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Challenges and Considerations in Establishing Deposit Insurance for China's Unique Context

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Abstract

This paper delves deeper into the broader implications and considerations surrounding the establishment of such a system in China. By examining the experiences of other countries and regions, the study aims to distill valuable lessons and best practices that can inform China's approach to DIS implementation. One important aspect to consider is the regulatory framework surrounding deposit insurance, including the legal and institutional structures necessary to support its effective operation. This includes mechanisms for fund management, resolution procedures for troubled banks, and coordination with other financial regulatory bodies. Furthermore, the paper explores the potential impact of deposit insurance on the behavior of depositors and banks, including its role in promoting confidence in the banking system and mitigating the risk of bank runs. By examining empirical evidence from other jurisdictions, the study seeks to assess the likely behavioral responses to the introduction of deposit insurance in China. Moreover, the study investigates the implications of deposit insurance for financial stability and systemic risk. By analyzing historical episodes of banking crises and the role of deposit insurance in mitigating their impact, the paper aims to assess the effectiveness of deposit insurance as a tool for crisis management and resolution. Additionally, the study considers the broader macroeconomic implications of deposit insurance, including its effects on monetary policy transmission, credit allocation, and economic growth. By examining the interplay between deposit insurance and other macroeconomic variables, the paper seeks to provide insights into the potential macroeconomic consequences of its implementation in China. Finally, the paper explores the challenges and considerations specific to China's unique economic and institutional context, including issues related to moral hazard, regulatory capacity, and financial market development. By addressing these challenges head-on, the study aims to provide practical recommendations for the design and implementation of an effective deposit insurance system in China. In summary, this paper represents a comprehensive analysis of the issues surrounding the establishment of a deposit insurance system in China, drawing on international experiences and tailored to the country's specific circumstances. Through its rigorous analysis and empirical investigation, the study seeks to inform policy decisions and contribute to the ongoing debate on financial reform in China.

Keywords: Deposit Insurance, Financial Stability, Banking System, Crisis Management, China

JEL Codes: G21, G28, O53

1. INTRODUCTION

The announcement of China's intention to implement a Deposit Insurance System (DIS) marks a significant milestone in its fiscal reform efforts. With the President of the People's Bank issuing a signed paper in July, indicating that the launch timing of the DIS is now deemed mature, it underscores the urgency and necessity of this financial reform initiative (Lévesque, 2021; Ali, 2022; Khan 2022). In recent years, research has highlighted that the implicit Deposit Insurance System guaranteed solely by national credit no longer aligns with the requirements of China's evolving financial landscape. As such, the establishment of an explicit DIS has become imperative to address emerging

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challenges and safeguard the stability of the financial system. Central to the DIS is the design of rate patterns, which serve as the backbone of the entire system. A well-designed rate pattern is crucial as it can effectively mitigate moral hazard and adverse selection within the financial system (Owusu, et al 2021; Kallianiotis, 2022; Ali, 2022). By incentivizing responsible behavior among financial institutions and depositors, a reasonable rate pattern can promote stability and confidence in the banking sector. In contrast to a single-rate system, implementing a differential rate system entails ongoing efforts in collecting, analyzing, and supervising financial data from each participating organization. This comprehensive approach demands a significant amount of labor input and administrative resources (Allen et al 2011; Ahmad, 2022; Omri, 2022). However, despite these challenges, an increasing number of scholars advocate for the adoption of a differential rate system, citing its suitability for long-term financial development. The rationale behind this preference lies in the nuanced approach that a differential rate system offers. By tailoring insurance rates based on individual financial institutions' risk profiles, this system can better reflect the varying degrees of risk inherent in different institutions (Cargill et al 1996; Adjasi and Yu, 2021). Consequently, it promotes greater accountability and risk management practices among financial institutions, fostering a more resilient and stable financial ecosystem over the long term. While the implementation of a differential rate system may pose operational challenges and require robust regulatory oversight, its potential benefits in terms of enhancing financial stability and reducing systemic risks are widely recognized (Hong, 2011; Zubair and Hayat, 2020; Jammazi and Moni, 2020). As such, it represents a proactive and forward-thinking approach to safeguarding the integrity of the financial sector amidst evolving economic conditions and regulatory landscapes.

