

**A CRITICAL EVALUATION OF THE NECESSITY FOR EXPLICIT
DEPOSIT INSURANCE IN MALAWI**

LLM (COMMERCIAL LAW) THESIS

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UNIVERSITY OF MALAWI

CHANCELLOR COLLEGE

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DECLARATION

I, the undersigned, hereby declare that this dissertation is my own original work which has not been submitted to any other institution for similar purpose. Where other people's work has been used acknowledgements have been made.

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CERTIFICATE OF APPROVAL

The undersigned certifies that this thesis represents the student's own work and effort and has been submitted with our approval.

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Supervisor

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ABSTRACT

Many countries that faced banking crisis have adopted explicit deposit insurance (EDI) systems as a way of promoting financial stability. However, country experiences also show that EDI systems have inherent disadvantages which can produce counterproductive effects such as promoting instability of financial systems. The chief disadvantage is moral hazard. After years of research, the International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision (BCBS) formulated Core Principles for Effective Deposit Insurance Systems. The Core Principles if adopted plus a country's strong institutional environment ensure that moral hazard is in check thereby enabling a country to reap the benefits of an EDI system. In 2014, following advice from World Bank and the International Monetary Fund (IMF), the Reserve Bank of Malawi (RBM) came up with a proposal for Malawi to adopt EDI. Even though Malawi has had a generally stable financial system the rationale for the RBM proposal was to be proactive by setting up EDI for future crisis situations. There has been no approval by government of the proposal three years down the line and Malawi has had no crisis that could have called EDI to use. The proposal by RBM is still pending up to now. The main objective of this paper is to critically examine the necessity for adopting the proposed EDI System.

TABLE OF CONTENTS

ABSTRACT.....	vi
TABLE OF CONTENTS.....	vii
LIST OF CASES.....	xi
LIST OF STATUTES	xii
LIST OF ABBREVIATIONS AND ACRONYMS	xiii
CHAPTER 1	1
INTRODUCTION	1
1.1 Background	1
1.2 Statement of the Research Problem	4
1.4 Hypothesis	5
1.5 Significance of the Study	6
1.6 Literature Review	6
1.7 Research Methodology or Design	10
1.8 Limitations of the Study	12
CHAPTER 2	13
CONCEPTUAL AND THEORETICAL FRAMEWORK.....	13
2.1 Introduction	13
2.2 Theories on Deposit Insurance	14
2.2.1 Laissez-faire (Free Banking) Theory	14
2.2.3 Uncertainty of Financial Market Theory	16
2.2.4 Mainstream Theory	18

2.3 Definition of Deposit Insurance	19
2.4 Rationale for Deposit Insurance	21
2.5 Types of Deposit Insurance	24
2.5.1 Implicit Deposit Insurance	24
2.5.2 How Implicit Deposit Insurance Work	25
2.5.3 Explicit Deposit Insurance	26
2.5.4 How Explicit Deposit Work.....	26
2.6 Comparison between Implicit and Explicit Deposit	27
2.6.1 Bank failure Resolution and Small Depositor Protection	28
2.6.2 Moral Hazard	29
2.6.3 Bank Runs	30
2.7 Other Types of Deposit Insurance System.....	31
2.7.1 Legal priority for the claims of depositors during Liquidation.....	32
2.7.2 Full explicit coverage.....	32
2.7.3 Limited Explicit Coverage	33
2.7.4 Discretionary Coverage system	33
2.8 Making Deposit Insurance Effective	34
2.9 Conclusion	37
DEPOSIT PROTECTION IN MALAWI	39
3.1 Introduction.....	39
3.2 Legal Framework.....	39
3.2.1 Financial Services Act, 2010	40
3.2.2 Statutory Management	42
3.2.3 Depositor Protection under the Financial Services Act	43
3.2.4 The Banking Act, 2010	44

3.2.5 Depositor Protection under the Banking Act	46
3.2.6 Reserve Bank of Malawi (RBM) Act, 1989	47
3.2.7 Depositor Protection under the Reserve Bank Act, 1989	49
3.2.8 Consumer Protection Act, 2003	50
3.3 Regulations and Directives Issued by the RBM	50
3.4 Nature of Depositor Protection in Malawi.....	51
3.5 Conclusion	52
CHAPTER 4	54
PROPOSAL FOR EXPLICIT DEPOSITOR PROTECTION IN MALAWI.....	54
4.1 Introduction.....	54
4.2 RBM Proposal on Explicit Deposit System	54
4.3 Flaws in Rationale for Proposal on Explicit Deposit System	55
4.4 The Fall of Finance Bank of Malawi Limited	59
4.5 Conclusion	61
CHAPTER 5	63
LESSONS FROM OTHER JURISDICTIONS	63
5.1 Introduction.....	63
5.2 United States of America.....	63
5.3 Japan	65
5.4 Nigeria	66
5.6 Tanzania.....	70
5.7 Zimbabwe	71
5.8 Countries without Explicit Deposit System	72
5.9 Lessons from Other Jurisdictions.....	72
5.10 Conclusion	74

CHAPTER 6	76
CONCLUSIONS AND RECOMMENDATIONS	76
6.1 Introduction	76
6.2 No Case for Explicit Deposit Insurance	76
6.3 How to Improve Depositor Protection in Malawi	79
BIBLIOGRAPHY	82

LIST OF CASES

(a) Kenya

Ashok Doshi and Another v Central Bank of Kenya and Imperial Bank Limited, Civil Cause No. 36 of 2016

Richardson and David Limited vs Kenya Deposit Insurance Corporation and Central Bank of Kenya, Civil Suit No. 482 of 2015

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The State vs Governor of RBM and Minister of Finance Ex-parte FBML, Miscellaneous Civil Cause No. 127 of 2005

(c) Nigeria

Alhaji Mohammed Maihaki Ali vs Nigeria Deposit Insurance Corporation (NDIC), CA/L/408/2009

NDIC vs Central Bank of Nigeria and Republic Bank Limited, Suit No: SC. 55/1999

NDIC vs First Bank Nigeria Limited CA/L/408/ 2017

(d) United Kingdom

Foley v Hill [1843-60] All ER Rep 16

(e) United States of America

Federal Deposit Insurance Corporation vs Philadelphia Gear Corporation 476 U.S. 426(1986)

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Kenya Deposit Insurance Act, 2012 Chapter 487C

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Nigeria Deposit Insurance Corporation Act, No. 22 of 1988

Reserve Bank of Malawi Act, 2010 Chapter 44:02

Republic of Malawi Constitution Act, 1994

Tanzania Banking and Financial Institutions Act, 2006

United States Banking Act, 1933

Zimbabwe Banking Act, 1999

Zimbabwe Deposit Protection Corporation Act, 2011 Chapter 24:29

LIST OF ABBREVIATIONS AND ACRONYMS

BCBS	Basel Committee on Banking Supervision
EDI	Explicit deposit insurance
EDIS	Explicit deposit insurance system
FBML	Finance Bank of Malawi Limited
IDI	Implicit deposit insurance
IDIS	Implicit deposit insurance system
IMF	International Monetary Fund
IADI	International Association of Deposit Insurers
RBM	Reserve Bank of Malawi

CHAPTER 1

INTRODUCTION

1.1 Background

A deposit is money entrusted to a bank for credit to the customer's account and repayable on demand with or without interest.¹ Depositors are attracted to banks because banks are mostly viewed as secured places to keep funds.² Bank depositors also keep their money in banks as a way of saving for the future.³ People are therefore attracted because of safety of their savings. Additionally, it is very rare for depositors to have restrictions on withdrawal of their funds from banks. This may not be the case where money has been kept in other forms, such as assets, since most of the times assets are not readily convertible into cash.

Bank deposits are assets for the bank;⁴ the depositor accounts become a liability to the bank.⁵ Bank deposits are therefore "unsecured creditors" with a claim against the

¹Section 3 of the Banking Act, 2010, Chapter 44:01 of the laws of Malawi.

² 'Reasons to Keep Money in a Bank' (2018) <eCampusTours.com> accessed 20th March 2018

³ Ibid

⁴ Lawrence Shaw v United States 580 US 137 S. Ct 462, where the Supreme Court of the United States held that a scheme to defraud customers also deprives the bank of money in which the bank held a "property right".

⁵ Foley v Hill [1843-60] All ER Rep 16, where the court held that the bank- customer relationship is that of debtor- creditor relationship. Money belongs to a banker and there is no breach of trust in using it. A banker can use it as deems fit & cannot account how they use it. It only must repay on demand at a branch.

bank.⁶ A bank can lend or invest the money deposited with it as it deems fit.⁷ Even though depositors provide cheap capital for banks, they have no control on how banks use their money.⁸ Deposits are safe as long as a bank remains solvent and liquid. There is however risk of loss of deposits if bank borrowers fail to repay their loans with the result that the bank becomes insolvent. To counter this risk, there is a trend the world over⁹ for the incorporation into the banking sector explicit deposit insurance (EDI) legislation as a mechanism to protect depositors and assure stability of banking systems.¹⁰ EDI is defined as;

A guarantee on bank deposit which ensures that depositors are reimbursed part or all of their deposits in the event of bank failure.¹¹

EDI enhances public confidence on stability of the financial system through prevention of bank runs.¹² Where such a scheme exists, depositors do not rush to banks to withdraw their money for fear of losing it. Without EDI, depositors may cause bank runs as they risk losing their fund in the event of bank failures.

⁶ Ellen Brown, 'Depositors Beware: Theft is Legal for Big Banks, and Your Money Will Never be Safe' (1st May 2013) <www.globalresearch.org> accessed 16th July 2017

⁷Foley v Hill(n5) above

⁸Brown, (n6)

⁹According to the International Association of Deposit Insurers, as of 31st January 2014, 113 jurisdictions had established deposit insurance while another 40 jurisdictions were considering the implementation of deposit insurance <<http://www.iadi.org/di.aspx>>accessed 15th July 2017

¹⁰Gillian Garcia, 'Deposit Insurance and Crisis Management' (2000) IMF Working Paper, 10

¹¹John Chikura, 'Role of Deposit Protection Systems' (2013) <www.zimtreasury.gov.zw>assessed 6th April 2017

¹²Randall S. Kroszner and William R. Melick, 'Deposit Insurance Around the World'(2008) MIT Press 182

Despite the benefits of EDI, there is empirical evidence of the fact that EDI creates instability of the financial system through moral hazard by giving banks wrong incentives to take unnecessary risks.¹³ Therefore to achieve its objectives and avert moral hazard, deposit insurance needs to be properly designed and supported by a strong institutional environment.¹⁴

Malawi does not have EDI. However, it has several statutes for supervision and regulation of the banking sector. These include the Reserve Bank of Malawi (RBM) Act, 1989¹⁵, the Banking Act, 2010¹⁶, the Financial Services Act, 2010¹⁷, and regulations issued by the RBM. Historically, the Malawi banking system has had one bank failure, when Finance Bank Malawi Limited(FBML) closed through voluntary liquidation.¹⁸ The stability of the Malawi banking system has largely been helped by the fact that it is largely not integrated into the global financial system.¹⁹ The banking system is largely not connected to the global financial system such that it is barely affected by crisis situations elsewhere.²⁰ The banking system is itself small and not

¹³Oleg Mogyl'nyy, "Establishing Effective Deposit Insurance System in Ukraine" (MA thesis, National University" Kyiv-Mogyla Academy 2001) 8

¹⁴Asli Demirguc-Kunt and Edward J. Kane, "Deposit Insurance around the Globe: Where does it Work?" (2002) 16 Journal of Economic Perspectives, 175-95

¹⁵Cap 44:02 of the Laws of Malawi

¹⁶Chapter 44:01 of the laws of Malawi

¹⁷Act No. 26 of 2000

¹⁸In the Matter of an application by RBM, and In the matter of Liquidation of Finance Bank Malawi Limited. Commercial case No. 62 of 2011

¹⁹Malawi: Financial Sector Profile by Making Finance Work for Africa <<https://www.mfw4a.org/malawi/financial-sector-profile.html#c11007>>accessed 9th May 2017

²⁰Ibid

integrated such that failure of one bank may not collapse the whole system.²¹ Even though the Malawi financial environment is generally stable RBM has recommended adoption of EDI after recommendations from the World Bank and International Monetary Fund(IMF).²² The RBM recommendations were made more than three years ago and are still pending government approval. This study critically evaluates whether there is a solid case for the introduction of EDI.

1.2 Statement of the Research Problem

Malawi has a duty to serve and protect its citizens.²³ It is the government's obligation to ensure that ordinary people's economic interests are not exploited by financial institutions. In Malawi, laws such as the Consumer Protection Act, 2003 advance this cause by stipulating consumer rights and governmental responsibilities. The proposed EDI can only be relevant if it enhances depositor protection.

Three things have prompted this research. Firstly, the fact that historically Malawi has had a generally stable banking system; secondly despite the benefits of EDI, there is empirical evidence that deposit insurance creates instability of the banking system by giving banks wrong incentives to take unnecessary risks which may fuel bank failures.²⁴ Apart from banks, other stakeholders to EDI exploit it as well.²⁵ This inherent risk of EDI calls for caution before it's adoption. Thirdly, since the RBM

²¹Ibid

²²Sopani Gondwe, 'Characteristics of Deposit Insurance Systems in Development,' Presentation on Malawi at IADA Biennial Research Conference < <http://www.iadi.org/di.aspx> > accessed 11th May 2017

²³Section 4 of the Republic of Malawi Constitution provides for equal protection.

²⁴Mogyl'nyy (n13)

²⁵ Ibid

proposal for EDI legislation more than three years ago, Malawi seems not to have felt the need for EDI. There has so far been no financial crisis that would have necessitated an EDI intervention. All the above three issues are pertinent to the question of EDI adoption in Malawi. Therefore, the problem that this study seeks to address is whether it is necessary to introduce EDI in Malawi.

1.3 Research Question

This research seeks to evaluate the need for EDI. Therefore, the main question the paper will answer is; is it necessary for Malawi to introduce EDI as a way of enhancing depositor protection? To answer this question, the paper will answer the following specific questions:

- (a) What are the theoretical and conceptual approaches to depositor protection?
- (b) What are the strengths and weaknesses in the current legal framework on depositor protection in Malawi?
- (c) What is the rationale for RBM proposals for adoption of explicit depositor protection in Malawi?
- (d) What lessons on depositor protection can be drawn from other jurisdictions?
- (e) How can Malawi strengthen its legal and regulatory framework on depositor protection?

1.4 Hypothesis

The hypothesis underpinning this study is that EDI system is not necessary for Malawi since there is adequate provision for depositor protection in the legal and regulatory framework.

1.5 Significance of the Study

Malawi seems to have had no deposit loss even when FBML went into voluntary liquidation.²⁶ It is therefore important to conduct this research because its finding may recommend improvements if EDI is necessary. This type of legal research is very significant for Malawi. It will contribute to the academic knowledge. On a practical aspect, the findings of this study may help government to protect depositors. Ordinary Malawians may find it important if it results into changes in the legal and regulatory framework that improves depositor protection. Even where the study finds that EDI is not necessary; its recommendation may help policy makers avoid mistakes that may have serious ramifications for the country.

One of the industries to immensely benefit from the research is the banking industry as recommendations from this research may improve the sector. Its findings may stimulate legal or policy changes on deposit protection in the banking sector. The research is therefore not confined to the legal profession. Its significance should therefore not be undermined.

1.6 Literature Review

Several authors have written on EDI across the world especially developed countries.²⁷ Protection of small unsophisticated depositors has mostly been one of the

²⁶RBM , Report on Finance Bank Malawi Limited(In voluntary Liquidation) (March 2012) < <https://zambiareports.com/wp-content/uploads/2014/06/RBM-Finance-Bank-Report.pdf>> accessed 13th June 2017

²⁷Curtis J. Milhaupt 'Japans Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?' (1999) Washington University Law Review Vol. 77 Issue 2, 400

rationales for EDI creation.²⁸ Garcia argues that it is difficult for a layman to know if a bank is financially solid.²⁹ She observes that banks may appear more solid than they really are.³⁰ She also observes that a bank that has loaned money to a borrower who is unable to repay may keep the bad loan on its balance sheet as long as possible, though the loan might never be paid back.³¹ Banks may keep the bad loan so that it sell off as bad debt to third parties.³² Because of the pivotal role of banks and their vulnerability to unusual risks, she concludes that there seem to be good reasons to protect deposits through an appropriate insurance scheme.³³ She however warns that care should be taken so that deposit insurance in the long run should not upset the financial system by weakening incentives for various stakeholders of EDI.³⁴

World Bank studies on deposit insurance systems across the world observed that deposit insurance has both advantages and disadvantages.³⁵ In its study the bank analysed and evaluated the implications and desirability of creating EDI systems in developing countries. It found that EDI is more effective in protecting small depositors because it is designed to accomplish this purpose.³⁶ However, it

²⁸ Fifth Report of Committee on Treasury, Publications and Records of United Kingdom Parliamentary Business
<<https://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/5609.htm>> accessed 16th June 2017

²⁹Gillian Garcia, 'Protecting Bank Depositors'(1997) International Monetary Fund, Economic Issue No. 9, 2

³⁰Ibid

³¹Ibid

³²Ibid

³³Ibid

³⁴Ibid 3

³⁵Asli Demirguc-Kunt and Edward J. Kane(n14)

³⁶Ibid

acknowledged the challenge of moral hazard prevalent in deposit insurance.³⁷ The study further observed that the major problem with deposit insurance in developing countries is that it is usually given weak financial structures; for example, unwillingness by government to adequately fund it.³⁸

Frolov³⁹ conducted a review of economic literature explaining the existence of deposit insurance in its modern form. He argues that deposit insurance is not the only means to cope with the problem of bank runs; it is just part of the general public policy of financial sector stability.⁴⁰ He identifies means of coping with bank runs such as lender of last resort mechanism and interbank lending.⁴¹ The former is where a Central Bank lends a bank facing liquidity shortage over a short period of time while the latter is a mechanism whereby healthy banks lend a distress bank to avert a bank run.⁴²

Calomiris analysed various banking insurance experiences in the U.S history and argues that unlimited branch banking(opening of branches of that same bank in other places⁴³), combined with privately administered insurance programs would have been adequate to protect the payments system from disturbances that produced banking

³⁷ Garcia, 'Deposit Insurance: Obtaining the Benefits and Avoiding the Pitfalls'(1996) IMF Working Paper, International Monetary Fund, 22;

³⁸Ibid

³⁹Mikhail Frolov, 'Deposit Insurance and Its Design: A Literature Review', (2004). Keio University Market Quality Research Project, Kumqrp Discussion Paper Series, Tokyo

⁴⁰Ibid 23

⁴¹Ibid

⁴²Ibid 10

⁴³Ross Cranston, 'Principles of Banking Law' (2nd edn, Oxford University Press 2002)

panics.⁴⁴ He concludes that the greatest threats to financial system stability historically were unit banking and ill-conceived attempts to promote stability through government-controlled insurance, which produced quite the opposite effect by promoting excessive risk-taking.⁴⁵

Demirguc-Kunt and Detragache⁴⁶ carried out an empirical research on whether EDI increases banking system stability. They analysed data from 61 countries during the period 1980-1997.⁴⁷ The 61 countries were sample countries from a data set assembled by the World Bank and the selected period was a time of increase in EDI adoption.⁴⁸ They concluded that EDI tends to be detrimental to bank stability especially when the system offers extensive coverage to depositors, the institutional environment is weak and run by government.⁴⁹ They however concluded that with countries with very good institutional environments deposit insurance does not lead to banking system instability.⁵⁰

In 2001, Demirguc-Kunt and Kane carried out a research pertaining to several financial and banking crises that occurred in the late 1990s.⁵¹ Due to these crises, a

⁴⁴Charles W. Calomiris, 'Is Deposit Insurance Necessary? A Historical Perspective,'(1990) *Journal of Economic History*, vol. 50, No. 2, 283-295

⁴⁵Ibid

⁴⁶Asli Demirguc-Kunt and Enrica Detragache, 'Does Deposit Insurance Increase Banking System Stability?' IMF Working Paper, January 2000

⁴⁷ Ibid, see Appendix A for list of sample countries.

⁴⁸Ibid

⁴⁹Ibid, 25

⁵⁰Ibid, 26

⁵¹Asli Demirguc-Kunt and Edward J. Kane, (n14)

growing number of developing countries had been seeking advice about designing and adopting EDI systems.⁵² The research documented the extent of cross country differences in deposit insurance design.⁵³ It also reviewed empirical evidence on how particular design features affected banking stability, private market discipline, financial development, and the effectiveness of crisis resolution.⁵⁴ The authors' findings suggested that countries with institutionally weak information, legal, and supervisory environments should refrain from adopting an EDI system until they assess and remedy any weaknesses in their environment.⁵⁵ Later in 2002, Demirguc-Kunt and Kane observed that deposit insurance is not always good or always bad.⁵⁶ However they further argue that in institutionally weak environments, designing a deposit insurance scheme that will not increase the possibility and depth of future banking crisis is hard to do.⁵⁷

1.7 Research Methodology or Design

This study primarily adopted a qualitative research strategy to examine and identify deficiencies on depositor protection in the Malawi legal and regulatory framework and assess whether they warrant EDIS adoption. Qualitative method was suitable because it seeks to explore an issue or problem for detailed understandings;⁵⁸ in the

⁵² Ibid

⁵³ Ibid

⁵⁴ Ibid

⁵⁵ Ibid, 26

⁵⁶ Asli Demirguc-Kunt and Edward Kane (n14)

⁵⁷ Ibid

⁵⁸ John W. Creswell, 'Qualitative Inquiry and Research Design; Choosing Among Five Approaches' (2nd Edn. SAGE Publishers 2007)

context of this study, depositor protection. This research included a study of various statutes, as such it also incorporated doctrinal legal research to locate the source of law and analyse it. Doctrinal research method involves an analysis of the legal provisions and concepts.⁵⁹ Using this methodology, the study examined the financial services laws; identified strengths and weaknesses in these laws and discussed how they protect depositors. At the end of the day this analysis helped in evaluating the necessity for EDIS adoption.

The research also adopted a comparative analysis methodology to supplement the outcome of a study of domestic statutes with what obtains in other countries. A comparative study is suitable for any proposed legal reform, such as this study since RBM is proposing legal reform on depositor protection. The aim is to see if there are worthwhile lessons from other countries that could be of assistance to Malawi. There are eight countries that the study has referred to for a comparative study, but a detail analysis has been done on only six countries because they have adopted EDIS, and these are USA, Japan, Nigeria, Kenya, Tanzania and Zimbabwe. The number of countries with EDIS in this study is more because the study would like to draw lessons on what necessitated EDIS adoption in these countries and how these countries have experienced EDIS. The six countries have been drawn from different economic sizes and geographical regions, among other unique variations. The other two countries, South Africa and Zambia are yet to adopt EDIS. They are representing countries that have no EDIS, from which lessons can as well be drawn.

⁵⁹ Vijay Gawar, 'Doctrinal legal research method a guiding principle in reforming the law and legal system towards research' (2017) International Journal of law vol. 3, Issue 5, 128-130

1.8 Limitations of the Study

One of the limitations of this study was inadequate materials on EDI in developing countries. Most authors have only written on EDI in developed countries. As such this paper has not had an in-depth analysis on deposit insurance in developing countries. To overcome this challenge, the study has looked at some developing countries' legal framework and supplemented it with the available general literature. These are developing countries with experience on Deposit Insurance than Malawi. On the same issue of materials, the other challenge was difficulties in accessing materials. For instance, RBM did not provide materials, understandably due to issues of confidentiality. The study had to rely on alternative sources on the internet to overcome this challenge. Time constraints was another limitation since the study had to be completed within a prescribed timeframe which was a big challenge to the candidate who had other pressing commitments.

CHAPTER 2

CONCEPTUAL AND THEORETICAL FRAMEWORK

2.1 Introduction

An appreciation of the nature of depositor protection is essential for this study. This chapter therefore addresses theoretical approaches and various concepts on depositor protection. The first part discusses four theories on depositor protection. These theories differ on whether government should intervene in a financial system with regulations and deposit insurance. The second part of the Chapter discusses different concepts on depositor protection. It defines depositor protection, discusses its rationale and types of depositor insurance. On the types, two main categories of depositor protection are contrasted, and these are implicit depositor protection and explicit depositor protection. The last part of the Chapter discusses features for an effective explicit depositor insurance. Here the Chapter discusses core principles for effective deposit insurance issued by the International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision (BCBS).⁶⁰ Different jurisdictions apply these principles to achieve effective explicit deposit insurance (EDI) but with modifications to suit domestic environments.⁶¹

⁶⁰ IADI International Association of Depositor Insurers, 'IADI Core Principles for Effective Deposit Insurance Systems' (2014) < <http://www.iadi.org/en/>> accessed 8th September 2017

⁶¹Ibid

2.2 Theories on Deposit Insurance

2.2.1 *Laissez-faire (Free Banking) Theory*

Proponents of this theory led by scholars like Dowd⁶² argue that if free trade is good, as most economists generally agree, then there is a prima facie case in favour of free banking.⁶³ He argues that if there is nothing wrong with free trade; there should be free transactions in the financial services sector.⁶⁴ The theory advocates that the creation of a central bank, government regulations of the banking sector and government sponsored deposit insurance systems should be abolished.⁶⁵ He avers that there is no problem with free banking that justifies government intervention; that most economists accept the general principles of free trade but they deny that these apply to financial services without giving a coherent defence of their position.⁶⁶ He asserts that there is evidence that supports the prediction of free banking theory that intervention generally weakens the financial system and causes the very problems it ostensibly is meant to cure.⁶⁷

⁶²Kelvin Dowd, 'The case for Financial Laissez-Faire'(1996) The Economic Journal, Vol 106, No. 346, 679-687,

< <http://www.jstor.org/stable/2235576> >accessed 28th June 2017

⁶³Ibid, 679

⁶⁴Ibid

⁶⁵Ibid

⁶⁶Ibid

⁶⁷Ibid

Dowd insists that problems with free banking do not justify financial regulation and that government run deposit insurance systems are the prime cause of banks' lower capital adequate rations and the problems of moral hazard.⁶⁸ He avers that once we introduce deposit insurance system, depositors have no incentives to monitor bank management and managers no longer need to worry about maintaining confidence.⁶⁹ Thus with a deposit insurance in place, so goes his argument, a bank's rational response is to reduce its capital, since the main point of maintaining capital strength-to maintain depositor confidence no longer applies.⁷⁰ He concludes that deposit insurance causes instability and that to protect depositors "market forces" should be used instead.⁷¹

2.2.2 Inevitability of Financial Regulation Theory

Benston and Kaufman are the leading scholars of this theory.⁷² They agree that free banking is desirable because government regulation constrains competition among banks, increase bank's costs and reduces the efficiency of the banking system.⁷³ They are, however of the view that financial regulation is inevitable to limit the costs of deposit insurance schemes.⁷⁴ They propose less and thoughtful regulation that conforms closely to market principles.⁷⁵

⁶⁸Ibid, 683

⁶⁹Ibid

⁷⁰Ibid

⁷¹Ibid, 683-684

⁷²George Benston and George Kaufman, 'The Appropriate Role of Bank Regulation'(1996) *The Economic Journal*, vol. 106, No.436, 688-697

⁷³Ibid, 689

⁷⁴Ibid, 688

They are not for EDI.⁷⁶ However they assert that since it is politically difficult to withdraw from deposit insurance or reduce it once it is introduced, regulation should be introduced to curb moral hazard and other excesses of deposit insurance.⁷⁷ They opt for regulation that mimic the way free markets would operate.⁷⁸ They assert that depositors must have the protection provided by a deposit insurance system, and the government alone, not the private sector, has resources to run such a system and absorb the costs of bank failures.⁷⁹ Therefore, appropriate regulation should be put in place to ensure that banks comply with acceptable capital adequacy standards as in laissez-faire approach.⁸⁰ Benston and Kaufman also posit that private insurance failed in the United States because they did not have unlimited resources as does the Federal Deposit Insurance Corporation (FDIC) which was later introduced.⁸¹

2.2.3 Uncertainty of Financial Market Theory

Dow⁸² argues that the case for regulation rests in the very special economic role of money and the uncertainty associated with it. He argues that there is usually an uncertainty which is attached to bank assets.⁸³ He asserts that free banking wrongly

⁷⁵Ibid, 697

⁷⁶Ibid, 696

⁷⁷Ibid, 693

⁷⁸Ibid, 696

⁷⁹Ibid, 689

⁸⁰Ibid, 696

⁸¹Ibid, 693

⁸²Sheila C. Dow, 'Why the Banking System Should be Regulated'(1996) The Economic Journal, vol. 106, No.436, 698-707 <
<http://www.jstor.org/stable/22355778>> accessed 28th June 2017

⁸³Ibid, 698

presumes that financial assets can be valued in the same way as goods so that there is no reason for banks to be regulated different from other producers.⁸⁴ The uncertainty of bank assets renders free banking unworkable since the proposal requires the non-banking public to assess the expected value of bank assets.⁸⁵ They contend that adequate knowledge can only be generated if money issuing was concentrated in a dominant institution, or set of institutions, which operated like a central bank.⁸⁶ They propose that instead of eradicating regulation on the ground that it is flawed the more appropriate response is to consider how to improve regulation.⁸⁷

He believes that financial laissez-faire incorrectly assumes that the fundamental instability in the financial sector can be removed through deregulation.⁸⁸ He argues that government regulation through the central bank and a deposit insurance system is required to minimize such volatility.⁸⁹ He accepts that there have been periods of significant financial instability when banks have been regulated: but the only reasonable alternative is not deregulation.⁹⁰ He proposed that more attention should be paid to regulation.⁹¹

⁸⁴Ibid, 700

⁸⁵Ibid

⁸⁶Ibid, 698

⁸⁷Ibid, 698

⁸⁸Ibid, 700

⁸⁹Ibid, 699

⁹⁰Ibid, 703

⁹¹Ibid, 703

2.2.4 Mainstream Theory

Williamson⁹² posits that the banking industry should be regulated and deposit insurance systems adopted because of information asymmetry in the financial sector.⁹³ They argue that the banking industry is characterized by enormous barriers to effective depositor monitoring.⁹⁴ Depositors have great difficulty determining the risk associated with the portfolio or monitoring the said risks.⁹⁵ The market tends to force excessive risk on depositors who are not competent to counteract due to information barrier.⁹⁶ The information problem is the theoretical basis for imposing deposit insurance and bank regulation.⁹⁷ Williamson advocates describes inadequate information the “classic rationale” for deposit insurance and general bank regulation.⁹⁸

According to Williamson, the type of information that necessitates deposit insurance is that on capitalisation and other financial aspects of a given bank which is difficult to obtain and is also incomprehensible to an average depositor.⁹⁹ He argues that while the bank could have some sophisticated depositors such as institutional depositors,

⁹²Mark Williamson, ‘Regulatory Theory and Deposit Insurance Reform’(1994), 42 Cleveland State Law Review Journal 105, <<http://engagedscholarshicsuohio.edu/clevstlrev/vol42/iss1/12> >accessed 27th June 2017

⁹³Ibid, 116

⁹⁴Ibid, 114-115

⁹⁵Ibid, 115

⁹⁶Ibid

⁹⁷Ibid, 116

⁹⁸Ibid

⁹⁹Ibid, 117

there is no active market to guarantee that other depositors will benefit from their expertise.¹⁰⁰ He avers that this information gap justifies deposit insurance.¹⁰¹

Critics of information based regulatory schemes do not generally dispute that inadequate information justifies regulation.¹⁰² They are rather concerned with whether an information defect actually exist and whether the proffered regulatory solution addresses the problem in a cost-effective manner.¹⁰³ In the context of deposit protection, opponents of deposit insurance like Dowd concede that information barrier is present but argue that deposit insurance is not necessary to correct the information problems and that it causes more problems than it solves.¹⁰⁴

2.3 Definition of Deposit Insurance

Deposit Insurance is also commonly known as deposit protection in banking terminology.¹⁰⁵ For this reason, these terms have been interchangeably used in this study. However, deposit insurance is a misnomer, because the depositor does not purchase insurance as is the case in “regular or normal insurance”.¹⁰⁶ Instead, insurance is assumed from the legal or regulatory framework, or from insurance banks

¹⁰⁰Ibid

¹⁰¹Ibid

¹⁰²Ibid, 116

¹⁰³Ibid

¹⁰⁴Ibid

¹⁰⁵Online dictionary <<http://www.deposits.org/dictionary/term/deposit-insurance/>> accessed 28th December 2016.

¹⁰⁶Garcia (n37), 2

that pay an insurance premium to the deposit fund holder as percentage of issued deposits.¹⁰⁷

There are several definitions of deposit insurance. These definitions are similar such that only few will be considered here. Chikura defines deposit insurance as a guarantee on bank deposit which ensures that depositors are reimbursed part or all deposits in the event of bank failure.¹⁰⁸ This definition is not complete; it is not clear who guarantees the deposits. The other definition is that it is an insurance given to depositors by a government regulating agency in the event of failure of the financial institution where the deposits are held.¹⁰⁹ Llewellyn has defined it as a scheme designed to compensate depositors in the event of a bank's insolvency.¹¹⁰ The two preceding definitions are also not complete as they ignore the fact that deposit insurance can sometime be implied from government practice and may not necessarily be a specific identifiable scheme or an arrangement championed by a regulatory agency.¹¹¹

Deposit Insurance could also be defined as an explicit or implicit guarantee usually given by government which ensures that depositors will be reimbursed part or all of their deposits in the event of bank failure.¹¹² The definition recognizes that at times

¹⁰⁷Mogyl'nyy (n13), 4

¹⁰⁸Chikura (n11)

¹⁰⁹Ibid

¹¹⁰David T. Llewellyn, 'Northern Rock Case Study, The Northern Rock Crisis: A Multi-Dimensional Problem Waiting to Happen'(2008) *Journal of Financial Regulation and Compliance* Vol. 16, No. 1, 35 – 58

¹¹¹Chikura (n11), 1

¹¹²Frolov (n39), 9

deposit protection can be offered privately without government backing even though this requires an enabling legislation.¹¹³ In deposit insurance bank failure triggers the reimbursements of depositors.¹¹⁴ Bank failure may be defined as the closing of a bank by a state banking regulatory agency when it has committed serious regulatory breaches or is unable to meet its obligations to depositors and other creditors because it has become insolvent or too illiquid.¹¹⁵ When a bank fails, its assets are liquidated and part of the liquidated fund is paid to depositors. However, the liquidated fund may not be enough to pay all depositors and other creditors hence deposit insurance comes in as a guarantee to reimburse the depositors.

2.4 Rationale for Deposit Insurance

Deposit insurance originated from the United States of America (USA).¹¹⁶ The first deposit protection was established during the Great Depression.¹¹⁷ The USA had already years of experience of providing deposit before the 1980s when most countries adopted it.¹¹⁸

The original purpose of deposit protection when it was first introduced was to remove the incentive to withdraw deposits from solvent banks when other banks were failing.¹¹⁹ It was designed as an instrument of financial stability. This is still one of

¹¹³Garcia (n37), 1

¹¹⁴ Mogyl'nyy(n13), 5

¹¹⁵Federal Deposit Insurance Corporation <<https://www.fdic.gov>> accessed on 28th October 2016

¹¹⁶Mogyl'nyy (n13), 2

¹¹⁷Ibid, 8

¹¹⁸Many jurisdictions have established deposit insurance < <http://www.iadi.org/di.aspx> > (n4)

¹¹⁹ Asli Demirguc-Kunt and Edward J. Kane,(n14), 47

the main objectives for deposit protection today.¹²⁰ Deposit insurance achieves this by providing banks with a core of stable deposits.¹²¹

Deposit protection is a tool for consumer protection.¹²² Deposit insurance offers a degree of social protection to bank depositors.¹²³ Given the opaqueness of bank assets, it is difficult for banks customers to monitor the condition of their bank.¹²⁴ Therefore government frequently protects depositors through deposit insurance.¹²⁵ Third, while deposit insurance is aimed principally at protecting deposits and their owners, it also serves to ensure the continued existence of individual banks by providing them with continued funding even in times of stress.¹²⁶

Despite the above reasons in favour of deposit insurance, there are also disadvantages that makes it unattractive. The chief disadvantage is moral hazard, a challenge that is endemic to all insurance programs.¹²⁷ In the deposit insurance context, moral hazard manifests itself in two ways.¹²⁸ First, EDI gives insured banks incentives to pursue added risks because they can capture any profits but shift any losses to the government.¹²⁹ Second, EDI reduces incentives by depositors and shareholders to

¹²⁰Ibid, 2

¹²¹Garcia (n37), 15

¹²²United Kingdom Parliamentary Business Report(n28)

¹²³Ibid, 15

¹²⁴Ibid, 16

¹²⁵Garcia, (n37) 2

¹²⁶Ibid 3

¹²⁷Patricia A. McCoy, 'The Moral Hazard Implications of Deposit Insurance: Theory and Evidence' (2007), 10

¹²⁸Ibid

¹²⁹Ibid

monitor their banks.¹³⁰ The knowledge that their deposits will be reimbursed for losses from bank failures of any kind makes them not monitor their banks.¹³¹

Worldwide, EDI has been shown to increase the likelihood of bank crises significantly.¹³² Combining EDI with interest rate liberalisation makes moral hazard even worse because it permits banks to chase high-yield investments carrying heightened risk.¹³³ The other disadvantage is that despite the serious moral hazard inherent in EDI, once adopted it is difficult to curtail due to its enormous popularity with citizens.¹³⁴ This political side of deposit insurance needs to be considered before embracing it.

EDI is costly.¹³⁵ It requires government to establish a fund and provide the initial funding which is later topped up by bank premiums.¹³⁶ Furthermore it is government's responsibility to ensure that the deposit fund is adequate to reimburse depositors.¹³⁷ There is therefore a continuing obligation to provide funding for the smooth running of depositor scheme. This obligation is the cost that makes deposit

¹³⁰Sharifah A.S Abdulla and Rubi Ahmad, 'Deposit Insurance: Concept and Theory' (June 2012) Bankers Journal Malaysia, 7

¹³¹Ibid

¹³²Ibid

¹³³Ibid

¹³⁴Ibid

¹³⁵Samuel H. Talley and Ignacio Mas 'Deposit Insurance in Developing Countries' (1990) World Bank; Policy, Research, and External Affairs Working Papers, Washington DC, 13

¹³⁶Ibid

¹³⁷Asli Dermirguc-Kunt, Baybars karacaorali and Luc Laeven, 'Deposit Insurance Around the World: A Comprehensive Database' April 2005 <http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/DepositInsuranceDatabasePaper_DKL.pdf> accessed 15th November 2016

insurance unattractive. Historically, most developing countries inadequately fund their deposit insurance schemes¹³⁸. Therefore, whereas government may have legitimate interest in the safety and soundness of the financial system through the adoption of deposit insurance, the costs must be weighed against the benefits.¹³⁹

2.5 Types of Deposit Insurance

There are two main types of deposit insurance and these are implicit deposit insurance system (IDIS) and explicit deposit insurance system (EDIS). Each of these has its own strengths and weaknesses on protecting depositors and maintaining a stable banking system.

2.5.1 Implicit Deposit Insurance

This is protection which is implied from general government's conduct that shows intent to protect the financial system.¹⁴⁰ IDIS is where government interventions to protect depositors are discretionary and ad hoc.¹⁴¹ Depositors receive assurances, not from the existence of a formal insurance fund or any legal obligation but from the government's intention to safeguard the stability of the financial system.¹⁴² These assurances are implied from government past conduct or publicized intentions.¹⁴³ The determination of the extent and form of the protection is also based on ad hoc decision

¹³⁸Talley and Mas (n135), 22

¹³⁹McCoy (n127)

¹⁴⁰Talley and Mas (n135), 14

¹⁴¹Milhaupt (n27), 407

¹⁴²Ibid

¹⁴³Ibid

making within government.¹⁴⁴ There are no rules or procedures that inform government when protecting depositors under this system, although prior actions in similar circumstances may influence the outcome.¹⁴⁵ Normally, any protection offered to depositors is financed out of the government's current budget or through the Central Bank.¹⁴⁶

2.5.2 How Implicit Deposit Insurance Work

There are three main basic ways in which government can extend protection in an IDIS. First, the government can make direct payments to depositors of a closed insolvent bank or arrange another bank to manage deposits of the failed bank.¹⁴⁷ Second, the government can organise and financially support a merger of a problem bank into another bank.¹⁴⁸ This initiative would prevent the failure of the bank, thereby protecting all depositors. Finally, the government can prevent the failure by restoring the bank.¹⁴⁹ This restoration could be through a direct equity capital injection into the bank.¹⁵⁰ Alternatively, the government could adopt some or all of the failing bank's non-performing assets at book value.¹⁵¹ This transaction would be tantamount to an equity injection, and would have the advantage of giving the bank a

¹⁴⁴Ibid

¹⁴⁵Talley and Mas (n135), 9

¹⁴⁶Ibid

¹⁴⁷Ibid

¹⁴⁸Ibid

¹⁴⁹Ibid

¹⁵⁰Ibid

¹⁵¹Llewellyn, (n110), 8

fresh start with a clean portfolio.¹⁵² With both types of restoration, the government is likely to emerge as the dominant shareholder, thereby effectively nationalizing the bank.¹⁵³

2.5.3 Explicit Deposit Insurance

EDIS is created by the enactment of a deposit insurance statute, which provides for the rules and procedures for running the system.¹⁵⁴ For instance, the Act would stipulate the type of financial institutions and deposits that qualify for insurance, and whether membership in the system would be voluntary or compulsory.¹⁵⁵ It would also stipulate the maximum of deposits that would be insured, how the system would be funded, the methods the system would use to resolve failing bank situations and other issues.¹⁵⁶ The amount of protection of depositors depends on the maximum coverage specified in the EDIS statute and whether the statute gives the insurer authority for resolving failing bank situations in ways that indirectly extend protection of uninsured depositors.¹⁵⁷

2.5.4 How Explicit Deposit Work

Under an EDIS, a fund is created usually with an initial capital contribution from government.¹⁵⁸ Banks regularly pay premiums to the fund.¹⁵⁹ Depositors are only paid

¹⁵²Ibid

¹⁵³Talley and Mas (n135), 9

¹⁵⁴Garcia (n37) 1

¹⁵⁵Talley and Mas (n135), 10

¹⁵⁶Ibid

¹⁵⁷Ibid

¹⁵⁸Abdulla and Ahmad (n130), 13

once the bank is closed, or liquidated.¹⁶⁰ Thus, the insurance cannot be activated if the bank remains open; EDIS presupposes that a bank has failed.¹⁶¹

Once a bank has failed, it can use two methods to handle the failed bank. It can use a payoff method where first, the fund allows the bank to fail and then pays off the amount of deposits up to the coverage limit.¹⁶² If the money is left after selling bank's assets, the fund can pay off more deposits.¹⁶³ The second method is called purchase and assumption method.¹⁶⁴ This method assumes a rehabilitation of an insolvent bank by merging it with a healthy bank.¹⁶⁵ In this scenario liabilities, namely deposits, move to the healthy bank thereby ensuring that depositors have their money safe without any losses.¹⁶⁶

2.6 Comparison between Implicit and Explicit Deposit

There are some differences between IDIS and EDIS, which are important for evaluating the desirability of each of the two alternative systems.

