Promoting Financial System Stability and Resilience during COVID-19 and other Disruptions: The Role of Deposit Insurance and Resolution Mechanism

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10.0 Introduction

The COVID-19 pandemic signifies the toughest test of the global financial system since the financial crisis of 2008, as it poses historical health, economic, and financial stability challenges (IMF, 2020). In contrast to the 2008 crisis, the COVID-19 shock originated outside the financial system. The COVID-19 Pandemic, which began as a health crisis, has degenerated into an existential crisis, as it has taken its toll on socio-economic life globally.

The prolonged threat posed by the Covid-19 Pandemic and its ongoing impact on the global and domestic macro-financial environment remains unprecedented in the economic history of nations, despite the fact that nations have adopted a diverse range of responses to mitigate its effects on their citizens. The pandemic compelled many governments across the globe to restrict the movement of their populations to a degree unimaginable, halting socio-economic activities as a means of stemming the spread of the virus. While the lockdown strategy seems to have worked by slowing down the rate of new infections and deaths, it has probably caused one of the worst recessions in recent history. COVID-19 has had an extraordinary impact on financial institutions' day-to-day operations. The rapid adoption of work-from-home arrangements has extended the breadth of cyber dangers and third-party service provider reliance. As banking institutions reduced physical interactions, the Pandemic has increased the adoption of digital services. COVID-19 has reinforced the need to promote resilience amidst other disruptions due to rapid technological change in the financial system. The pandemic has made authorities turn to deposit insurance, along with monetary/fiscal measures, to help restore market confidence and promote financial system stability.

Following the 2008 financial crisis, the significant role of deposit insurance as a financial safety-net player was apparent across many jurisdictions of the world. The 2008 crisis also birth the concept of a bank resolution framework to complement deposit insurance in order to ensure an orderly resolution of banks and protect depositors from bearing the cost of bank failures. This is because effective deposit insurance management remains critical to the management of bank failures through depositors’ confidence to prevent the likelihood of bank runs. Depositors must have confidence in the authorities' ability to manage a bank's failure, whether through the use of resolution mechanisms or, in the case of smaller banks, through the prompt payment of protected deposits. Although deposit insurance is a critical pillar of trust in the financial industry, it is however most effective in ensuring financial stability when used in conjunction with other trust pillars such as financial supervision, resolution mechanisms, and, ultimately, central banks' lender of last resort function. A stable financial system is capable of allocating resources efficiently, assessing and managing financial risks, maintaining employment levels close to the natural rate of the economy, and avoiding relative price movements of real or financial assets that would jeopardize monetary stability or employment levels.

It is worth noting that the impacts of the COVID-19 pandemic on the economy and financial stability are being moderated by massive policy responses across the globe. This study, therefore, seeks to discuss the role of deposit insurance and resolution mechanisms in promoting financial system stability and resilience during the COVID-19 crisis. Following this introduction, the rest of the study is as follows: Section 2 conceptualises financial system stability and resilience; Section 3 discusses the impact of the pandemic on the global and domestic economies; Section 4 establishes the relationship between the pandemic and financial system while Section 5 highlights the role of deposit insurance in the financial system. The concept of the deposit insurance system in Nigeria is discussed in Section 6, while Section 7 contains the conclusion.

10.1 Concept of Financial System Stability and Resilience

Financial system and resilience are often used interchangeably in the literature as both aims to ensure robustness in the financial system. This section, however, seeks to draw a line between the two concepts, especially for the sake of this study. There is no consensus as to a standard definition of financial system stability among financial stakeholders across the globe. However, as defined by Schinasi (2004): (a) the financial system's ability to: (b) facilitate the efficient allocation of economic resources, both spatially and especially temporally; (c) assess, price, allocate, and manage financial risks; (d) maintain its ability to perform these critical functions—as defined by Schinasi (2003). According to Schinasi (2004), when a financial system is able to facilitate (rather than impede) the performance of an economy and dissipate financial imbalances that occur endogenously or as a result of substantial adverse and unforeseen events, it is in a stable state.

Similarly, according to the World Bank (2019), Financial stability is achieved when financial imbalances that arise naturally or as a result of big adverse and unexpected events are dissipated by the financial system. Financial systems are defined as stable when they can efficiently allocate resources, assess and manage financial risks, maintain employment levels close enough to the natural rate of the economy and eliminate relative price movements of real or financial assets that could harm monetary stability or employment levels. It is worth noting that the financial system is constantly subjected to shocks that have a detrimental effect on the system, frequently imposing unimaginable hardships on a large number of its stakeholders, particularly households. Thus, financial system stability refers to the ability of the financial system, i.e., the primary financial markets and institutional financial system, to withstand economic shocks and carry out its essential duties of financial intermediation, risk management, and shock absorption.