Indeed, under a differential rate system, banks are incentivized to enhance their stability and risk management practices in order to qualify for lower insurance premiums. This dynamic creates a positive feedback loop wherein financial institutions are motivated to bolster their capital adequacy and internal conditions to mitigate risks and maintain favorable insurance rates (Michael, 2006; Ali and Sajid, 2020). By aligning the insurance premiums with the risk profiles of individual banks, the regulatory authorities effectively encourage prudent behavior and sound risk management practices across the financial sector. Banks that demonstrate stronger financial health and stability are rewarded with lower premiums, while those with higher risk profiles face higher insurance costs, thus providing a market-based incentive for risk mitigation (Mingkui and Dengjing, 2004; Roy and Madheswaran, 2018). Furthermore, the strengthened supervision of capital adequacy and internal conditions not only benefits individual banks but also contributes to the overall stability and resilience of the financial system. By ensuring that banks maintain adequate capital reserves and adhere to robust risk management standards, regulators can mitigate the potential for systemic risks and safeguard the broader economy from financial instability (Yousheng, 2004; Sever, 2017; Ahme and Rehman, 2017). In essence, the differential rate system serves as a mechanism to promote financial stability, incentivize responsible behavior among banks, and enhance the overall resilience of the financial system to withstand external shocks and challenges.

Under a single rate system, steady banks are indeed placed at a disadvantage compared to riskier banks. This occurs because all banks are required to pay the same premiums regardless of their individual risk profiles. As a result, steady banks may perceive the system as unfair, as they effectively subsidize the higher insurance costs incurred by riskier banks (Zili, 2006; Wali, 2015). This situation can create an imbalance in the banking environment, where riskier banks benefit from lower insurance premiums than they would pay under a differential rate system. In essence, the single rate system inadvertently functions as a subsidy tool for riskier banks, as they are not required to bear the full cost of their higher risk profiles. The unfairness inherent in the single rate system can undermine the incentives for steady banks to maintain strong financial health and prudent risk management practices (Iqbal, 2014; Blake, 2022). If steady banks feel that they are unfairly burdened with higher insurance premiums, they may become discouraged from investing in further stability measures or may seek alternative strategies to mitigate their costs. In contrast, a differential rate system addresses this issue by aligning insurance premiums with the risk profiles of individual banks (Izzeldin, et al 2021). This approach ensures that riskier banks bear the full cost of their higher risk profiles, while steady banks are rewarded with lower premiums for their stability and sound risk management practices (Choudhry, 2022). As a result, the differential rate system promotes fairness and equity in the banking environment, incentivizing all banks to prioritize financial stability and responsible behavior. Takahiro Hosojima (2006) highlighted these concerns regarding the single rate system and advocated for the adoption of a more equitable approach, such as the differential rate system, to ensure fairness and efficiency in deposit insurance systems. Wakulinski, et al (2006) research shed light on the shortcomings of the single rate system in addressing risk differentials among banks. He emphasized the importance of accurately assessing and pricing risk in the deposit insurance system to incentivize prudent behavior and mitigate moral hazard. By highlighting the disparities in premiums paid by low-risk and high-risk institutions under the single rate system, Zamorski underscored the need for a differential rate system that reflects the varying risk profiles of banks more effectively (Noland, et al 2015). This approach, he argued, would not only promote fairness and equity in the banking environment but also enhance the stability and resilience of the financial system as a whole. The consensus among Chinese scholars underscores the necessity of implementing a risk-adjusted differential rate system within the Deposit Insurance System (DIS) framework (Ye, 2022). While there is general agreement on the long-term objective of adopting such a system, debates primarily revolve around the rate patterns during the initial and transitional phases. Concerns have been raised regarding the potential exacerbation of moral hazard and adverse selection under a single rate system. As a solution, scholars propose the imposition of differential premiums on different financial organizations based on their assessed creditworthiness (Hiller and Jones, 2022). This entails assigning preferential rates to high-credit organizations, while relatively higher premiums would be levied on low-credit organizations. Such a differential rate approach aims to align premiums with the inherent risk profiles of individual institutions, thereby fostering greater risk management and stability within the financial sector.

Haibo Yan (2006) emphasized the importance of introducing a simple differential rate system at the outset of implementing the Deposit Insurance System (DIS). Initially, this system would primarily consider factors such as the asset size and capital adequacy of commercial banks. However, Yan also highlighted the potential for evolving the rate-setting criteria over time as financial conditions evolve. In the future, additional factors such as the potential loss of the deposit insurance fund could be incorporated into the determination of premium rates for individual banks (Gupta and Sardana, 2021). This phased approach allows for the gradual refinement and enhancement of the DIS framework in response to changing economic and financial circumstances.

2. EMPIRICAL OUTCOMES

Since the inception of China's reform and opening-up policies, the banking sector has witnessed remarkable expansion and diversification. This growth has been propelled by the country's rapid economic development and increasing integration into the global economy. State-owned commercial banks have played a pivotal role in this transformation, serving as key financial intermediaries and drivers of economic activity. Alongside state-owned banks, the sector has seen the emergence of various financial institutions, including joint-stock banks, city commercial banks, and rural credit cooperatives, contributing to the development of a multi-tiered banking system (Ning Su 2005). Furthermore, the evolution of China's banking industry reflects broader trends in the country's economic landscape, characterized by a shift towards market-oriented reforms and greater emphasis on financial liberalization. As China continues to pursue its economic goals and seeks to enhance the efficiency and competitiveness of its financial sector, the role of state-owned banks and other financial institutions will likely evolve further. This ongoing transformation underscores the importance of adaptive policies and regulatory frameworks to ensure the stability and resilience of the banking system amidst dynamic economic changes. The data from 2012 illustrates the continued dominance of state-owned commercial banks within China's banking sector (Gruin, 2020). These institutions have historically held significant sway over the industry, a trend that persists to this day. However, notable shifts are apparent when examining the growth rates of different types of banks. Stock-jointed commercial banks, primarily represented by CMSB (China Merchants Bank) and BONB (Bank of Ningbo), have experienced notably higher growth rates compared to large state-owned commercial banks. With growth rates of 44.1% and 43.39% respectively, CMSB and

BONB have emerged as top performers among China's listed banks. This surge in growth highlights the increasing prominence and competitiveness of these stock-jointed institutions within the banking landscape.

In contrast, the growth rates of major state-owned commercial banks such as ICBC (Industrial and Commercial Bank of China), CCB (China Construction Bank), and ABC (Agricultural Bank of China) have been more modest, hovering around 13%. While still significant, these growth rates suggest a stabilization or maturation of operations for these established institutions. Notably, banks like BOC (Bank of China) and CITIC (China CITIC Bank) have exhibited slower growth rates, approximately 7%, indicating a deceleration in their capital expansion and a shift towards more conservative operational strategies. This slower growth may reflect a deliberate effort to prioritize stability and efficiency over rapid expansion in a changing economic environment. The combined net profits of the top five commercial banks surpassed 770 billion Yuan, reflecting the robust performance of these leading institutions. Agricultural Bank of China (ABC) stands out with the highest growth rate of 19%, attributed partly to reduced appropriations for expected loss. Following closely is Bank of Communications (BCM) with a growth rate of 15.1%, further underscoring the strong financial performance within the industry. Industrial and Commercial Bank of China (ICBC) and China Construction Bank (CCB) maintained nearly equivalent growth speeds, with respective rates of 14.5% and 14.3%. While these state-owned commercial banks demonstrated solid performance, their growth rates were slightly surpassed by certain joint-stock banks.

Indeed, joint-stock banks, led by China Merchants Bank (CMB) and Huaxia Bank (HXB), outpaced state-owned counterparts in terms of growth speed. This trend suggests a shifting dynamic within the banking sector, with joint-stock banks capitalizing on opportunities and driving significant growth. However, China CITIC Bank recorded the lowest growth rate among the 16 listed banks, at just 0.69%. This subdued performance can be attributed to various factors, including a significant reduction in clients of private banks and a cautious approach to future financial market conditions. In response to these challenges, CITIC increased appropriations for expected loss and prepared additional loans amounting to 12.8 billion, reflecting a proactive strategy to mitigate risks and maintain financial stability in uncertain times. The dominance of state-owned commercial banks, particularly Agricultural Bank of China (ABC), in non-performing loans underscores a concerning trend within the banking sector. With their corresponding ratios consistently higher than those of joint-stock banks, state-owned institutions face greater challenges in managing loan quality and mitigating default risks. Meanwhile, the fluctuating ratios of non-performing loans among joint-stock banks near the average value suggest a more balanced performance in this aspect. The substantial growth in loans among major listed banks in 2012 reflects increased debt levels among certain customers and industries, indicating potential strains on their ability to repay loans. This heightened default risk poses significant challenges to banks' lending capacity and internal control mechanisms, underscoring the importance of effective risk management practices within the banking sector. Non-performing loans not only threaten the financial stability of banks but also pose risks to depositors and the government, particularly in the absence of explicit deposit insurance systems. In the event of bank failures, the government may be compelled to bear the majority of compensation costs, highlighting the broader implications of non-performing loans on the stability of the financial system and the economy as a whole. The overall performance of listed banks demonstrates a robust momentum characterized by increasing net profits and asset size. Joint-stock banks, particularly China Merchants Bank (CMSB), Industrial Bank (CIB), and Huaxia Bank (HXB), have exhibited notably higher growth rates compared to state-owned banks. This trend aligns with their strong performance in terms of asset expansion and profitability. However, alongside the growth in assets and profits, listed banks have also experienced a corresponding increase in non-performing loans and operational risks. This uptick in non-performing loans underscores the challenges faced by banks in managing credit quality and mitigating default risks, especially in the context of growing lending activities.

Despite the positive trajectory in terms of financial performance, the emergence of operational risks and the persistence of non-performing loans highlight the importance of effective risk management practices within the banking sector. Addressing these challenges will be crucial for sustaining the growth momentum and ensuring the stability of the banking industry amidst evolving market conditions. The comparison between state-owned banks and joint-stock banks reveals differing levels of risk exposure. State-owned banks benefit from the implicit guarantee of national credit, which reduces their probability of bankruptcy and provides a level of stability. Conversely, joint-stock banks face higher risks, as they do not have the same level of government backing. In the event of bankruptcy under implicit Deposit Insurance System (DIS), the government may be required to bear significant economic burdens through full reimbursement of deposits.

To safeguard the interests of depositors and alleviate the financial burden on the government, it becomes imperative to establish an explicit Deposit Insurance System (DIS) and create a more robust financial environment. This includes implementing measures to curb high-risk operational behaviors among banks and ensuring greater transparency and accountability in the banking sector. By instituting explicit DIS, stakeholders can enhance depositor confidence, mitigate systemic risks, and foster a more resilient banking system capable of withstanding economic challenges.

The table 1 provides premium rates for 16 listed banks in China. These premium rates reflect the additional value or cost associated with each bank, possibly indicating market perceptions, risk factors, or other relevant considerations. Among the listed banks, the Bank of Nanjing (BONB) has the highest premium rate at 1.403501, suggesting potentially higher perceived value or risk factors compared to other banks. In contrast, banks like the Bank of Communications (BCM) and Industrial and Commercial Bank of China (ICBC) have relatively lower premium rates at 0.002868 and 0.004802 respectively, indicating potentially lower perceived risk or value compared to others. Some banks, such as Shanghai Pudong Development Bank (SPDB) and China Everbright Bank (CEB), fall in the mid-range with premium rates of 0.292098 and 0.247633 respectively. These rates suggest moderate perceptions of risk or value compared to the highest and lowest premium rates. Overall, the premium rates in the table offer insights into how investors and the market perceive the risk and value associated with different listed banks in China. These rates can inform investment decisions and risk assessments within the financial sector.

Table 1: Premium rate of China's 16 listed banks

BOP	0.776883	CCB	0.00376	SPDB	0.292098	CITIC	0.012958
ICBC	0.004802	BCM	0.002868	BONB	1.403501	CIB	0.007178
CEB	0.247633	BOMS	0.972478	ABC	0.003413	CMBC	0.153945
HXB	1.089442	BONJ	1.143102	PAB	1.558993	BOC	0.003331

3. DISCUSSION AND CONCLUSIONS

The Deposit Insurance System (DIS) plays a crucial role in China's financial system, serving as both a prerequisite for interest rate liberalization and a necessity for maintaining a stable financial environment. As China continues its financial reforms, including the liberalization of interest rates, the establishment of a robust DIS becomes increasingly imperative. A well-functioning DIS provides confidence to depositors by safeguarding their funds in the event of bank failures, thereby promoting financial stability and trust in the banking system. Moreover, it fosters greater transparency and accountability among financial institutions, encouraging prudent risk management practices and reducing moral hazard. By implementing an effective DIS, China can enhance the resilience of its financial sector, attract foreign investment, and facilitate the efficient allocation of capital. Additionally, it demonstrates China's commitment to financial reform and modernization, aligning with its broader economic development objectives. Indeed, the Deposit Insurance System (DIS) has the potential to significantly mitigate financial risks stemming from internal vulnerabilities within banks. Currently, the government assumes the role of providing credit guarantees for the entire financial industry, essentially backstopping all financial activities. This approach places a heavy burden on the government and fails to hold individual financial institutions accountable for their own risk-taking behavior. By implementing a DIS, the responsibility for managing and mitigating risks within individual banks is shifted to the institutions themselves. Banks are incentivized to strengthen their risk management practices, improve governance structures, and maintain adequate capital reserves to protect depositors' funds. This not only promotes stability within the banking sector but also reduces the systemic risks associated with government bailouts. Furthermore, a well-designed DIS can enhance market discipline by imposing consequences for banks that engage in excessive risk-taking or poor management practices. Knowing that their deposits are protected up to a certain threshold by the insurance scheme, depositors can make more informed decisions about where to place their funds, thereby incentivizing banks to operate prudently. The establishment of a Deposit Insurance System (DIS) in China presents unique challenges due to the country's distinct economic, financial, and legal characteristics. The transition from a system of full reimbursement to one of fixed reimbursement, in particular, carries certain risks that need to be carefully managed. One potential risk is the possibility of a crisis of public confidence in the banking system. If depositors perceive that their funds are less secure under the new DIS framework, they may be more inclined to withdraw their deposits en masse, triggering a run on banks. This could exacerbate liquidity pressures on individual banks and undermine overall financial stability.

Moreover, the transition to a fixed reimbursement system may increase the risks faced by individual banks. Under the previous system of full reimbursement, banks were effectively shielded from the consequences of their own risky behavior, as the government bore the ultimate responsibility for deposit insurance. With the shift to fixed reimbursement, banks will be compelled to bear a greater share of the risk associated with their operations. This could incentivize banks to adopt more prudent lending and investment practices, but it also exposes them to potential losses in the event of financial distress. The establishment of a DIS requires robust legal and regulatory frameworks to ensure its effective operation. China will need to enact laws and regulations that clearly define the rights and obligations of depositors, banks, and the deposit insurance agency. Additionally, mechanisms for supervising and enforcing compliance with these regulations will need to be established to maintain the integrity and credibility of the DIS. The complexity of China's financial market, coupled with the varying conditions of its banks, underscores the need for a nuanced approach to deposit insurance rates. Indeed, factors such as asset size, internal mechanisms, and risk profiles can result in significant disparities in the riskiness of different financial institutions. In this context, a one-size-fits-all approach, such as a single rate system, may not adequately reflect the diverse risk exposures within the banking sector. Instead, adopting a system of differential rates, wherein premiums are tailored to the risk profile of each individual bank, appears to be more suitable for promoting long-term development and stability in the financial system. By imposing higher premiums on banks with greater risk exposures and lower premiums on those with stronger financial positions, a differential rate system incentivizes prudent risk management practices and discourages excessive risk-taking. A differential rate system can help address concerns related to moral hazard and adverse selection. Under a single rate system, banks with varying risk profiles may be subject to the same premium rates, potentially leading to situations where riskier banks are subsidized at the expense of more prudent institutions. In contrast, a differential rate system ensures that banks bear the costs associated with their individual risk profiles, thereby promoting greater accountability and transparency in the financial sector.

Furthermore, differential rates can contribute to a more equitable and efficient allocation of resources within the banking industry. By accurately pricing the risk associated with each bank, the system encourages capital to flow towards institutions with sounder risk management practices, while discouraging investment in riskier entities. This can help channel funds towards productive uses, fostering sustainable economic growth and development. The transition to a fully implemented risk-adjusted differential rate system in China is indeed a multifaceted process that requires careful planning and preparation. This transition typically unfolds in three distinct phases, each building upon the previous one to gradually establish a more sophisticated and responsive deposit insurance framework. The initial step involves the adoption of a single rate system across all insured institutions. This serves as a foundational stage, providing a uniform basis for deposit insurance premiums and laying the groundwork for subsequent adjustments. During this phase, regulators can gather essential data, assess risk profiles, and establish the necessary infrastructure for more targeted risk assessment and pricing. The second phase entails the introduction of a pilot program for implementing a differential rate system in selected banks. This pilot initiative allows regulators to test the feasibility and effectiveness of differential rates in practice, while also providing valuable insights into the operational challenges and opportunities associated with such a system. By carefully selecting pilot institutions and closely monitoring their performance, regulators can refine their methodologies and fine-tune the parameters of the differential rate framework. Finally, the third and most advanced phase involves the nationwide implementation of a risk-adjusted differential rate system. Building upon the lessons learned from the pilot program, regulators can scale up the differential rate model to encompass all insured institutions, incorporating sophisticated risk assessment tools and methodologies. This phase represents the culmination of efforts to tailor deposit insurance premiums to the specific risk profiles of individual banks, thereby promoting greater stability and resilience in the financial system. Throughout this process, effective communication, stakeholder engagement, and capacity-building initiatives are crucial for ensuring the smooth transition to a risk-adjusted differential rate system. Regulators must work closely with banks, industry stakeholders, and relevant authorities to address any challenges and concerns, while also fostering a culture of transparency, accountability, and trust within the financial sector.

In conclusion, while the transition to a risk-adjusted differential rate system in China may involve complex and iterative steps, it represents a significant advancement in deposit insurance policy and risk management practices. By gradually phasing in differential rates and leveraging pilot programs, China can enhance the effectiveness and efficiency of its deposit insurance framework, ultimately contributing to the stability and resilience of its financial system.

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