¹⁵⁹Talley and Mas (n135), 10

¹⁶⁰Ibid

¹⁶¹Ibid

¹⁶²Mogyl'nyy (n13), 5

¹⁶³Abdulla and Ahmad (n130), 13

¹⁶⁴Talley and Mas (n135), 10

¹⁶⁵Abdulla and Ahmad (n130), 13

¹⁶⁶Ibid

2.6.1 Bank failure Resolution and Small Depositor Protection

Both IDIS and EDIS have a potential for protecting small depositors. However, EDIS appears better designed to accomplish this objective because the protection of small depositors is in the form of legal obligation, and this legal obligation is backed up by a deposit insurance fund. By contrast, IDISs involve no legal obligation to protect even small depositors.¹⁶⁷

The administration process for handling failing banks and protecting depositors is faster, smoother and relatively consistent under EDIS because it operates on the basis of established rules and procedures spelled out in the deposit insurance statute.¹⁶⁸ Furthermore, EDIS is prefunded, thereby eliminating the need to determine the funding source for protecting depositors.¹⁶⁹ In contrast, the process of handling failing banks and protecting depositors with an IDIS will not necessarily be fast and smooth, and outcomes are likely to be unpredictable and inconsistent over time.¹⁷⁰ There are no rules and guidelines in the operation of an IDIS, and no readily available funds hence it is inconsistent and slow to operate which constitutes a serious problem during banking crisis.¹⁷¹

¹⁶⁷Talley and Mas (n135), 14

¹⁶⁸Ibid, 15

¹⁶⁹Ibid

¹⁷⁰Ibid

¹⁷¹Ibid

2.6.2 Moral Hazard

Both IDIS and EDIS have moral hazard challenges.¹⁷² Garcia states that “Moral hazard is where parties covered by the guarantee become careless in their personal habits or business practices or deliberately exploit the insurance system”.¹⁷³ The parties directly covered by the insurance include insured depositors, the bank's owners and its managers.¹⁷⁴ The effects widens to other creditors, borrowers and other parties such as regulators, supervisors and politicians, who may exploit the protection the guarantee offers to pursue their own interests to the detriment of the insurance fund and the taxpayers that back it.¹⁷⁵ Moral hazard has been blamed for most of the failures of deposit insurance in the USA and other countries.¹⁷⁶ For example, moral hazard was blamed for being one of the causes of the 2008 financial crisis which created the so-called too-big-to-fail(TBTF).¹⁷⁷ TBTF means that some institutions are so large and essential to the functioning of the economy that government has to bail them out no matter the cost to taxpayer.¹⁷⁸ Applying the TBTF principle, the USA bailed out American International Group(AIG), with U\$D 85 billion during the crisis.¹⁷⁹

¹⁷²Ibid, 16

¹⁷³Garcia (n37), 22

¹⁷⁴Ibid

¹⁷⁵Ibid

¹⁷⁶Mogyl'nyy (n13), 8

¹⁷⁷Nikhil Sonnad, “The most Memorable Phase of Financial Crisis Taught us the Wrong Lesson”(2018) <<https://qz.com/1387808/the-financial-crisis-in-2018-the-lessons-of-too-big-to-fail-and-moral-hazard/>> accessed 10th October 2018

¹⁷⁸Ibid

¹⁷⁹Ibid

Many commentators such as Mishkin have analyzed IDIS and suggest that they might generate less moral hazard than their EDIS alternative.¹⁸⁰ He argues that in an implicit system government has the flexibility to respond only to systemic crises, rather than being formally bound to protect all banks.¹⁸¹ He posits that depositors can withdraw funds from banks facing distinctive shocks, providing discipline against excessive risk taking.¹⁸² Thus, as regards moral hazard, IDIS seem to be superior to the EDIS variety. In general, “Good corporate governance and sound risk management of individual banks, effective market discipline, and frameworks for strong prudential regulation, supervision and laws, can mitigate moral hazard and these elements are most effective when used in concert.”¹⁸³

2.6.3 Bank Runs

A bank run is when depositor, fearing that their bank will be unable to repay their deposits, simultaneously try to withdraw their funds immediately.¹⁸⁴ This creates problems because banks keep only a small fraction of deposits on hand in cash, most deposits are lent out to borrowers.¹⁸⁵ The sudden increase in withdraw forces a bank to sell assets hastily at fire prices.¹⁸⁶ Losses from such sales can lead a bank into insolvency. If a run on one bank causes depositors of other banks believe that no bank

¹⁸⁰Talley and Mas (n135), 17 quoting Frederic Mishkin

¹⁸¹Ibid

¹⁸²Ibid

¹⁸³See Financial and stability report, Guidelines for Developing Effective Deposit Insurance Schemes(Basel, 2001), 41

¹⁸⁴ George G. Kaufman, ‘Bank Run’< <https://www.econlib.org/library/Enc/BankRuns.html> > accessed 10th October 2018

¹⁸⁵Ibid

¹⁸⁶ibid

is safe, it would be transformed in a run on the banking system as a whole.¹⁸⁷ An example of a bank run is the Northern Rock Crisis, where in three days £3 billion was withdrawn from Northern Rock Bank in the United Kingdom.¹⁸⁸ The run stopped only when government intervened through a guarantee of all deposits at the bank.¹⁸⁹ The ability of EDIS to stem bank runs depends on the extent to which depositors feel protected from loss in the event of a bank failure.¹⁹⁰ In the Northern Rock example EDIS did not stop depositors from withdrawing their funds because the insurance did not cover all deposits in the bank. Government had to further come in and guarantee all deposits to stop the run. Thus, a fully EDIS is likely to provide more assured deposit protection than an IDIS. Consequently, it follows that an EDIS is likely to be more effective than an IDIS in preventing bank runs.¹⁹¹

2.7 Other Types of Deposit Insurance System

There are other forms of deposit insurance employed to protect depositors and maintain stability of the banking system. These are a variety of either IDIS or EDIS discussed above. According to Garcia, other forms of deposit protection are:¹⁹²

- (1) legal priority for the claims of depositors over other claimants during the liquidation of insolvent bank;
- (2) a full explicit guarantee.
- (3) limited explicit coverage

¹⁸⁷ibid

¹⁸⁸Llewellyn, (n110), 1

¹⁸⁹Ibid, 8

¹⁹⁰Talley and Mas (n135), 19

¹⁹¹Ibid

¹⁹²Garcia, Working Papers on Deposit Protection quoted in Mogyl'nyy (n13), 4

- (4) discretionary coverage system, and
- (5) an implicit guarantee;¹⁹³

2.7.1 Legal priority for the claims of depositors during Liquidation

When a bank fails in such a way that it leaves a shortfall in assets, the relevant losses are allocated among the creditors.¹⁹⁴ The basic principle in insolvency law is that all creditors should share equally in the shortfall.¹⁹⁵ However, to protect depositors, an exception to this principle is to give depositors legal priority on their claims.¹⁹⁶ This is where claims from depositors are paid first or after liquidation costs, thereby giving them an opportunity to get their deposits. Courts have upheld this arrangement; in a Nigerian case of *Nigeria Deposit Insurance Corporation vs First Bank Nigeria Limited*,¹⁹⁷ for example, the court held that priority provisions on depositor claims during liquidation are not open for debate.

2.7.2 Full explicit coverage

This type of insurance covers all deposit accounts in fully.¹⁹⁸ The insurer can employ a broad range of plans to resolve failing bank situations, including reimbursing insured deposits or transfers, financially assisted mergers, and rehabilitations.¹⁹⁹ Even

¹⁹³A discussion on this type is the same as that on IDPS covered above.

¹⁹⁴Paul Durban, 'Changing the Priority of Claimants: New Depositor Preference Legislation' (2015) <www.internationallawoffice.com> accessed 10th June 2017

¹⁹⁵Ibid

¹⁹⁶Ibid

¹⁹⁷CA/L/408/ 2017

¹⁹⁸ Talley and Mas (n135), 12

¹⁹⁹Ibid

though this system has been extensively discussed in public policy circles and in the deposit insurance literature, it has been rarely implemented in practice.²⁰⁰

2.7.3 Limited Explicit Coverage

This system is designed mainly to protect small depositors when banks fail. Under this system, deposit accounts are covered up to a certain maximum amount.²⁰¹ Failure of a bank activates the system such that the insurance is authorized to pay insured depositors the maximum amount insured, or transfer all of the failed bank's insured deposits to another bank.²⁰² Under this system, the insurer is not authorized to rehabilitate banks or arrange financially assisted mergers, since doing so would extend de facto protection to uninsured depositors.²⁰³

2.7.4 Discretionary Coverage system

This system lies between limited coverage and full coverage insurance.²⁰⁴ In a discretionary coverage system, all deposit accounts are insured to a certain limit (as with a limited coverage system).²⁰⁵ In addition to this, the insurer is mandated under certain circumstances to extend coverage to uninsured depositors by using a purchase and assumption transaction to resolve failure, or by organizing a financially assisted merger or restoration to prevent a failure.²⁰⁶ In summary, a discretionary coverage

²⁰⁰Ibid

²⁰¹Ibid

²⁰²Ibid

²⁰³Ibid

²⁰⁴Ibid

²⁰⁵Ibid

²⁰⁶Ibid

system can function like a limited coverage arrangement in normal banking situations, but could be converted into a de facto full coverage insurance system where there is a serious threat on a banking crisis.²⁰⁷ This system has been recommended for developing countries, since the banking systems are often unstable.²⁰⁸

2.8 Making Deposit Insurance Effective

Most authors such as Milhaupt agree that a well-organized, EDIS is the superior institutional choice when compared to the IDIS alternative.²⁰⁹ However, they also agree that a poorly organised EDIS can be expensive and counterproductive.²¹⁰

EDIS should therefore be properly formulated to be effective. World best practices of EDIS have been formulated after years of extensive research and experience with deposit insurance. These are Core Principles for Effective Deposit Insurance Systems issued by IADI and BCBS in June 2009 and subsequently modified in 2014.²¹¹ The Core Principles are used as a benchmark for assessing the quality of EDIS, identifying gaps and measures to address them.²¹² The Core Principles are also used by the International Monetary Fund (IMF) and the World Bank to assess the effectiveness of

²⁰⁷Ibid, 13

²⁰⁸Ibid

²⁰⁹Milhaupt (n27), 426

²¹⁰Ibid

²¹¹IADA Core Principles (n60)

²¹²Ibid

jurisdictions' EDISs and practices.²¹³ They are intended as a framework supporting EDI practices.²¹⁴

There are sixteen Core Principles for providing a comprehensive standard for establishing or enhancing EDIS. The IADI advise national authorities to be free in putting in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions.²¹⁵ The Core Principles are briefly that deposit insurance should:

- (1) Have public policy objectives²¹⁶
- (2) Have legal mandate and powers²¹⁷
- (3) Be well governed and operationally independent²¹⁸
- (4) Closely coordinate and share information with other participants in the financial sector²¹⁹
- (5) Share information and coordinate with deposit insurers in relevant jurisdictions²²⁰
- (6) Have in place effective contingency planning and crisis management policies and procedures²²¹

²¹³Ibid

²¹⁴Ibid

²¹⁵Ibid, 5

²¹⁶Ibid, 18

²¹⁷Ibid 19

²¹⁸Ibid, 121

²¹⁹Ibid, 23

²²⁰Ibid, 24

²²¹Ibid, 25

- (7) Ensure that membership in a deposit insurance system should be compulsory for all banks.²²²One can view this as meant at ensuring that all bank depositors are protected in a country.
- (8) Have clear defined coverage limits²²³ The limit should be adjustable annually to cover most depositor thus minimizing risk of bank runs.
- (9) Have readily available funds to ensure prompt reimbursement of depositors' claims²²⁴
- (10) Ensure that the public is informed on an ongoing basis about the benefits and limitations of the deposit insurance²²⁵
- (11) Have legal protection for officials working for the insurer for actions in good faith²²⁶
- (12) Have power to seek legal redress against parties at fault in a bank failure²²⁷
- (13) Be able to provide for the early detection of, and timely intervention in troubled banks.²²⁸
- (14) Should have effective failure resolution which should enable the deposit insurer to provide for protection of depositors and contribute to financial stability²²⁹

²²²Ibid, 26

²²³Ibid

²²⁴Ibid, 29

²²⁵Ibid, 32

²²⁶Ibid, 34

²²⁷Ibid, 35

²²⁸Ibid, 26

- (15) Reimburse depositors' insured funds promptly²³⁰
- (16) Have, by law, the right to recover its claims in accordance with the statutory creditor hierarchy²³¹

These Core Principles alone are not enough for effective deposit insurance and for curbing moral hazard.²³² In addition to these principles, a country should have a strong institutional environment, without which EDI will do more harm than good to their overall financial stability and depositor protection.²³³ A good institutional environment is characterized by elaborate banking regulation systems in place, stable macroeconomic conditions, a sound financial structure, sound accounting and disclosure regimes and a well-developed legal framework supported by a well-functioning judiciary.²³⁴

2.9 Conclusion

This chapter has discussed theory and various concepts on depositor protection. The first part has looked at four theories on depositor protection; Laissez-faire, inevitability of financial regulation, uncertainty of financial market and mainstream theory. It has noted that these theories differ on whether government should intervene in a financial system with regulation and deposit insurance. The second part of the Chapter has discussed different concepts on depositor protection. It has defined

²²⁹Ibid, 37

²³⁰Ibid, 39

²³¹Ibid, 41

²³²Ibid, 11

²³³Asli Demirguc-Kunt and Edward J. Kane (n14)

²³⁴IADI Core Principles (n60)

depositor protection, discussed its rationale and types of depositor insurance. On the types, two main categories of depositor protection have been contrasted, and these are implicit depositor protection and explicit depositor protection. The last part of the Chapter has discussed features for an effective explicit depositor insurance. Here the Chapter discussed core principles for effective deposit insurance issued by IADI and BCBS. It is concluded, at the end of this section that a strong institutional environment is required for the core principles to produce an effective EDI. The Chapter has, overall, discussed depositor insurance generally and not in the Malawi context.

CHAPTER 3

DEPOSIT PROTECTION IN MALAWI

3.1 Introduction

The current state of depositor protection in Malawi need to be appreciated for proper evaluation on the need for explicit deposit insurance (EDI). Therefore, the Chapter discusses relevant provisions in the legal framework. The Chapter analyses the Financial Services Act 2010, Banking Act 2010, Reserve Bank Act 1989 and the Consumer protection Act 2003 and observes that these are mainly instruments for maintaining financial stability. A similar pattern is observed when the Chapter later discusses the Reserve Bank Regulations. The other issue this Chapter discusses are two policies of lender of last resort and interbank lending. It is discussed that though these policies are employed to avert a bank crisis in the financial system, they indirectly provide for depositor protection. Finally, the Chapter discusses the nature of depositor protection in Malawi by summing up what the legal and regulatory framework provides. This discussion highlights strengths and weakness of the legal framework on protecting depositors in Malawi.

3.2 Legal Framework

There is no law creating explicit deposit insurance system (EDIS) in Malawi. Deposit protection is achieved through the general legal framework on banking system and other relevant statutes discussed below. The Reserve Bank of Malawi (RBM)

recognizes that the general regulatory and supervisory powers in the legal framework aim at protecting depositors and maintaining a stable financial system.²³⁵

3.2.1 Financial Services Act, 2010

The main purpose of this Act is to provide for the regulation and supervision of financial institutions in Malawi.²³⁶ The Act includes banks in the definition of financial institutions.²³⁷ The Act identifies the object of regulation and supervision as aimed at fostering (1) the safety and soundness of financial institutions, (2) the highest standard of conduct of business by financial institutions, (3) the fairness, efficiency, and orderliness and of the financial sector, (4) the stability of the financial system and the reduction and deterrence of crimes in the financial sector.²³⁸ This Act is a backbone of supervision and regulation of the financial services sector in Malawi. To achieve its mandate, the Act has appointed the Reserve Bank Governor as Registrar of Financial Institutions, and responsible for supervision of bank operations.²³⁹

The Registrar has vast supervisory and regulatory powers under the Act, such as licensing and registration of banks.²⁴⁰ He is also empowered to suspend, issue additional conditions or revoke a licence where a bank is in an unsound financial

²³⁵RBM, <<http://www.rbm.mw/Supervision/BankSupervision/?activeTab=BASULegalandRegulatoryFramework> >accessed 13th May 2017

²³⁶Financial Services Act 2010, Section 3

²³⁷Ibid, Section 2

²³⁸Ibid

²³⁹Ibid, Section 8

²⁴⁰Ibid, Section 23

position or causing or promoting instability in the financial system²⁴¹. Furthermore, he can apply or approve an application to court for an order of winding up of an insolvent financial institution where he is satisfied that it will not be restored to solvency within a reasonable time.²⁴²

The Registrar also approves the appointment of board of directors and executive managers of banks and other financial institutions.²⁴³ He disqualifies persons from such appointments based on competence among other grounds.²⁴⁴ Among other purposes, it can be posited that such powers assist in ensuring that right people manage banks in Malawi thereby safeguarding the interest of the financial system and depositors.

The Registrar uses his supervisory and regulatory powers to issue directives to banks with the view of ensuring that banks maintain sound financial position and do not cause or promote instability in the financial system.²⁴⁵ Besides these regulations he is empowered to conduct examinations and investigations to check whether banks are complying with financial services laws or terms of their licences, or are involved in financial crimes.²⁴⁶ Where a bank is found to be unsound such as where it becomes

²⁴¹Ibid, Section 27

²⁴²Ibid, Section 72

²⁴³Ibid, Sections 29 and 30

²⁴⁴Ibid, Section 31

²⁴⁵Ibid, Section 34, see also *Richardson and David Limited vs Kenya Deposit Insurance Corporation and Central Bank of Kenya*, Civil Suit No. 482 of 2015, where the court held that these powers are for public protection.

²⁴⁶Ibid, Section 41

illiquid, the Registrar reports to the minister of finance and also immediately takes remedial measures as prescribed in financial services laws.²⁴⁷

3.2.2 Statutory Management

The remedial measures that the Registrar can take where he finds that a bank is unsound include placing it under statutory management.²⁴⁸ One can define statutory management as a situation when a regulator or supervisor of the financial services appoints someone to run a business regulated under the financial services law. In Malawi, when a prudentially regulated financial institution is placed under statutory management, the Registrar or any other person appointed by him shall be the statutory manager.²⁴⁹ The law requires that once an institution is placed under statutory management, the public must be immediately informed.²⁵⁰ This, it is submitted, to safeguard the public from dealing with the troubled institution. The statutory manager oversees the management of the institution to the exclusion of the company's directors and other managers.²⁵¹

The Registrar places a bank under statutory management when he finds that it is not complying with financial services laws and this could be where it is or is likely to be in an unsound position, or where it is engaging in unsafe or unsound financial

²⁴⁷Ibid, Section 11

²⁴⁸Ibid Section 68

²⁴⁹Ibid Section 68(3)

²⁵⁰Ibid Section 68(5)

²⁵¹Ibid Section 69(2)

practices.²⁵² Placing an institution under statutory management does not mean closure is the only option. The task of the statutory manager is to manage the affairs of the institution with the greatest economy possible compatible with efficiency.²⁵³ He is obliged to report to the Registrar what steps need to be taken at the institution to correct things up or if not practicable whether to transfer the business or to wind it up.²⁵⁴ So far, Finance Bank of Malawi Limited(FBML) was the first and only bank to be placed under statutory management.²⁵⁵

3.2.3 Depositor Protection under the Financial Services Act

Looking at the powers vested in the Registrar of financial institutions by the Act, it becomes clear that they are aimed at maintaining or promoting stability of the financial system. This protects depositors since a stable financial system, without bank crisis ensures the safety of deposits. Statutory management protects depositors by alerting them of a troubled bank. Depositor loss may also be averted where new management corrects things up thereby restoring a troubled bank. However, where statutory management fails to bring a troubled bank to normal, the Registrar can apply to court for winding up.²⁵⁶ Where closure up of a bank takes place, the law provides for depositor protection during liquidation. Section 72(8) of the Act ranks depositors second in priority when ranking claims during liquidation; the first rank being

²⁵²Ibid Section 68(2)

²⁵³Ibid Section 69(4)

²⁵⁴Ibid

²⁵⁵Mr. Neil Nyirongo then Deputy General Manager at the central bank was appointed Statutory Manager see Report on Finance Bank Malawi (n26)

²⁵⁶Financial Services Act 2010 Section 69(4)(b) as read with Section 72(2)

liquidation costs. This may enable depositors get reimbursements in the event of bank failure. However, this may not be enough depositor protection where the funds are inadequate to reimburse all deposits. Moreover, since depositor claims are only considered after paying liquidation costs and their consideration is also in *Pari passu* with policy holder claim and pension member benefits, there is no guarantee that the failing bank can have enough funds to reimburse their deposits. Even where all depositors get reimbursements, this could be after waiting for many years due to the slow pace of liquidating financial institutions.²⁵⁷ Therefore the Financial Services Act falls short on depositor protection in situations where the liquidated assets are not enough to pay all depositors in the event of bank failure.

3.2.4 The Banking Act, 2010

The Banking Act provides for regulation of the business of banking in Malawi.²⁵⁸ It makes specific supplementary provisions on supervision and regulation of banks, adding to those under the Financial Services Act discussed above.²⁵⁹ It is a requirement that a registered company first obtain a licence under the Financial Services Act before embarking on banking business in Malawi.²⁶⁰ Such a licence is only granted by the Registrar of Financial Institutions upon fulfilling conditions for licensing of banks, and these include issues of interest of depositors.²⁶¹

²⁵⁷RBM Report (n26), where depositors waited for six years before reimbursements

²⁵⁸Banking Act, 2010, see preamble

²⁵⁹Ibid

²⁶⁰Banking Act, 2010 Section 4, non-compliance to this provision is an offence.

²⁶¹Ibid, Section 5

Under Part III, the Act imposes certain obligations on banks. These include a requirement to maintain capital funds and minimum capital ratios,²⁶² an obligation to submit to the Registrar all information and data on its operations in Malawi including periodic returns²⁶³. The Registrar has power to periodically or at any time at his discretion examine the business of any bank to determine whether the bank is financially sound or complying with the law.²⁶⁴

The Registrar's supervisory powers exercised under part III of the Act are quite extensive. He can appoint an external auditor for a bank in the event that the bank fails to nominate or obtain approval of a nominated external auditor to audit the bank as required under the Financial Services Act.²⁶⁵ However remuneration of the auditors is paid by the bank.²⁶⁶ As part of its monitoring functions of the financial system, the Registrar requires banks to seek approval before certain actions are carried out. These include huge undertakings by the bank such as restructuring, going into liquidation and many others.²⁶⁷ Furthermore he can prohibit or restrict certain transactions to avoid conflict of interest and insider dealings within a bank.²⁶⁸ Where a bank is unlikely to meet the demands of its depositors or pay for its obligations in the normal course of business the Registrar can place it under statutory management.²⁶⁹ It can be

²⁶²Ibid, Section 10

²⁶³Ibid, Section 13

²⁶⁴Ibid, Section 14(1) similar to powers under Section 41 of the Financial Services Act

²⁶⁵Ibid, Section 16

²⁶⁶Ibid

²⁶⁷Ibid, Section 25

²⁶⁸Ibid, Sections 20 and 22

²⁶⁹Ibid, Section 27, undercapitalization and depletion of capital are other reasons that would make the Registrar place a bank

submitted that one of the aims of this course of action is to steady the bank and prevent the crisis from affecting other banks commonly known as systematic financial risk or contagion.

The Registrar can also make monetary directives such as those on liquid reserve requirements on banks.²⁷⁰ These are aimed at protecting depositors and the financial system, non-compliance of which attracts a penalty.²⁷¹ Specifically on protection of depositors, the Act empowers the Registrar to appoint an additional director to the board of directors of a bank to safeguard the safety of depositors.²⁷² The additional director represents depositor interest during board meetings where bank policies are deliberated and agreed upon.

3.2.5 Depositor Protection under the Banking Act

The pattern on depositor protection in the Banking Act is like that in the Financial Services Act. Provisions that prioritise depositor claims during liquidation and appointing additional directors to board of banks to safeguard the safety of depositors stand out on depositor protection in the Banking Act. Part IV of the Banking Act provides for winding-ups or liquidation of banks.²⁷³ The Registrar or his agent can commence proceedings for winding up of a bank if the bank is insolvent and cannot

under statutory management.

²⁷⁰Ibid, Section 38(1) (a)

²⁷¹Ibid, Section 39

²⁷²Ibid, Section 45

²⁷³Ibid, Section 29

be restored to solvency within a reasonable time.²⁷⁴ Simultaneously its licence is revoked.²⁷⁵ Of all the liquidation provisions section 32(1) is of interest on depositor protection; the section prioritises depositor claims by ranking them second in priority during liquidation. Just like under section 72(8) of the Financial Services Act, depositor protection in the above section is in the form of priority of claim during winding up of a bank. The section ranks depositors claims second after liquidation expenses. This may enable depositors get reimbursements of their deposits in the event of bank failure. However, just like in the Financial Services Act, the Banking Act may also prove inadequate if the liquidated assets are insufficient to refund all depositor claims.

3.2.6 Reserve Bank of Malawi (RBM) Act, 1989

The Constitution establishes the Reserve Bank of Malawi as a central bank.²⁷⁶ It further provides that an Act of Parliament shall establish the bank.²⁷⁷ In line with the constitution, the RBM Act, 1989²⁷⁸ establishes the RBM whose principal objects include promoting a sound financial structure, supervising banks and other financial

²⁷⁴Ibid, Section 29(3)

²⁷⁵Ibid, Section 39

²⁷⁵Ibid, Section 45

²⁷⁵Ibid, Section 29

²⁷⁵Ibid, Section 29(3)

²⁷⁵Ibid

²⁷⁶Republic of Malawi (Constitution) Act, Section 185

²⁷⁷Ibid

²⁷⁸RBM Act

institutions and act as lender of last resort to the banking system.²⁷⁹ The bank has monetary, supervisory and regulatory powers that enable it to fulfill its mandate. Sections 36 and 37 of the Act require banks to maintain cash reserves as deposits with it. Under section 36, the deposit is a percentage of liabilities from demand deposits while the cash reserve under section 37 is an amount not exceeding five percent of demand liability. These reserve deposits do not earn interest.²⁸⁰ The purpose of these reserve deposits is to ensure that banks regularly maintain enough cash to provide to depositors and other clients upon request.²⁸¹ In a way this prevents bank runs since banks make use of them during liquidity shortages. Furthermore, the Act provides that RBM is a banker to other banks in Malawi.²⁸² As such it lends to commercial banks for short periods of time.²⁸³ Other supervisory and regulatory powers of the RBM are provided for under section 48 of the Act. These include powers to require banks to submit financial statements, appoint inspectors to investigate affairs of banks from time to time, issue guidelines, regulation and directives with respect to liquidity, insolvency and sound management of banks.

Lender of Last Resort (LOLR) is a policy for maintaining financial stability where the RBM lends to banks for short periods of time at an interest.²⁸⁴ The LOLR exists to

²⁷⁹Ibid, Section 4

²⁸⁰Ibid, Section 38

²⁸¹Bank of International Settlement, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' (January 2013) <www.bis.org>accessed 15th May 2017

²⁸² RBM Act, Section 44

²⁸³ Ibid

²⁸⁴ Joseph Norton, Rosa Lastra and Douglas Arner, 'Legal Aspects of Depositor Protection Schemes: Comparative Perspective' (2002), University of London, 4

help solvent banks to handle liquidity shortages.²⁸⁵ It helps banks sort out liquidity challenges without resorting to selling assets at fire prices. It can be submitted that the stability of the payment system in Malawi is assisted by means of a LOLR facility. This taken together with the regulatory and supervisory powers ensures financial system stability and depositor protector.

Interbank Lending operates in the same way as LOLR. The only difference is that instead of the Reserve Bank lending to an illiquid bank, it is a situation whereby a healthy bank(s) lends to a distressed bank to avert a bank crisis.²⁸⁶ The other difference is that interbank lending rate is slightly at a higher interest than that in a LOLR.²⁸⁷ This might be because the lending rate of Central banks is always higher than that in commercial banks since commercial banks aim at maximizing profits.

3.2.7 Depositor Protection under the Reserve Bank Act, 1989

The Reserve bank Act provide depositor protection indirectly from the general monetary and supervisory provisions that maintain and promote stability of the financial system. So long as the financial system is stable, deposit safety is guaranteed. The supervisory and regulatory role of the RBM need to be taken seriously and applied vigilantly for the banking system to remain stable.²⁸⁸ Policies such as the LOLR and the interbank lending contribute to depositor protection in the

²⁸⁵ Ibid, 6

²⁸⁶ Frolov (n39)

²⁸⁷ Ibid

²⁸⁸ See case of Ashok Doshi and Another v Central Bank of Kenya and Imperial Bank Limited, Civil Cause No. 36 of 2016 where depositors sued central bank for lack of vigilance

like manner. Other than the above, the Act seems not to have specific provisions for depositor protection in the event of bank failure.

3.2.8 Consumer Protection Act, 2003

This Act provides for protection of rights of consumers and an effective redress mechanism for consumer claims.²⁸⁹ Apart from rights of customers, the Act also stipulates government undertakings on consumer protection aimed at ensuring that consumers derive maximum benefits from goods and services.²⁹⁰ Bank depositors being consumers of banking services are likewise covered under this piece of legislation.²⁹¹ Section 28 of the Act provides for access to banking and financial services by consumers and provides that where a contract governing financial transactions is formed, it has to be made in good faith and consistent with the law governing or regulating financial transactions. There seem to be no bank deposit protection in the Act. Thus, one cannot rely on this legislation for depositor protection even though depositors are consumers as well.

3.3 Regulations and Directives Issued by the RBM

Under section 48(2) of the Reserve Bank of Malawi Act, the RBM can issue guidelines, regulations and directives with respect to the liquidity and solvency and sound management of banks.²⁹² RBM issues Regulations offering Guidelines on Mergers and Acquisitions, Regulations on Risk Management, Regulations on Capital

²⁸⁹Consumer Protection Act, 2003 see Preamble to the Act

²⁹⁰Ibid, Sections 3 and 4

²⁹¹Section 2 defines a consumer as a person who purchases services.

²⁹²Similar powers are found under Section 34 of the Financial Services Act, 2010

adequacy, Corporate Governance Guidelines, Directives on Directors, Audit Members and Senior Management Officials. All these are preventive in nature in that they are meant at maintaining and promoting a sound banking system. They offer indirect protection to depositors. They have no provisions on depositor protection in the event of bank failure.

3.4 Nature of Depositor Protection in Malawi

The legal and regulatory framework shows that Malawi financial services laws provide for financial stability and depositor protection. Besides this depositor claims are rank second in priority during liquidation of banks thus guaranteeing that they will receive at least some of their deposits. There is however no provision for EDIS in Malawi. Malawi seems not to have IDIS either. As earlier discussed, implicit insurance is where a government gives assurance that it will reimburse depositors if banks fail. There is no government assurance now such that one cannot conclude that Malawi has an implicit deposit protection scheme. Some commentators like Kyei have argued that where no identifiable system exists, most governments have provided support for stability of the financial system and protection of depositors on an ad hoc basis.²⁹³ He therefore argues that the likely depositor protection system present is an implicit guarantee.²⁹⁴ This argument overstretches the concept on implicit depositor protection by relying on experiences from other countries when there is no assurance of government conduct domestically. The flaw in the argument is that it may not be correct to assume that government will intervene on an ad hoc

²⁹³Alexander Kyei quoted in Garcia, (n37)

²⁹⁴Ibid

basis during a bank failure in Malawi just because some countries do so. As such, concluding that Malawi has an implicit depositor protection system basing on what other countries do may not be correct.

A survey of the legal framework shows that there are two forms of depositor protection in Malawi. The first is that derived from the general supervisory and regulatory framework. By promoting or maintaining a stable financial system the general supervisory and regulatory framework averts bank failure thereby ensuring that depositors do not lose their deposits. The use of many laws for ensuring financial stability accord depositors adequate protection during normal times. The protection of depositors accorded by the general legal framework may not be adequate in times of bank failure. The law therefore provides for a second form of deposit protection which is available during bank failure, the preferential depositor claims during liquidation. Both the Financial Services Act and the Banking Act place depositors second in priority of claims from liquidated assets, the first being liquidation costs. Depositors may therefore get some reimbursement in the event of bank failures. However, where the amount on receivership is inadequate, depositors may suffer some loss. Therefore, there is still a threat that depositors may lose some deposits in the event of bank failure despite their preferential claims during liquidation. This is a weakness in the legislation.

3.5 Conclusion

This Chapter has looked at the current state of depositor protection in Malawi for a better appreciation on the need for EDI. It has discussed relevant provisions in the legal and regulatory framework and has observed that there is no explicit deposit

protection in Malawi. However, it has been noted that there is depositor protection in normal times derived from the general legal framework for maintaining financial stability. The Chapter has observed that there is a preferential claim for depositors during liquidation which is another form of protection during bank failure. The protection is not enough where the amount on receivership is inadequate. The Chapter has also discussed two policies; lender of last resort and interbank lending. It has been concluded that though these policies are employed to avert a bank crisis in the financial system, they indirectly provide for depositor protection in normal times. Finally, the Chapter has discussed the nature of depositor protection in Malawi by summing up what the legal and regulatory framework provides. This discussion has highlighted the strengths and weakness of the legal framework on protecting depositors in the absence of deposit insurance.

CHAPTER 4

PROPOSAL FOR EXPLICIT DEPOSITOR PROTECTION IN MALAWI

4.1 Introduction

The preceding Chapter concluded that there is inadequate protection of depositors during bank crisis time. It also observed that Malawi has not adopted explicit deposit insurance system (EDIS). This Chapter discusses Reserve Bank of Malawi (RBM) proposals for adoption of depositor protection in Malawi. The first part of the Chapter discusses the said proposals, their rationale and argues that there are many flaws in these proposals. In brief the proposals fall short of meeting the core principles for effective deposit protection discussed in Chapter two. The last part of the Chapter examines the closure of Finance Bank of Malawi Limited (FBML) and discuss whether it provides a convincing case for the adoption of EDIS. A case for EDIS adoption may be made out if the fall of FBML occasioned deposit loss.

4.2 RBM Proposal on Explicit Deposit System

In 2013 the RBM proposed that Malawi adopt EDIS.²⁹⁵ These proposals are still pending government approval. The two key functions of the proposed EDIS are promotion of financial stability and protection of depositors.²⁹⁶

²⁹⁵Gondwe (n22)

The proposal to establish EDIS was to adopt a scheme that would be jointly owned by the RBM (60%) and the government (40%), which would proportionally contribute the seed funding of K3 billion(US\$ 4 million).²⁹⁷ Once established, the EDIS would be funded via a flat premium rate of 2% of average annual deposits.²⁹⁸ The proposed coverage limit is MWK 500,000(US\$ 700) which would cover over 90% of depositors.²⁹⁹ Thus the proposal would leave out some depositors uninsured.³⁰⁰ The proposed system would be established outside RBM, with a board of directors from public and private sector.³⁰¹ It would have a line of credit with the RBM and would receive special contributions from government in times of need.³⁰² Such contribution would be through parliamentary fund to the EDIS.³⁰³

4.3 Flaws in Rationale for Proposal on Explicit Deposit System

According to the Reserve Bank, the rationale is to be pro-active and establish EDIS even though the Malawian banking sector is considered stable.³⁰⁴ The proposal for EDIS also motivated by the experience of the financial crisis and the liquidity squeeze of 2010–2011(mainly affected Europe and other developed countries) even though

²⁹⁶Ibid 6

²⁹⁷Ibid 7

²⁹⁸Ibid

²⁹⁹Ibid 6

³⁰⁰Ibid

³⁰¹Ibid 7

³⁰²Ibid

³⁰³Ibid

³⁰⁴Ibid 4

Malawi did not experience any bank failure.³⁰⁵ It can be viewed that the proposal concentrated more on importing what other countries were doing than focusing on weaknesses in our financial system.

The proposal for EDIS was made more than three years ago and up to now nothing has materialized perhaps signaling a lack of willingness on the part of government to adopt EDIS. The proposed EDIS cannot be effective without government support.³⁰⁶ RBM also noted that government views the seed money for initiating EDIS as idle money hence buttressing the observation that government is not willing to support EDIS adoption.³⁰⁷ Perhaps government is right since Malawi has not felt the need for EDIS. Indeed, over three years since these proposals were made no situation has arisen necessitating EDIS which indicates that the proposed EDIS could have been superfluous and that further insistence on them may not be necessary.

Besides the cost of K3 billion seed capital, the proposed system would generally be costly to tax payers who would pay for the cost of seed money and other contributions to the EDIS fund. It would be costly to insured banks as well through premium contributions proposed to be at 2%, a relatively higher rate when compared to other similar jurisdictions.³⁰⁸ There would be operational costs and other expenses associated with running EDIS. During bank failure the EDIS need to have readily

³⁰⁵Ibid 4

³⁰⁶Talley and Mas (n1135), 22

³⁰⁷ Ibid 6

³⁰⁸Gondwe (n22), 7

available funds to promptly reimburse depositors. All these costs may not be justified in adopting EDIS as a proactive measure in Malawi.

The other challenge faced by the proposed EDIS is the low financial literacy rate within the country.³⁰⁹ In order to protect depositors and contribute to financial stability it is essential that the public is informed on a regular basis on the benefits and limitations of EDIS.³¹⁰ As noted in Chapter two, this is one of the Core Principles for establishing an effective deposit insurance system. Depositors are unlikely to cause bank runs if they are fully aware that their deposits are safe through an existing EDIS. The knowledge that their savings are protected gives depositors confidence in the banking system. Without such knowledge EDIS may not achieve its purpose. With the low literacy rate in Malawi, it is very unlikely that most of the citizenry would comprehend the role of EDIS rendering its effectiveness minimal.

It was noted in Chapter two that governance is one of the crucial Core Principles for operating an effective EDIS. EDIS needs to be operationally independent and insulated from external interference from government, central bank, politicians and other players.³¹¹ An example is where these apply pressure on EDIS to procrastinate or not act on failing banks.³¹² Inaction by regulators whether due to political interference or their own negligence may make it too hard restore a crisis bank. Guaranteeing operational governance would be a challenge in Malawi where there is a

³⁰⁹ Ibid, 11

³¹⁰ IADI Core Principles, principle 10 (n60)

³¹¹ Ibid

³¹² Garcia, (n29) 7

lot of government interference in public institutions.³¹³ EDIS may therefore not be effective in Malawi and the proposal could be viewed as a case of importing laws from other countries without a thorough assessment of local conditions.

The main disadvantage with EDIS is moral hazard discussed in Chapter two. Before adopting EDIS, mechanisms must be put in place to minimize moral hazard challenges. This is very important since Malawi has a liberalized interest rate policy which makes moral hazard to thrive.³¹⁴ The proposal by the RBM seems lacking on mechanisms that minimize moral hazard. In addition, before EDIS can be adopted, it is also advisable to ensure that the institutional environment is strong, otherwise EDIS would be counter-productive. A strong institutional environment keeps moral hazard in check. There seem to be no study on Malawi's institutional environment to determine its suitability for EDIS adoption. Even if one were to argue that there was a study on the Malawi institutional environment before the proposal by RBM was made, it is unlikely that the findings of such a study can still be applicable now, more than three years after they were made. Reliability of such findings would also be suspect in view of the absence of repercussions more than three years after recommendations emanating from them were made.

³¹³Thom Khanje, 'Government has to Bite the Bullet and Sell Malawi Savings Bank' *Time Online Publication* (Blantyre, 9th June 2015) <www.times.mw> accessed 12th August 2017

³¹⁴Institute of Bankers in Malawi 'Interest Rate Policy in Malawi: Past and Present' <www.iobmalawi.com> accessed 11th September 2017

Though the preceding chapter noted a weakness in the legal and regulatory framework for depositor protection in times of bank failure there seem to be no need for EDIS adoption. The weakness is not as serious as to justify EDIS adoption.

4.4 The Fall of Finance Bank of Malawi Limited

Finance Bank of Malawi Limited (FBML) is the only bank to close in the history of Malawi banking sector. The bank was incorporated in 1994. From 1999, RBM observed that FBML was repeatedly engaged in practices which violated the Banking Act and the Exchange Control Regulations.³¹⁵ It failed to observe the “Know Your Customer Concept”, operated ghost accounts which were used to externalize foreign exchange to Pakistan and engaged in money laundering activities. For example, more than 3000 accounts were opened and closed the same day, more than 4000 accounts were opened and closed within the same month, other 75 accounts were opened and operated by one person.³¹⁶ FBML also used to accept huge deposits in Malawi Kwacha which were subsequently followed by huge debits in foreign currency.³¹⁷

FBML was on several occasions warned by the RBM about the banking malpractices and was advised to change but it did not.³¹⁸ After several warnings the Minister of Finance revoked the banking licence of FBML on 18th May 2005.³¹⁹ On 19th May 2005 FBML obtained leave to commence judicial review of the decision by the

³¹⁵ Report on Finance Bank of Malawi (n26), 1

³¹⁶ Ibid

³¹⁷ Ibid

³¹⁸ Ibid

³¹⁹ Ibid, 2

Minister to revoke the banking licence.³²⁰ The High Court granted the leave and also ordered a stay of the decision revoking the licence.³²¹ Several court battles ensued following the stay order culminating into a consent order between the parties. The consent order reinstated FBML banking licence but it was agreed that FBML be placed under statutory management.³²² It was also agreed that a forensic audit be conducted on the bank and that FBML should identify a buyer to acquire it.³²³

RBM accepted a request from shareholders of FBML to go into liquidation after failing to identify an acceptable buyer in line with the consent order. On 15th June 2006 FBML went into voluntary liquidation and appointed Mr. Khuze Kapeta as liquidator.³²⁴ The liquidator called in depositors and creditors to lodge their claims with him. Most of the depositors who lodged their claims were given their money and by March 2012 the liquidator had finalized refunding all depositors who had lodged their claims.³²⁵ However up to now, the liquidation of FMB has not been finalized as other matters on the same are still being litigated. The failure of FBML does not provide a convincing case for adopting EDIS in Malawi. From the narration above, FBML failure did not occasion any loss of deposits in that by March 2012, all depositors who lodged their claims were reimbursed by the liquidator. Thus, the

³²⁰The State vs The Governor of the Reserve Bank and Minister of Finance Ex-parte FBML, Miscellaneous Civil Cause No. 127 of 2005

³²¹Ibid

³²²Report on Finance Bank of Malawi (n26),4

³²³Ibid, 5

³²⁴Ibid,7

³²⁵Ibid, 10

preferential treatment of depositor claims during liquidation of a bank provided in the legal framework was adequate depositor protection.

It can also be noted that FBML closed not because it was failing to meet its financial obligations such as an inability to pay deposits and other creditors. In other ways it was still a solvent and liquid bank. It may therefore be correct to aver that real bank crisis cases of insolvency and illiquidity are yet to occur in Malawi. Thus, the closure of FBML, more than 11 years ago, does not provide a compelling case for the adoption of EDIS. Ill-advised adoption of EDIS may bring instability through moral hazard and other side-effects. Malawi may therefore not need this system now. The country may take heed of the advice of Mc Coy who stated as follows: -

Countries considering EDI should watch out for what they wish for. Unless a country has strong banking regulation, a strict failed bank resolution regime, carefully designed deposit insurance with safeguards against risk, healthy private monitoring, and, most of all, strong institutions, EDI will only be a recipe for future bank crises. Conversely, if all five of these safeguards are in place, EDI can protect depositors while holding moral hazard in check.³²⁶

4.5 Conclusion

This Chapter has discussed Reserve RBM proposals for adoption of depositor protection in Malawi. It has noted that though there is a weakness in the legal and regulatory framework in times of bank failure, the said weakness does not justify EDIS adoption. The Chapter noted some flaws in the RBM proposals. In general, it

³²⁶McCoy (n127), 86

was argued that the proposals fall short of meeting the core principles for effective deposit protection discussed in Chapter two. The last part of the Chapter has observed that Malawi has a generally stable financial system and only FBML has been liquidated in its history. This part has then examined the closure of FBML and has discussed whether it provides a convincing case for the adoption of EDIS. It has concluded by submitting that FBML closure does not provide a convincing case for adoption of EDIS.

CHAPTER 5

LESSONS FROM OTHER JURISDICTIONS

5.1 Introduction

Depositor protection varies across jurisdictions whereby some countries have adopted explicit deposit insurance system (EDIS) while other have not. This Chapter discusses depositor protection in few selected jurisdictions with a view of learning from their legal frameworks and experiences. The Chapter discusses deposit insurance in the United States of America (USA), Japan, Nigeria, Kenya and Zimbabwe. The discussion shows that these countries adopted EDIS at different times and have had practical experience with it. South Africa and Zambia are yet to adopt EDIS just like Malawi. The Chapter highlights these two jurisdictions to indicate that the absence of EDIS is not unique for Malawi. The Chapter concludes by drawing reasons from the above jurisdictions.

5.2 United States of America

The US deposit insurance system was established in 1934 in response to the Great Depression.³²⁷ The Banking Act was adopted in 1933 under which Temporary Deposit Insurance Fund was established with limited coverage of \$2500 per

³²⁷Mogyi'nyy (n13), 8

deposit.³²⁸ After two years, with the creation of the Federal Deposit Insurance Corporation, the deposit insurance system became to operate permanently.³²⁹ Coverage limit was raised up to \$5000, all Federal Reserve members were required to join, and insurance premium amounted to 0.5% of all, not just insured, deposits.³³⁰ The term ‘deposit’ is strictly construed such that a standby letter of credit backed by a contingent promissory note does not give rise to an insured deposit.³³¹ The deposit insurance system includes other financial institutions such as savings and loan associations (1934), credit unions (1970). It is government legislated and administered and jointly funded.³³² The government provided the initial funding, borne losses of savings and loan associations in the past.³³³ Membership is compulsory for all nationally chartered and almost all banks and thrifts.³³⁴ Premiums are risk adjusted.³³⁵ Even though federal deposit insurance program has had its challenges over the years, for example moral hazard, overall, the program has served the USA well.³³⁶

³²⁸Ibid, 9

³²⁹Ibid

³³⁰ibid

³³¹Federal Deposit Insurance Corporation vs Philadelphia Gear Corporation 476 U.S. 426(1986)

³³²Mogyl’nyy (n13), 8

³³³Ibid

³³⁴Ibid 10

³³⁵ibid

³³⁶Federal Deposit Insurance Corporation Division of Research and statistics, ‘A brief History of Deposit Insurance in the United States’ (Washington DC. 1998) 60

5.3 Japan

Japan's EDIS was established in 1971, with the aim of protecting bank depositors and maintaining the stability of the financial system in the face of increased competition resulting from financial liberalization.³³⁷ The system is administered by the Deposit Insurance Corporation, a special corporation established under the Deposit Insurance Law with capital contributed by the Ministry of Finance, the Bank of Japan, and private financial institutions.³³⁸ Membership is compulsory for virtually all depository institutions.³³⁹

EDIS was first established in Japan in 1971.³⁴⁰ For the next two decades, however, financial regulators, working together with the banking sector, continued to operate a highly successful implicit safety net that rendered the formal deposit protection system superfluous.³⁴¹ The collapse of the bubble economy(an economy undergoing an unsustainable boom), however, caused changes in the economic, political, and regulatory environments that rendered the implicit safety net to fail miserably, leaving a gap in Japan's bank regulatory infrastructure.³⁴²

Consequently, Japan established two separate deposit insurance systems, one for commercial banks and another for agriculture and fisheries cooperatives.³⁴³ The first

³³⁷Milhaupt (n27), 408

³³⁸Ibid

³³⁹Ibid

³⁴⁰Ibid, 404

³⁴¹Ibid

³⁴²Ibid

³⁴³Ibid, 408

scheme covers demand and time deposits in domestic currency.³⁴⁴ The law on deposit insurance was amended in 2002, making special deposits for settlements and payment uses fully covered.³⁴⁵ The coverage is otherwise per depositor per institution.³⁴⁶ The system is legislated and government administered.³⁴⁷ The government and the central bank provided the initial capital.³⁴⁸ The fund can borrow from the central bank and government can guarantee the debt.³⁴⁹ Membership is compulsory.³⁵⁰

5.4 Nigeria

Nigeria was the first country to introduce EDIS in Africa.³⁵¹ A history of bank failures was one of the considerations that led to the introduction of EDIS in Nigeria.³⁵² The Nigerian Deposit Insurance Corporation (NDIC)³⁵³ was formed following a survey of the banking sector that revealed that many banks would be technically insolvent if provisioning rules were enforced.³⁵⁴ From inception, the NDIC was established to minimise risk with core functions to guarantee deposits of insured institutions, carry

³⁴⁴Ibid

³⁴⁵Ibid

³⁴⁶Ibid, 413

³⁴⁷Ibid

³⁴⁸Ibid

³⁴⁹Ibid

³⁵⁰Ibid

³⁵¹Lawrence Stephene Ijimdiya, “The legal and institutional framework for the operation of deposit insurance scheme in Nigeria” (LLM thesis, University of Ahmadu Bello, Nigeria 2016)

³⁵²Ibid

³⁵³Nigerian Deposit Insurance Corporation Decree No. 22 of 1988

³⁵⁴Asli Dermirguc-Kunt, Baybars karacaorali and Luc Laeven , (n137)

out supervision of insured institutions, partake in failure resolution processes and liquidate failed insured institutions.³⁵⁵

The initial NDIC was created in June 1988 by enactment of the Nigeria Deposit Insurance Corporation Act, 1988, but EDIS started in 1989.³⁵⁶ In 2006, this Act was repealed by the Nigeria Deposit Insurance Corporation (NDIC) Act, 2006 making the NDIC which started as an offshoot of the Central Bank an independent body corporate.³⁵⁷ It is jointly owned by the central bank and the ministry of finance, and both are represented in the Board of the NDIC. The chairman and members of the Board are appointed by the country's President.³⁵⁸

It is compulsory for all commercial and merchant banks engaged in the business of receiving deposits to join the insurance system.³⁵⁹ All deposits, except those of insiders or those held as collateral for a loan and excluding certificates of deposits, up to a maximum of N 200,000(US\$ 600) are covered.³⁶⁰ Section 20(1) of the Act empowers the Corporation to vary upwards the maximum amount which a depositor receives from the Corporation in respect of deposits of failed banks. According to the enabling Act, the corporation finances come from yearly premiums contributed by deposit-taking financial institutions. Supervisory duties and information are shared between the NDIC and the Central Bank. For instance, the NDIC is empowered to

³⁵⁵Ibid

³⁵⁶Ibid

³⁵⁷Section 1(2) (a) the Nigeria Deposit Insurance Corporation Act, 2006.

³⁵⁸Ibid, Section 5(4)

³⁵⁹Ibid, Section 15(1)

³⁶⁰Ibid, Section 20

request any information from member banks. In practice NDIC has been involved in liquidation and refunding depositors of several defunct banks in Nigeria.³⁶¹ Its mandate to act as liquidator has been challenged before court on several occasions.³⁶²

5.5 Kenya

Kenya had a Deposit Protection Fund Board³⁶³ (DPFB) as an explicit deposit protection system created under section 36 of the Banking Act, 1985.³⁶⁴ The DPFB was created in 1985 in the wake of four bank failures.³⁶⁵ In 2012, sections 36 of the Banking Act together with other sections providing for EDIS were repealed by the Kenya Deposit Insurance Act, 2012.³⁶⁶ The new Act besides making extensive provisions for EDI in Kenya also established Kenyan Deposit Insurance Corporation (KDIC) in place of the Deposit Protection Fund Board that was operating under the old law.³⁶⁷ The KDIC works separately from the central bank. It provides deposit insurance scheme for depositors of member institutions and manages funds levied as contributions from member institutions.³⁶⁸ The KDIC also liquidates institutions in respect of which it has been appointed receiver.³⁶⁹ In collaboration with the Central

³⁶¹Nigeria Deposit Insurance Corporation <www.ndic.gov.ng> accessed 17 July 2017

³⁶²Nigeria Deposit Insurance Corporation vs Central Bank of Nigeria and Republic Bank Limited, Suit No: SC. 55/1999; see also Alhaji Mohammed Maihaki Ali vs Nigeria Deposit Insurance Corporation, CA/L/408/2009

³⁶³See generally Deposit Protection Fund Board, Balance Sheets as at 20th June 2009.

³⁶⁴Banking Act, 1985 Chapter 488 of the Laws of Kenya

³⁶⁵Talley and Mas (n135), Appendix A, 15

³⁶⁶Kenya Deposit Insurance Act, 2012

³⁶⁷Ibid, Section 4

³⁶⁸Ibid, Section 5

³⁶⁹Ibid

Bank of Kenya the KDIC is also involved in bank surveillance and problem bank resolution.³⁷⁰

The KDIC is administered by a Board of Directors whose chairperson is appointed by the President.³⁷¹ Section 20 creates a Deposit Insurance Fund which vests in the KDIC and administered by the Board. The Board has powers from time to time to fix the size of the Fund sufficient to protect the interest of depositors.³⁷² Membership of the deposit protection fund is compulsory for all licensed banks and financial institutions that accept deposits and issue loans.³⁷³ Banks contribute to the fund through premiums.³⁷⁴ The fund can also borrow from the Central Bank.³⁷⁵ During crisis situations, the Act empowers Parliament to approve funding allocations that may be required by the Fund for purposes of depositor protection.³⁷⁶ Maximum insurance coverage is KS 100,000(US\$ 100) but the Corporation has powers to determine a higher sum from time to time.³⁷⁷ This guarantees deposit protection. In practice the KDIC has rescued depositors of various failing banks.

³⁷⁰Ibid, Section 38

³⁷¹Ibid, Section 7

³⁷²Ibid, Section 20A

³⁷³Ibid, Section 24

³⁷⁴Ibid, Section 27

³⁷⁵Ibid, Section 21

³⁷⁶Ibid, Section 20(4)

³⁷⁷Ibid, Section 28(1)

5.6 Tanzania

The explicit deposit system of Tanzania was initiated in 1991 when it enacted the Banking and Financial Institutions Act (BFIA), 1991 and it became operational in 1995.³⁷⁸ Under section 24, the BFIA also provides for a Deposit Insurance Board (DIB), a body corporate whose responsible for policy formulation, management and control of the Deposit Insurance Fund (DIF). The DIF exists by the provisions of section 23 (I) of the BFIA. The board is made up of public officers and chaired by the Governor of the Bank of Tanzania, the country's central bank.³⁷⁹ Other members come from or are appointed by the Ministry of Finance.³⁸⁰ Banks are required to provide annual contributions to the fund as determined by the DIB, but the government provided the initial funding for the insurance.³⁸¹

The aim of DIF is to protect depositors and allow for sound growth of banks and other financial institutions. The DIB charges 0.1% of average annual total deposits on member banks as insurance premiums and the money forms part of the deposit insurance fund. All types of deposits are covered up to TZS 1,500,000(US\$ 700)³⁸² and membership to the fund is compulsory for all banks.³⁸³ Apart from acting as insurer by securing depositors against bank failure, the DIF also acts as a liquidator in

³⁷⁸Section 23, Banking and Financial Institutions Act

³⁷⁹ Ibid, Section 24(2)

³⁸⁰ Ibid

³⁸¹ Ibid, Section 25

³⁸²Magdalena Utouh, 'Tanzania deposit insurance system law and practice: a comparative analysis of deposit insurance in Tanzania and United States' < <http://hdl.handle.net/123456789/47825> > accessed 15th June 2017

³⁸³ Ibid

case of bank insolvency. However, it can only act as a liquidator of a default bank or financial institution if so appointed by the Bank of Tanzania³⁸⁴

5.7 Zimbabwe

Zimbabwe had a relatively stable and highly regulated banking sector since independence in 1980.³⁸⁵ Deregulation in the early 1990s exposed the banking sector and a need for deposit insurance was underscored by failures of four banks between 1995 and 2001.³⁸⁶ In light of these bank failures the Government considered it necessary to set up an explicit deposit protection scheme to protect vulnerable depositors in the event of bank failures.³⁸⁷ The deposit insurance system of Zimbabwe was created in 2003 when the government established a Deposit Protection Fund under the Banking Act.³⁸⁸ The fund is controlled and managed by the Deposit Protection Corporation whose mandate is derived from the Deposit Protection Corporation Act.³⁸⁹ The coverage limit is Zimbabwe \$200,000 (US\$ 600) but is subject to review.³⁹⁰ Coverage is calculated per deposit per institution.³⁹¹

³⁸⁴Ibid

³⁸⁵Chikura (11), 1

³⁸⁶Ibid

³⁸⁷Ibid

³⁸⁸Banking Act, Section 66

³⁸⁹Deposit Protection Corporation Act, Chapter 24:29 of the Laws of Zimbabwe.

³⁹⁰Asli Dermirguc-Kunt, Baybars karacaorali and Luc Laeven , (n137)

³⁹¹Ibid

It is compulsory for every banking institution in Zimbabwe to be a member of the Deposit Protection Corporation.³⁹² The deposit insurance scheme is financed from banking institutions subscriptions, which are agreed upon by the Corporation and the institutions annually.³⁹³ EDIS scheme in Zimbabwe was establishment in 2003. Since its inception, Deposit Protection Corporation has compensated depositors of more than five failed banking institutions, which were subjected to liquidation.³⁹⁴

5.8 Countries without Explicit Deposit System

There are many countries that have not adopted EDIS. In Africa for example many countries have not adopted EDIS.³⁹⁵ For example, Zambia, with no much difference in banking system to Malawi is yet to adopt EDIS. South Africa, one of the top African economies is yet to adopt EDIS as well even though its financial system is integrated to the global financial system.³⁹⁶ The South African Reserve Bank is currently soliciting views from stakeholders on EDIS adoption.³⁹⁷ South Africa is in a way assessing the suitability and necessity for EDIS in its domestic setting.

5.9 Lessons from Other Jurisdictions

Several lessons can be drawn from the experiences of the countries above. One such lesson is that countries introduced EDIS after facing bank failures and that led to

³⁹²Chikura (n11), 1

³⁹³Ibid

³⁹⁴Ibid

³⁹⁵See list of jurisdictions that have adopted EDIS < <http://www.iadi.org/di.aspx> > (n4)

³⁹⁶Lameez Omarjee, 'New Policy to Protect South Africans from Financial Crisis' <www.fin24.com> accessed 30th September 2017

³⁹⁷Ibid

financial system instability and loss of deposits. All the jurisdictions above introduced EDIS following bank failures. They were driven by the objective of maintaining stability in the banking system and protecting the interests of small depositors. The degree of failure differed in that in some countries there was systematic failure (USA for example) while in other countries the level was at a low level and deposit insurance was introduced to avoid the failure from escalating into a contagion. There seem to be no country that introduced deposit insurance as a proactive measure in anticipation of future failures.

On IDIS, the country experiences show that IDIS failed to avert crisis and led to losses of deposits. The Japan's experience for instance shows that a well-designed, EDIS is the superior institutional choice from an IDIS. Japan's experience indicates that implicit safety nets not only suffer from the moral hazard and forbearance flaws found in explicit systems, but also generate additional problems such as a lack of a formal institutional structure for failed bank.³⁹⁸ EDIS itself need to be well designed to achieve the desired purpose. A poorly designed explicit insurance system can be expensive and bring instability of the financial system. It can be counterproductive.

It is not proper to import EDIS without first analyzing domestic institutional environment. The history of EDIS shows that in the 1980s and early 1990s, many governments regarded the establishment of EDIS as a logical step in strengthening the financial sector's infrastructure.³⁹⁹ The countries provided more generous depositor

³⁹⁸Milhaupt (n27), 427

³⁹⁹Ibid, 2

protection and paid little attention to whether the new measure fitted the domestic financial environment.⁴⁰⁰ As a result the design of newly created EDIS was simply imported from the policies of other countries, and the systems had many flaws.⁴⁰¹ It was no surprise that after a series of banking crises the EDIS were the first to come under fire, leading some governments to believe that they should call for the abolition of EDIS.⁴⁰²

Certain challenges with deposit insurance are peculiar to developing countries. Historical record indicates that developing countries typically do not create effective EDIS. Any developing country contemplating to have EDIS should address these peculiar challenges. These challenges include little capital for running EDIS and poor governance structures.⁴⁰³ The other challenge is a lack of government back up support that EDIS may need to get through a difficult period. As a result, most systems in developing countries have lacked credibility and are frequently frozen into inaction.⁴⁰⁴

5.10 Conclusion

Chapter five has discussed how deposit protection is done in some selected jurisdictions with a view of learning from their legal frameworks and experiences. These jurisdictions include those with EDIS such as United States of America (USA), Japan, Nigeria, Kenya and Zimbabwe. The discussion has shown that these countries

⁴⁰⁰Ibid

⁴⁰¹Ibid

⁴⁰²Ibid

⁴⁰³Talley and Mas(n135), 21

⁴⁰⁴Ibid, 22

adopted EDIS at different times and have had practical experience with it. One lesson is that these countries adopted EDIS to solve crisis situations in their countries. The Chapter has also observed that EDIS adoption pose unique challenges for developing countries due to poor governance and weak institutional environments among other factors. It was noted that among other countries South Africa and Zambia are yet to adopt EDIS just like Malawi. The Chapter concludes by drawing reasons from all selected jurisdictions.

CHAPTER 6

CONCLUSIONS AND RECOMMENDATIONS

6.1 Introduction

Chapter 6 discusses conclusions and recommendations of the study. The first part evaluates whether there is a case for explicit deposit insurance (EDI) in Malawi. In doing this the Chapter highlights some points already covered in all the preceding chapters and observes in its finding that currently there is no case for EDI adoption in Malawi. Lastly the chapter discusses recommendations on how to improve depositor protection in Malawi without adopting EDI. These recommendations are in view of weakness in depositor protection when a bank fails.

6.2 No Case for Explicit Deposit Insurance

In Chapter One, this paper noted that EDI has both merits and demerits; as such it requires caution before being adopted in the country. It was also noted that historically, Malawi has generally a stable financial system. The main objective of the paper was to assess the need for EDI in Malawi following a proposal by the RBM.

This paper was divided into six chapters. Chapter one provided the general introduction to the research question, the research methodology and other introductory matters. Chapter one, specifically under literature review noted that EDI is a tightrope system that requires considerable care when adopting it so that it does

not cause instability of the financial system. Due care should be taken when designing and assessing its suitability to the domestic institutional environment. To be effective therefore the system should be properly designed, and the institutional environment must be strong.

Chapter two gave the conceptual and theoretical approaches to depositor insurance. It discussed theories on depositor insurance, defined depositor insurance, provided its rationale, types of depositor insurance and core principles for effective depositor insurance. Chapter three was a discussion on depositor insurance in Malawi. It looked at strengths and weaknesses in the legal and regulatory framework. The chapter showed that generally Malawi has a strong legal and regulatory system on depositor protection; the only weakness identified being that depositors may not be reimbursed when a bank fails and where its assets are insufficient to cater for all depositor reimbursements. It was observed that this weakness does not justify EDI adoption.

Chapter four discussed the proposal for EDI in Malawi. It analysed the rationale for such a proposal. It was noted in this Chapter that the proposed EDI may not be in line with the core principles for effective EDI; principles such as those on moral hazard, governance and financial literacy rate within the country. It was further noted that EDI might be an unnecessary cost to tax payers. The rationale for adoption could not be justified in view of the inherent demerits of EDI. This was the finding of this study. It concluded that EDI is not necessary for Malawi. Chapter four also discussed the liquidation of Finance Bank of Malawi Limited (FBML) to see if it provides a case for adoption of EDI in Malawi. The liquidation of FBML was a test for the legal and regulatory framework of depositor protection in Malawi. What was on test is the

protection afforded to depositors during bank failure through preferential claims. The fact that no deposit loss occurred suggests that depositors were adequately protected such that the fall of this bank may not provide a justification for adoption of EDI. However, had the FBML liquidated funds not been enough, depositors would have lost some deposits without recourse from the legal and regulatory framework. This might be the only weakness on depositor protection in Malawi. With the current general stable financial system this weakness does not warrant EDI intervention. Indeed, the rationale for the proposed EDI is to be proactive to avert future bank failures. Thus, the proposed EDI is not for immediate use in the country. It is therefore an acknowledgment on the part of RBM that currently the country does not need such a system. It was also noted in Chapter four that there is a lack of willingness on the part of Government to accept EDI. Governments' silence for more than three years after the proposals were made shows that there is no support to this initiative. The lack of Government support is a recipe of failure of any EDI initiative. EDI require government support during its initiation and to get through crisis times. History of EDI the world over has shown that without government support EDI lacks credibility and is frozen to inaction.⁴⁰⁵ Government inaction is therefore indicative that the country may not adopt an effective EDI.

Chapter five looked at lessons that can be drawn from other jurisdictions. The lessons drawn buttressed the conclusion that EDI is not necessity for Malawi. For instance, it was observed that countries adopted EDI to address failing bank situation in their

⁴⁰⁵Talley and Mas (n135), 22

financial systems and there seem to be no jurisdiction for adopting EDI as a proactive measure. EDI was not adopted in anticipation for future banking challenges. The other lesson was an observation that countries that copied EDI from other jurisdictions before assessing its suitability to domestic environment came up with ineffective systems that could not cope with bank failures. It is thus doubtful if the proposed EDI would be effective in view of the lack of assessment of the institutional environment.

6.3 How to Improve Depositor Protection in Malawi

The above discussion avers that EDI is not necessary for Malawi. So long as the financial system remains stable deposits are safe and the need for EDI does not arise. By arguing against the proposed EDI, it is not suggested that it cannot be considered in future when the financial system becomes unstable. After all, Chapter 3 noted a weakness in the legal and regulatory framework on deposit protection during bank failure. The threat to deposits posed by the weakness identified in legislation can be minimized through improvements in the financial system. To maintain and improve the financial system, regulators and policy makers need to be proactive. This study makes the following recommendations for maintenance of stability of the financial system:

The main recommendation is that Malawi should not adopt the proposed EDI as it is not necessary for now. In assessing the necessity for EDI in Malawi and concluding like this, this paper proceeds to make the following further recommendations in view of the identified weakness in legislation during bank failure:

Firstly, is on the regulatory and supervisory role by the RBM. Chapter three noted that deposits are safe if the financial system remains stable and that this stability is ensured

by the supervisory and regulatory functions of RBM. Chapter three also noted that the RBM has many powers for its supervisory and regulatory functions; powers to issue directives, powers to license and suspend a bank, powers to issue monetary directives on liquidity and many more. These powers plus remedial measures need to be vigilantly applied by the RBM. Regulatory forbearance, which is an unwillingness (or indecision) by a regulatory body to intervene when called up to do so,⁴⁰⁶ should be avoided if Malawi is to maintain the stable financial stability. It is crucial that RBM be very proactive and remain vigilant in its supervisory and other mandates so that the financial system remains stable.

It was also noted in Chapter three that lender of last resort (LOLR) helps to maintain stability of the financial system. The LOLR exists to help solvent banks to handle liquidity (but not insolvency) problems both in normal times and during crises. It helps solvent banks not sell assets at low prices to solve liquidity challenges. The lender of last resort mechanism therefore helps in preventing a solvent bank from going into liquidation. Similarly, interbank lending helps in preserving stability of the financial system by assisting an illiquid (but solvent bank) with fund. The stability of the payment system in Malawi is maintained and promoted by means of a lender of last resort facility of the central bank and interbank lending mechanisms. These mechanisms need to be strengthened by elevating them from policy to legislation. They need to be incorporated in legislation. It is hoped that such incorporation would give them legal force and detail.

⁴⁰⁶Kenneth K. Mwenda, *Legal Aspects of Banking Regulation: Common Law Perspectives from Zambia* (Pretoria University Law Press 2010) 73

Lastly is a recommendation on statutory management discussed in Chapter three. Statutory management is a situation whereby a regulator or supervisor of the financial services appoints someone to run a business regulated under the financial services law. The Registrar places a bank under statutory management when he finds that it is not complying with financial services laws and this could be where it is or is likely to be in an unsound position, or where it is engaging in unsafe or unsound financial practices.⁴⁰⁷ Placing an institution under statutory management is meant to restore it. It is therefore paramount that RBM acts in time otherwise it becomes too late to restore a troubled institution. The mechanism to restore a financial institution needs prompt action whenever RBM is convinced that statutory management needs to be carried out. The history of the country shows that no bank has ever survived statutory management perhaps due to delays by the RBM.⁴⁰⁸ Decisiveness on the part of RBM is recommended to maintain a stable financial system that is necessary for depositor protection.

⁴⁰⁷ Financial Services Act 2010, Section 68(2)

⁴⁰⁸ Finance Bank Malawi Limited closed after being placed under statutory management

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