Financial system resilience, on the other hand, encompasses more than individual institutions' ability to weather shocks, as it is concerned with the system's proclivity for shocks in the first place, as well as its capacity to adapt and continue to evolve as a result of them. According to Berry, Ryan-Collins, and Greenham (2015), financial system resilience is the ability of the financial system to adjust to both short-term shocks and long-term changes in economic, social, and ecological situations while continuing to serve the real economy. While a stable financial system is one that can absorb shocks, a resilient financial system can adapt and reorganize itself in reaction to a shock as well as absorb it (Jain, 2021). That is, no assumptions are made regarding the magnitude of probable shocks; rather, resilience seeks to develop systems that are capable of dealing with the full range of conceivable shocks.

From the foregoing, the focus of financial system regulation and oversight is expected to be on ensuring that the financial system as a whole, as well as individual financial institutions, are not

only capable of absorbing shocks but also of adapting to changing conditions. This is because a resilient system is capable of rapidly recovering from the harm caused by shocks and continues to operate during times of disruption, ensuring that lending continues and capital flows smoothly.

10.2 COVID-19 Pandemic: Effects on the Global and Domestic Economy

A typical global shock, such as the COVID-19 pandemic, wreaks havoc on the entire financial system, with ripple effects extending to and affecting almost every other sector of the economy in virtually every country across the globe. The COVID-19 Pandemic, which began in late 2019, has caused unthinkable havoc on human society, resulting in massive loss of human life and economic prosperity. The direct consequences of the pandemic, as well as the indirect effects of containment measures, wreaked havoc on global, regional, and national economies. On the back of low global growth in 2020, the Pandemic's economic losses were measured in trillions of dollars. In many countries, unemployment has risen, combined with inflation, to raise poverty levels. According to the IMF in October 2021, the Pandemic has forced between 65 million and 75 million people into poverty. Thus, the COVID-19 epidemic can be termed the most severe challenge the global financial system has faced since the 2008 financial crisis.

The COVID-19 pandemic plunged the global economy into an unprecedented severe recession in 2020, with some lasting impacts through various transmission mechanisms like reduced investment, erosion of human capital due to unemployment and loss of schooling, and disruption in global trade and supply linkages. There were deeper economic recessions and slower recoveries, particularly in countries where COVID-19 pandemic cases were on the relatively high side during the year. The COVID-19 pandemic has incurred significant and escalating human and economic consequences around the world, including a decline in global economic activities. For instance, the global economy was plunged into recession in 2020, with sluggish recovery growth in 2021.

According to the World Economic Outlook of the IMF, January 2022 update, the global GDP growth was revised to negative 3.1% in 2020 on the back of the pandemic, while the economy returned to positive growth of 5.0% in 2021, though weaker than expected. Advanced Economies contracted by 4.5% in 2020, with the economies of the United States, Germany, France, Italy, Spain, and the United Kingdom contracting by 3.4%, 4.6%, 8.0%, 8.9%, 10.8%, and 9.4% in the year, respectively. The Sub-Saharan African economy also contracted by 1.7% in 2020, with Nigeria and South African economies recording a contraction of 1.8% and 6.4%, respectively. The countries, however, recorded positive growth in 2021 due to concerted policy responses to contain the pandemic and the base effect. It is worth noting that Nigeria’s economy slipped into a severe recession in 2020 due to a negative shock in oil prices and disruption in economic activities occasioned by the COVID-19 outbreak. However, Nigeria’s economy exited recession in the fourth quarter of the year after recording economic growth of 0.11%.

Similarly, the World Trade Volume (goods and services) shrank by 8.2% in 2020 amidst the shutdown of tourism frontiers and workplace closures, while the global trade volume grew by 9.3% in 2021 (IMF, 2022). In addition, workplace closures disrupted supply chains and lowered productivity & income while triggering business closures and job losses. For instance, the United States job losses during week 4 of March 2020 exceeded 6.6 million when compared with about 280,000 just two weeks before. It is also noteworthy that the OPEC basket crude oil prices dropped by 65% from $69.38 per barrel as of 3rd January 2020 to as low as $18.05 per barrel as of 30th April 2020, resulting in a cut in oil production quotas of many countries to shore up prices.

10.3 COVID-19 Pandemic and Financial System

The COVID-19 epidemic has caused substantial economic disruptions around the world, which has weakened credit conditions and lowered asset prices in the financial system. In several jurisdictions, house and commercial mortgage delinquency rates have risen significantly, posing a risk to bank loan portfolio asset quality. If the current situation persists, banks may be obliged to boost their loan loss provisions (LLPs) and allowances to deal with a significant increase in non-performing loans (NPLs) as a result of the growth in household and business defaults. However, continued deterioration in bank asset quality and earnings performance may limit banks' ability to tolerate larger loan losses over time, compromising their ability to offer credit and contribute to the economy's recovery.

The Financial System is confronted with a two-fold challenge: maintaining the flow of funding to the real economy while also maintaining resiliency. During the COVID-19 epidemic, intermediation decreased: loan disbursement and collection decreased, putting financial institutions' liquidity at risk. As debt repayment becomes more difficult due to decreased unemployment, earnings, and economic activity, asset quality has deteriorated. As a result of the hard macroeconomic environment brought on by the Pandemic, banks' profits from operations have decreased, and they have less access to capital funding. This has the potential to restrain bank capitalization, putting the financial system's stability at risk.

10.3.1 COVID-19 Effects on the Banking Industry

Banking systems began the COVID-19 crisis with higher levels of capital and liquidity than in previous crises. However, vulnerabilities exist in a number of areas. Numerous banks continue to suffer from poor valuations, low profitability, and large levels of non-performing assets, particularly in some parts of the world (IMF, 2020a; ECB, 2020a). Irrespective of the crisis, problems such as poor interest margins may be exacerbated by the low-interest rate environment and flat yield curves currently prevalent in many jurisdictions (Patalano and Roulet, 2020). Additionally, a protracted and severe disruption could result in a significant increase in non-performing loans (NPLs) as a result of an increase in household and business defaults, forcing banks to increase their loan loss provisions (LLPs) and allowances. Notably, a decline in bank asset quality and earnings prospects may have an effect on banks' ability to sustain increased loan losses.

Specifically, the impact and implications of COVID-19 for the domestic banking system are highlighted below:

- Regulatory forbearances can bring to bear a higher tendency for manipulative accounting and slacked compliance to extant prudential guidelines by fraudulent CEOs, thereby raising the stake of regulatory oversight.
- Greater liquidity injection into the economy through increased banking sector access to intervention funds may lead to inflationary tendencies.
- Disruption to business due to measures to curtail the spread of the virus may cause actual banking system income to decline.
- Increased risks of higher NPLs (debt default rates), cancellations of contracts, or “no-shows” in the banking system on disruption to households and business activities.
- Difficulty in accessing bank branches for routine operations
- Disruption in the flow of credit

- Worsening Liquidity Position
- Increasing vulnerability to Cyber Fraud

10.3.2 COVID-19 Pandemic and Effect on Financial Markets

The COVID-19 pandemic has placed the global financial system under strain. Some of the global financial stability issues generated by the COVID-19 pandemic as documented by IMF include recession and financial crisis (risk to global economic recession and financial crisis due to debt overhang); asset prices plummet (sharp fall in the price of risk assets, such as equities, commodities and high-yielding bonds); sharp tightening of financial conditions (the speed at which global financial conditions tightened prompted global central bankers to provide liquidity through swap line arrangements, and reactivated programmes, like purchase of riskier assets to prop liquidity); unprecedented outflows (emerging markets saw unprecedented portfolio outflows in terms of both size and speed, and such financial deleveraging may aggravate selling pressures); skyrocketing speeds/borrowing costs (lowering credit ratings have resulted in sharp rise in borrowing costs and so weakens overall borrowers' credit quality); and lower bank capitalization (capital relative to assets) (based on equity market valuations have worsened in recent times which indicates investors' concerns about prospects and profitability of global banking systems).

10.4 Deposit Insurance System (DIS) and its Roles in the Financial System

A deposit insurance System (DIS) is a safety net instrument used by governments to ensure the stability of the banking systems and to protect depositors, in full or in part, in the event of bank failure. Bank deposit insurance systems arose from the need to safeguard depositors from loss, as well as the banking system from instability caused by runs and loss of confidence (Ogunleye, 2002). Similarly, a deposit insurance system (DIS) is a collection of specific functions (whether performed by a dedicated legal entity or not) that are essential to providing protection to bank depositors, as well as their interaction with other financial system safety net participants in order to maintain financial stability (FSB, 2012).

The Banking Act of 1933, which established the Federal Deposit Insurance Corporation (FDIC), paved the way for the development of comprehensive DIS. The public initiative was prompted by the tragedy of the Great Depression and the Federal Reserve's failure to prevent the subsequent epidemic of bank failures, which totaled almost 10,000 between 1929 and 1933. (Eisenbeis and Kaufman, 2010). However, it is documented that in 1924, former Czechoslovakia implemented a comprehensive credit and deposit insurance scheme (McCarty, 1980). Since then, DIS has become a more important part of financial safety-net arrangements employed by numerous governments across the world to safeguard the stability of banking systems and protect bank depositors from huge losses due to bank collapses (Demirguc-Kunt, Karacaovali, and Laeven, 2005). DIS has a stabilizing effect in normal circumstances by lowering the danger of contagion to illiquid but solvent banks and assisting in the orderly resolution of distressed banks. DIS also improves financial sector competition, encourages sophisticated depositors to monitor banks and enforce market discipline, reduces government obligations (that is, contingent liability), and gets banks to contribute to the cost of bank resolution, in addition to its primary role of protecting the wealth of the average household in the event of bank failure. Additionally, DIS stabilizes the financial system in the case of bank failures by guaranteeing depositors quick access to their insured cash regardless of whether their bank falls, lowering their incentive to stage a bank run.

Furthermore, the following importance can be attributed to DIS:

- It minimizes or eliminates the risk that depositors placing funds with a bank will suffer a loss.
- It offers protection to the depositors of households and small business enterprises, which may represent life savings or vital transaction balances.
- Creates a formal mechanism for addressing bank failure, thereby enhancing public confidence in the banking system.

10.5 Deposit Insurance in Nigeria

The Nigeria Deposit Insurance Corporation, which administers deposit insurance in Nigeria, was founded and began operations as a risk minimizer in 1989, with the following mandate: Deposit Guarantee, Distress Resolution (Responsibility undertaken in consultation with Central Bank of Nigeria (CBN)), Bank Supervision (Responsibility is shared with the Central Bank of Nigeria) and Bank Liquidation. This section highlights the role of DIS in promoting financial stability, especially during the pandemic in Nigeria.

10.5.1 The Role of Deposit Insurance in Promoting Financial Stability

The Pandemic has undoubtedly impacted not just the macroeconomic environment but also the financial system's stability. The pandemic's worsening economic conditions, as well as the weaknesses of banks' financial conditions, have thrown public confidence into disarray. This is because any interruption or difficulty in a financial institution would not only aggravate the condition of depositors but it might also lead to systemic instability. Deposit Insurance serves a useful purpose in this regard as it stabilizes the financial system in the event of bank failures by assuring depositors of rapid access to their insured deposits even if their bank fails, hence decreasing their motivation to stage a bank run.

DIS strengthens financial system stability in many ways:

a. Instilling confidence in insured institutions through:
   - Supporting and contributing to an orderly or proper functioning of the payment system; and
   - Assuring the public that a Naira in their bank accounts is the same as a Naira in their pockets.

b. Encouraging banks to manage risks responsibly and reduce moral hazard by:
   - Providing incentives for sound risk management of banks.
   - Supporting market discipline through limited insurance coverage.

Other financial system stability functions of DIS include:

1) Reducing the likelihood of bank runs and preventing banking panic from spreading quickly to other banks - the so-called contagious effect, though:
   - Assurance of deposit guarantee
   - Public awareness campaign on DIS and deposit safety under DIS
   - Prompt reimbursement of deposit to the coverage limit in the event of bank failure.
2) Minimizing the severity of an economic downturn by mitigating the depositors' repercussions of insured institution failures. For instance, altering the coverage's level and scope during times of crisis.
3) Instilling discipline in member institutions and motivating responsible behavior by:
   - Requiring riskier banks to pay a higher premium.
   - Imposing fines for regulatory rule violations.

- Threats of membership termination and cancellation, as well as the removal of Directors and/or Officers.

4) DIS also helps banks improve their operational standards by enforcing sound governance and healthy banking practices that promote prudent risk management, integrity, and fair/equitable consumer treatment.
5) By aggressively encouraging financial literacy, DIS helps to maintain market discipline since financially literate clients are more likely to make reasonable decisions about risk-reward trade-offs.
6) DIS, in partnership with other safety-net players, assists in the establishment of additional consumer protection infrastructure, including alternative dispute resolution mechanisms, to ensure that all customers receive equitable treatment.

10.5.2 DIS Support for Financial System Stability during the Pandemic

The DIS provides support for financial system stability through the following:

1. Rapid activation of business continuity plans and crisis management frameworks to assure the continued availability of critical functions and operations (e.g., premium collecting and reimbursement systems) and to ensure complete system preparedness;
2. Ensuring readiness for deposit pay-outs – online filling of claims to ensure rapid depositor reimbursement;
3. