank’s Act of Namibia in that its liabilities exceeds its assets.\textsuperscript{76} This action was meant to prevent further losses by the bank after it lost N$200 million through questionable investments in South Africa.\textsuperscript{77} The Namibian Minister of Finance, honourable Calle Schlettwein, issued a statement, that stated:

“The Bank of Namibia has an obligation under the Banking Institutions Act to protect depositors and shareholders investments from losses due to consistent failure to meet prudential requirements. The Central Bank has taken appropriate actions to avert further perpetual losses than to require more capital injection in an institution that is failing. It will be unbecoming to continually use taxpayers’ money for perpetual bail out of the SME Bank in its current form.”\textsuperscript{78}

The Government (as the majority 65% shareholder) has over the years injected approximately N$448,774,901.00\textsuperscript{79} into the SME Bank. Where there has been a mismanagement of public funds, government cannot permit the situation to continue, and the Bank of Namibia is, furthermore, compelled to seek the a winding-up of SME Bank to protect the State from further mismanagement and wastage of public funds.\textsuperscript{80}

It was stated in the founding affidavit that if an order for the winding-up of the SME Bank is not granted and the banking institution continues to trade under insolvent conditions, depositors, which are both creditors and depositors of the institution, are likely to lose all their funds. An inability to pay its debts may further lead to a run on


\textsuperscript{75} Bank of Namibia v Small & Medium Enterprises Bank Limited and Others 2017 NAHCMD 187.

\textsuperscript{76} Bank of Namibia v Small & Medium Enterprises Bank Limited and Others 2017 NAHCMD 187.


\textsuperscript{78} “Bank of Namibia wins legal case to liquidate SME Bank” 2017 (n 77) 7.

\textsuperscript{79} NAD is equal to Rand in value.

\textsuperscript{80} “Bank of Namibia wins legal case to liquidate SME Bank” 2017 (n 77) 7.
the bank, which will cause the imminent dissipation of SME Bank’s remaining assets. In addition, certain creditors may be preferred and others will be prejudiced.\textsuperscript{81}

\section*{2.4 VBS Mutual Bank failure}

VBS Mutual Bank is a wholly black-owned bank that was set-up in 1982 as the Venda Building Society and is registered with the South African Reserve Bank (the SARB).\textsuperscript{82} It became a mutual bank in the early 90’s and has most of its clientele in Limpopo.\textsuperscript{83} Mutual Banks are aimed at encouraging a culture of saving within the communities they operate in and they a regulated by the SARB via the Mutual Bank’s Act No. 24 of 1993.\textsuperscript{84}

On 11 March 2018, the South African Reserve Bank, through the Governor of the SARB, in consultation with the Minister of Finance, announced that it had placed VBS Mutual Bank (VBS) under curatorship.\textsuperscript{85} Preceding this announcement, the SARB noticed a large increase in deposits made to VBS from various municipalities for “investment” purposes, this was found to be irregular because the Municipal Finance Management Act No. 56 of 2003 prohibits municipalities from investing taxpayers’ money in mutual banks.\textsuperscript{86} Following its finding, the National Treasury instructed the municipalities to withdraw the deposits made to VBS, which resulted in more than R1 billion worth of deposits being withdrawn. The withdrawal of these deposits, in a short period of time, pushed VBS into a liquidity crisis and in the end resulted in the bank being placed under curatorship.

To add on to VBS woes, there are various reports of widespread looting of the bank which is alleged to have been conducted by the bank’s directors and CEO; and this was covered up by falsifying audit reports through KPMG.

\begin{flushright}
\textsuperscript{81} Bank of Namibia v Small & Medium Enterprises Bank Limited and Others 2017 NAHCMD 187. \\
\textsuperscript{83} Masondo (n 82) 2. \\
\textsuperscript{84} Masondo (n 82) 2. \\
\textsuperscript{85} Malherbe “How guaranteed is a VBS guarantee” 2018 Banking & Finance in Africa Feature 19. \\
\textsuperscript{86} Mutual Banks are not regulated as strictly as commercial banks, and as such, investments with mutual banks carry a greater risk. \\
\textsuperscript{87} Malherbe (n 86) 19. 
\end{flushright}
2.5 Conclusion

When an institution is declared to be insolvent, such as in the case of SME Bank, it means that all depositors will not be compensated in full as the remaining (unpaid) debts owed to depositors might be written off as bad debts. Some depositors may in such an event not be compensated because when the assets of the institution are being sold, they might sell at a lower price due to the fact that the assets are being auctioned to the highest bidder.

In the case of VBS, an institution being placed under curatorship may be equated to a business rescue process, in that the aim is to try and salvage an ailing business; a recent example of this in the banking sphere is that of African Bank which saw a portion of the bank being salvaged and is now out of curatorship. On the 4 July 2018, the Governor of SARB announced that retail deposits amounting to R100 000 per a depositor were guaranteed; this only amounts to retail deposits and is not the same for bank guarantees which may be cancelled by the curator subject to section 69(3) of the Banks Act.

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88 Malherbe (n 86) 20.
89 The minister may empower the curator of a bank to cancel any bank guarantee that was issued prior to it having been placed under curatorship.
90 Malherbe (n 86) 20.
CHAPTER THREE
Deposit Insurance Schemes

3.1 Introduction
Based upon its focus and function in the monetary sector, a deposit insurance scheme is a financial guarantee which protects bank customers in the occurrence of the failure of a bank, and it also offers a degree of safety for the banking sector.\(^{91}\)

In most countries in which deposit insurance schemes exists, they serve as one of the complementary supervisory institutions used by the financial sector authorities for the orderly resolution and successful management of issues related to both failing and failed deposit-taking establishments.\(^{92}\) An additive of the scheme is that it also offers a system of deposit guarantee to consumers which in turn ensures that their confidence in the financial sector is not eroded in instances where banks establishments fail.\(^{93}\) Furthermore, it provides the state with a framework for intervention and resolution of issues which disrupt the financial sector following the failure of depository establishments. Legislatures have many choices with regards to the kind of policy they can deploy to protect depositors.\(^{94}\)

3.2 Deposit insurance in history [from the Great Depression (1929-1939) to the Global Financial Recession of 2008]
Until the early 1930s, generally, there was no interest in deposit insurance.\(^{95}\) A struggle ensued over deposit insurance legislation after the 1933 banking crisis.\(^{96}\) Golembe noted out over thirty years ago that:

“Deposit insurance was not a novel idea; it was not untried; protection of the small depositor, while important, was not its primary purpose; and finally it was the only important piece of legislation during the New Deal’s famous ‘one hundred days’ which was neither requested nor supported by the new administration.”\(^{97}\)

\(^{92}\) "Deposit insurance" (n 91) 1.
\(^{93}\) "Deposit insurance" (n 91) 1.
\(^{94}\) "Deposit insurance" (n 91) 1.
\(^{96}\) Vietor (n 95) 1-2.
\(^{97}\) Golembe “The deposit insurance legislation of 1933: an examination of its antecedents and its purposes” 1960 Political Science Quarterly Volume 75/2 181.
The United States suffered the worst economic reduction in the country’s history in 1933, and advocates for deposit insurance proposed it as a solution to prevent a repeat of the trouble and depositor loss that overwhelmed the American financial sector in the early 1930s. If the Great Depression did not take place, it seems improbable that the United States would have implemented a deposit insurance scheme.

Deposit insurance cannot be described as an emergency measure deployed hastily as a solution to an ongoing bank-run. The banking crisis of 1933 had come to an end months before the new insurance scheme had been implemented and its introduction did not have an affect on previous losses of depositors and banks, even though the policy had been discussed for years prior to the crises. Finally there was an alternative solution to the unsteadiness in America’s banking sector and it had been gaining political ground in the 1920s, partially in response to the failures of state deposit insurance schemes and widespread failures of agricultural unit banks.

Insurance for bank liabilities began in the United States as a solution to the problems caused by the “unit” (single office) banking establishments that existed in most states. Unit banks inherently carry high risk as a result of their lack of ability to vary the location of their lending or to synchronize their responses to comparable problems by combining their resources. The groups who support unit banking encouraged the introduction of liability insurance to safe-guard depositors and bank note holders from losses, because liability insurance offered an alternative to branching as a manner of providing stability in the banking sector. Support for liability insurance went hand in hand with the backing of unit banking.

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99 Calomiris and White (n 98) 146.
100 Calomiris and White (n 98) 146.
101 Calomiris and White (n 98) 165.
102 Calomiris and White (n 98) 165.
104 Calomiris and Jaremski (n 103) 4.
105 Calomiris and Jaremski “Deposit insurance: theories and facts” 2016 NBER 16.
106 Calomiris and Jaremski (n 105) 16.
The financial crisis of 2008 revealed how important an effective deposit insurance scheme can be, as an essential component of the global financial stability framework. A loss of confidence in the financial sector was evident during the crisis. In order to curb the anxiety of the depositors, some authorities extended the range of coverage of their deposit insurance scheme and others offered an explicit deposit blanket guarantee. The implementation of increased coverage levels of deposit insurance was implemented in order to prevent panic from spreading from debt investors to depositors. The increase in deposit insurance coverage helped reinstate the public’s confidence in the banking sector, in addition it increased stability in the financial sector and stopped the spread of bank runs during the crises.

Since the United States introduced deposit insurance in 1934, a few other nations have followed its example by deploying their own deposit insurance schemes, this is evident in the recent surge of deposit insurance schemes amongst developing nations. Nonetheless, there is still a large number of nations who have thus far not decided to implement deposit insurance schemes, and schemes differ in coverage and safety guards from country to country.

3.3 Countries with deposit insurance: a few examples

3.3.1 United States of America

The United States Corporation entrusted with insuring deposits against bank failure is the Federal Deposit Insurance Corporation (FDIC). The FDIC was created as a response to the numerous bank failures in the 1920s and 1930s. Since its inception on January 1st 1934, no depositor has lost any amount of insured funds from a bank.

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108 Hannoun (n 117) 2.
110 Micaikova (n 109) 167.
111 Micaikova (n 109) 167.
113 Laeven (n 112) 210.
failure. The FDIC preserves and stimulates the public's confidence in the financial sector in the United States by insuring deposits in banks for at least U$250 000; the FDIC carries this out by identifying, assessing and monitoring risks to the insured funds; and by reducing the effect of risk on the monetary system when a banking institution fails.

The Federal Deposit Insurance Corporation's main purpose is to prevent the type of bank-run scenarios that plagued a lot of the banks during the Great Depression. Before its inception, there was no guarantee extended beyond the bank's own assets. This meant that those who were too slow or waited too long to withdraw their money stood a chance of losing their life savings, in contrast to those who were the first to withdraw. The FDIC only insures deposits, It does not insure any other types of investments, securities or mutual funds.

3.3.2 Nigeria
Few African countries offer depositor protection schemes. One African country with a successful deposit insurance scheme is Nigeria. Seven Nigerian banks were discovered to be insolvent in the early 1980’s. At that time, the country had no system in place to see the orderly exit of banks. The Nigeria Deposit Insurance Corporation (NDIC) was established in 1988, its establishment was brought about by the need of a government agency to guarantee deposits of the failed banks and to handle the liquidation of such banks in order to prevent a banking crises.

119 Kagen (n 114) 2.
120 Kagen (n 114) 2.
123 Ademola, Olusegun & Kehinde (n 122) 51.
The main reasons for the founding of the NDIC were: \(^{124}\)

1. the lessons of the past and the experiences of previous bank failures in Nigeria;
2. the need to ensure banking stability and encourage saving via increasing the protection of deposits and ensuring development of the banking sector in the best possible manner; and
3. the need to set up an entity to manage the deposit insurance scheme on the governments behalf, to act as a vessel for implementing resolutions for failed banks and to manage badly managed banks.

It is an undeniable fact that the Nigerian Deposit Insurance Corporation has contributed vastly to restoring the public’s confidence in the Nigerian banking sector. \(^{125}\) So far the corporation has lived up to its mandate and has paid out claims to depositors of failed banks, furthermore it has also paid out claims to uninsured depositors, in doing so it has brought stability to the financial system. \(^{126}\) This is a commendable achievement, seeing that funds that could’ve been lost have been paid back to depositors. \(^{127}\)

3.3.3 Zimbabwe

The need for a deposit insurance scheme in Zimbabwe was driven by bank failures between the years 1995 and 2000; these were mainly the failures of United Merchant Bank, Universal Merchant Bank, Zimbabwe Building Society and First National Building Society. \(^{128}\) In order to prevent an individual systemic banking crisis, the Zimbabwe Deposit Protection Scheme was designed to contribute to the financial sector’s stability by stimulating public confidence. \(^{129}\)

\(^{124}\) Ademola, Olusegun & Kehinde (n 122) 55.
\(^{125}\) Ademola, Olusegun & Kehinde (n 122) 55.
\(^{126}\) Ademola, Olusegun & Kehinde (n 122) 56.
\(^{127}\) Ademola, Olusegun & Kehinde (n 122) 56.
This is achieved through some of the following ways:

1. In the event of a bank failure, the Deposit Protection Corporation (DPC) will reimburse depositors of the failed bank up to the coverage threshold which is currently set at U$500.\textsuperscript{130}

2. Deposit protection is a apparatus employed to thwart panic from depositors of other banks by assuring them of the integrity of the entire sector.\textsuperscript{131} In other words, protection has an added benefit of limiting the likelihood of a bank run and public panic in the sector.\textsuperscript{132}

3. Deposit protection covers consumers of small and big banks, it correspondingly applies to state-owned or private deposit-taking organisations, this is achieved via guaranteeing reimbursements of deposits for all participants in the sector.\textsuperscript{133} As such, it creates a fair playing field and promotes competition in the financial sector.\textsuperscript{134}

4. During a bank closure, the DPC is responsible for securing and making a list of the failed bank’s assets, as well as preparing a final batch of financial statements.\textsuperscript{135} If the bank is liquidated, the depositors and creditors will receive payment from the proceeds from the sale of assets and recoveries from debtors.\textsuperscript{136}

\subsection*{3.3.4 Canada}

Canada, which introduced compulsory deposit insurance in 1967 via an Act; the implementation of deposit insurance was also in response to the public’s loss in confidence in the safe practice of deposit-taking establishments, like in the United States.\textsuperscript{137} Two banks in Alberta failed in 1985.\textsuperscript{138} This confirmed earlier fears brought to light by the nation’s largest banks and ended up resulting in a exhaustion of the

\textsuperscript{130} Chikura (n 128) 2.
\textsuperscript{131} Chikura (n 128) 2.
\textsuperscript{133} “Role of deposit insurance in Zimbabwe’s financial sector” (n 132) 4.
\textsuperscript{134} “Role of deposit insurance in Zimbabwe’s financial sector” (n 132) 4.
\textsuperscript{135} “Role of deposit insurance in Zimbabwe’s financial sector” (n 132) 5.
\textsuperscript{136} “Role of deposit insurance in Zimbabwe’s financial sector” (n 132) 5.
deposit insurance fund and the government had to step in and bailout the failed banks.\textsuperscript{139} There have been no in Canada failures since 1996.\textsuperscript{140}

The federal deposit insurance scheme was partially introduced to "reassure" concerned depositors.\textsuperscript{141} The motivations that underpin the Canadian deposit insurance scheme are implied in the passage bellow from Senate debates in 1967.\textsuperscript{142}

"... Bill C-261, to establish the Canada Deposit Insurance Corporation has, ... a philosophy ... summarized by saying that the purpose of the bill is to ensure the safety of the savings of individuals who as depositors use the financial institutions of this country for that purpose. It is also intended to stimulate confidence in our deposit-taking institutions in a country where, with sound management of our affairs, the expansion and business activity and the multiplication of banking facilities and deposit-taking institution facilities are almost certain to develop as rapidly as our economy grows."

Like any other DIS, it was established to restore confidence in their deposit-taking institutions with sound management of affairs.

3.5 Conclusion

In conclusion, we can ascertain that deposit insurance schemes were created and implemented as a response to the financial crises caused by the Great Depression in the 1930’s. The scheme was successful in restoring consumer confidence in the American banking sector and other countries followed suit soon after. The Great Depression necessitated the need for a federal deposit insurance scheme, unfortunately a lot of depositors never recovered their savings because the policy was not applied retrospectively.

\textsuperscript{139} Laeven (n 138) 4-5.
\textsuperscript{140} Laeven (n 138) 5.
\textsuperscript{142} Pothier (n 141) 9.
CHAPTER FOUR
Adoption of a Deposit Insurance Scheme

4.1 Introduction

The Central Bank of Namibia formally investigated the desirability and feasibility of installing deposit insurance in Namibia. In late 2018 the government drafted and tabled the Namibia Deposit Guarantee Bill. The Namibia Deposit Guarantee Act was passed on the 28 December 2018, it provides for the establishment and governance of the Deposit Guarantee Authority. The Act is not clear on the size of the scheme. Part 4 and 5 of the Act envisage that the fund will be funded by members of the scheme and that the coverage limits are to be determined by the Minister of Finance in consultation with the board of directors. As of yet, there is no indication as to when the authority and scheme will be set up.

The Namibian banking sector is dominated by a number of South African banks. Bank failures rarely occur in South Africa but when they do they cause chaos. Because they have implicit deposit insurance, it was possible for the government to compensate these banks when they do fail depending on the size of the failing bank and the strength of the economy at the time of such failure. In principle, it is not ideal that taxpayers funds get used to pay for private failures.

In 2017, South Africa promulgated a Financial Sector Regulation Act to put in place a framework that will enable the resolution of failing financial institutions in a well-ordered and transparent way so that the use of government funding to bail out such institutions is minimised. The Financial Sector Laws Amendment Bill was tabled in

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145 No 16 of 2018.
146 Namibia Deposit Guarantee Act No 16 of 2018.
149 Groepe (n 146) 3.
150 No 9 of 2017.
151 Groepe (n 146) 1.
2018 and a key component of the framework introduced in the Bill is the establishment of an explicit deposit insurance scheme to ensure that the depositors who are most exposed and not able to protect themselves against financial loss in the event of a bank failure are protected against any losses and hardship that may arise as a consequence of a bank failure. Section 39 of the Financial Sector Laws Amendment Bill amends section 7 of the Financial Sector Regulation Act 2017 by adding a provision which introduces a deposit insurance scheme to subsection 1. There is an expectation that the introduction of a deposit insurance scheme will enhance the public’s trust in the banking sector.

It is for these reasons that the South African government is moving away from a state-funded implicit deposit insurance scheme to an explicit deposit insurance scheme which will be funded by the banks. The explicit deposit insurance scheme will ensure that there is always adequate funding and it will set out the payment terms.

In this chapter, the author will investigate arguments for and arguments against the adoption of an explicit deposit insurance scheme, and end with overcoming arguments against the adoption of such a scheme. This is vital because when looking into adopting such a scheme the pros have to weigh against the cons in order to ensure that an effective scheme is put in place.

4.2 Arguments for the adoption of a deposit insurance scheme
The main aim of a deposit insurance scheme is to limit, if not entirely prevent, the probability of bank runs and to protect more vulnerable depositors from financial losses. The United States experienced widespread bank runs during the time of the Great Depression, this saw the financial sector suffer substantial losses on asset sales as result of them attempting to meet the demand the public withdrawing their deposits. The situation was so distressing for the banks, that in response, it prompted President Roosevelt to declare a bank holiday and when the banks

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152 Groepe (n 146) 1-2.
154 Groepe (n 146) 2.
155 Groepe (n 146) 3.
156 Groepe (n 146) 3.
157 Barth, Lee and Phumiwasana “Deposit insurance scheme” 2013 *Encyclopidia of Finance* 208.
158 Barth, Lee and Phumiwasana (n 155) 208.
reopened their deposits were insured by the federal government.\textsuperscript{159} This ensured depositors that their funds were now safe, and as such there was no need to panic and withdraw them.\textsuperscript{160} This act by the government was sufficient enough to repair the public’s confidence in the banking sector and customers that their funds were safe.\textsuperscript{161} Bank runs in the United States of America were effectively eliminated by the establishment of a safety net for bank depositors.\textsuperscript{162}

Deposit insurance’s objective, in the event of a bank closure, is to ensure that the reimbursements of depositor’s savings are carried out in an efficient, speedy, and transparent manner; in order to avoid the possibility of a bank run.\textsuperscript{163} The main purpose of the legislation will be to prescribe measures for the protection of deposits held in bank accounts the consumer has chosen and thus provide compensation for those deposits in the event of bank failures.\textsuperscript{164}

There are a number of reasons a country would implement a scheme, these include:\textsuperscript{165}

1. affording small depositors with consumer protection by providing a mechanism for the instant reimbursement of the insured portion of their deposits;
2. boosting the public’s confidence and stability within the sector by establishing a framework for the resolution of failed banks, that specifically deals with individual bank failures in order to prevent them from spreading;\textsuperscript{166}
3. increasing savings and encouraging fiscal growth;
4. enabling newly established and small banks to compete with larger and or/ state-owned banks;
5. defining the boundaries of the state’s exposure to losses caused by a bank or a group of banks failing in normal times; and

\textsuperscript{159} Barth, Lee and Phumiwasana (n 155) 208.
\textsuperscript{160} Barth, Lee and Phumiwasana (n 155) 208.
\textsuperscript{161} Barth, Lee and Phumiwasana (n 155) 208.
\textsuperscript{162} Barth, Lee and Phumiwasana (n 155) 208.
\textsuperscript{164} “Namibia financial sector strategy 2011-2021” (n 161) 23.
\textsuperscript{166} An example of this is when the Turkish financial system suffered a near collapse in 1999 when a small and unregulated bank was found to be insolvent. The governments initial policy was to close the bank and impose the losses on depositors and creditors, this had an adverse affect as runs on all the banks began once the public realised that the assumed implicit insurance was not invoked. The Turkish authorities stabilised the situation through implementation of a full, explicit deposit guarantee.
requiring banks to contribute to the fund in order to bailout their failed peers.

In sum, the principal reasons for adopting a deposit insurance scheme is to protect small deposits and enhance the stability of the financial sector by strengthening the incentive structure, which includes a strong exit framework.¹⁶⁷

4.3 Arguments against the adoption of a deposit insurance scheme

If not carried out carefully, explicit deposit insurance can fuel a bank crises by indirectly giving banks the incentive to take more risks.¹⁶⁸ In the 1980’s and early 1990’s, the United States of America learned a tough lesson in this regard when a deposit insurance scheme that was overly generous aided in setting off the largest string of bank failures there since the Great Depression in the 1930’s.¹⁶⁹ This experience suffered by the United States suggests that, any country that implements an explicit scheme must contend with the destabilizing effects it has on the country’s financial system.¹⁷⁰

A financial safety-net that is well designed helps to contribute to the stability of a financial sector.¹⁷¹ On the other hand, if it is poorly designed, it may increase risks, more notably the risk of moral hazard.¹⁷² Moral hazards represent one of the key arguments against deposit insurance and also represent one of the negative fall outs of deposit insurance, especially explicit deposit insurance.¹⁷³ Krugman describes moral hazard as “any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly”.¹⁷⁴ It is argued that explicit deposit insurance increases the risk-taking incentives of players in the financial

¹⁶⁷ Garcia (n 163) 4-5.
¹⁶⁹ Demirguc-Kunt and Kane “Deposit insurance around the globe: where does it work” 2002 Journal of Economic Perspectives 16/8493 176.
¹⁷⁰ McCoy (n 166) 1.
¹⁷³ “Enhanced guidance for effective deposit insurance systems: mitigating moral hazard” (n 170) 7.
system and makes depositors complacent in monitoring their deposits with banks.\textsuperscript{175} Such behaviour usually come about in instances where the depositors and other creditors are protected, or they assume they are protected implicitly, from losses or when they assume that their government will not allow a bank to fail.\textsuperscript{176} In such instances, there is less of an incentive for depositors to go through the necessary information to monitor the institution they bank with.\textsuperscript{177} As a consequence, when there is a lack of regulatory or other restraints in the system, badly managed banks are able to attract deposits for high-risk investments at a lower rate than usually.\textsuperscript{178}

Deposit insurance becomes a disincentive for insured depositors to monitor the actions of their banks, thus creating a moral hazard.\textsuperscript{179} It is further held that the managers of banks will rationally maximise the bank’s value by taking the return element of the deposit insurance into account, which invariably would increase their propensity to take risks.\textsuperscript{180} Wheelock argues that since deposit insurance absorbs part or all of the losses when a bank fails, it seemingly becomes an equivalent of a subsidy to take risk.\textsuperscript{181}

Deposit insurance also creates a moral hazard problem by freeing those entrusted with creating economic decisions for banks from the consequences of their actions related to both the liability and the asset sides of a bank’s balance sheet.\textsuperscript{182} When it comes to liability, depositors do not feel obligated to evaluate the credit-risk in relation to depositing funds in a specific bank, instead they end up selecting a bank based on the attractiveness of interest rates offered rather than the bank’s financial position.\textsuperscript{183} While on the asset side, banks are persuaded to pursue high risk investments for

\begin{footnotesize}
\begin{enumerate}
\item[175] McCoy (n 166) 9.
\item[176] McCoy (n 166) 9-10.
\item[177] McCoy (n 166) 9-10.
\item[181] Wheelock “Deposit insurance and bank failures: new evidence from the 1920’s” 1992 Economic Enquiry 30/3 530.
\end{enumerate}
\end{footnotesize}
higher rewards more than they normally would, because of the knowledge that their depositors will not suffer in the event of a bank failure.\textsuperscript{184}

4.4 Overcoming arguments against the adoption of deposit insurance

Admittedly, no one can ostensibly write off the role of deposit insurance (explicit or implicit) in maintaining financial system stability.\textsuperscript{185} Moral hazard, as has been seen, represents the negative externality in the midst of countless benefits of deposit insurance.\textsuperscript{186} The undeniable importance of deposit insurance spells the need to put policy measures in place to curb or cut off the moral hazard side of it.\textsuperscript{187} This dissertation therefore, agrees with the fact that deposit insurance should coexist with measures that curb moral hazard.\textsuperscript{188}

McCoy P, suggests following measures to curb moral hazard:\textsuperscript{189}

- Deposit insurance schemes should incorporate risk-reducing features.
- Incentives should be put in place to encourage depositors, shareholders and creditors to monitor banks.
- Countries should have strong institutional environments in place which will design workable coverage limits, create risk-adjusted premiums, set up workable coinsurance schemes and drive market discipline.
- Finally, the institutional environment should be consistent in monitoring to identify credit crunches, under-capitalisation and other vital signs to ensure safeguards against them and prevent instability and eventual bank runs.

The implementation and monitoring of these measures may require the creation of an insurance deposit corporation, such as the Federal Deposit Insurance Corporation (FDIC) in the United States or the Nigerian Deposit Insurance Corporation (NDIC) in Nigeria. It is therefore seen that it the issue is not on whether to implement deposit insurance or not, rather it is an issue of ensuring that measures are put in place to mitigate or prevent the occurrence of moral hazard, which is arguably, the main

\textsuperscript{184} Ngalawa, Tchana and Viegi (n 39) 474.
\textsuperscript{185} Ume, Oleka and Obasikene (n 177) 6.
\textsuperscript{186} Ume, Oleka and Obasikene (n 177) 6.
\textsuperscript{187} Ume, Oleka and Obasikene (n 177) 6.
\textsuperscript{188} Ume, Oleka and Obasikene (n 177) 6.
\textsuperscript{189} McCoy (n 166) 17-18.
negative fallout of deposit insurance. An explicit DIS defines, in a explicit manner, the extent of depositor protection; it can therefore carry out quick payments from a standing deposit insurance fund which is built up from previous years of no failures so that depositors are compensated within a reasonable time frame.

4.4 Conclusion
In conclusion, the drawbacks to implementing a deposit insurance scheme should not be a deterrent. There are measures a state can put in place to overcome the drawbacks associated with the implementation of deposit insurance. Moral hazard, which is the main drawback, can be curbed through risk-reducing features, incentives, coinsurance, and monitoring by the state organs.

190 Ume, Oleka and Obasikene (n 177) 6.
CHAPTER FIVE
Conclusion and Recommendations

5.1 Conclusion
In conclusion, the reason countries have chosen to adopt a DIS may be explained by the doctrine of necessity. International experience shows that in the case of a severe banking crisis, a government will have no choice but to bail out depositors even if the government has made no explicit promise to do so. In country after country, governments that have closed banks and attempted to allow depositors to incur losses only found that they themselves must step in to offer assistance, in order to deal with or prevent political outrage and put a stop to the crises from spreading.

To avoid the burden of where the government has to bail out depositors, which often, results in situations whereby taxpayers are presented with a large bill for mitigating these disruptions,\textsuperscript{191} it is best countries adopt an explicit DIS. Therefore, a deposit insurance scheme can enhance a country’s current financial safety-net framework by improving the certainty of compensation to depositors of failed banks and providing clarity on the extent of protection, as well as making the procedure for claiming compensation clear to depositors. Thus, a deposit protection scheme needs to be designed in a way which provides a set of inducements (that include both a positive and negative reinforcements) in order to encourage all of the banking and financial institutions involved to act in ways that enhance and strengthen the banking system.\textsuperscript{192}

Timing the introduction of deposit insurance appropriately is not an easy job. On the one hand, "starting a deposit insurance scheme while the banking system is unsound" is regarded as a "departure from best practice" as it is likely to lead to a scheme with very a wide coverage.\textsuperscript{193} On the other hand, restoring the public’s confidence in the

\textsuperscript{191} Demirguc-Kunt and Kane “Deposit insurance around the globe: where does it work” 2001 Journal of Economic Perspectives 16/8493 2.
\textsuperscript{192} Kane “How incentive incompatible deposit insurance funds fail” 1992 Journal of Financial Services Research 34.
financial sector and avoiding bank runs are important pieces to the jigsaw in restoring the health of the banking sector, which is an argument for an earlier introduction.

5.2 Recommendations

When designing a DIS the first step to make is establishing it as a subsidiary of the central bank, housed as a separate legal entity. This is so that it can pursue its own objectives without any political interference, but with the backing of the Central Bank for good governance and operational support. Secondly, deposits at all banks, small, medium and large, would be covered to the same threshold of R100 000. The threshold of R100 000 is the same amount that most countries cover. Thirdly, the envisaged deposit insurance scheme would be funded by registered banks who would be obliged to contribute, thus creating a self-funded DIS free from taxpayer money. Generally, policymakers face difficulties in designing and operating a country’s financial safety-net, they usually seek foreign experts to help them in deciding to implement an explicit scheme or not, and if so, how to design a workable system.

As mentioned earlier, when establishing a DIS, one needs to mitigate the moral hazard. To mitigate the moral hazards inherent to deposit insurance, market discipline needs to be introduced to limit or reduce the risks and costs of a bank failure to the insurer. Such discipline can be exercised by:

- setting a ceiling of protection;
- introducing risk-based insurance premiums instead of a flat rate that does not consider risk taken;
- establishing adequate firewalls so as not to subsidize trading activities;
- raising bank capital requirements, which act as a deductible;
- and/or introducing a system of coinsurance or a system of private insurance.

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196 Lastra Central Banking and Banking Regulation (1996) 133.
197 Lastra (n 194) 133.
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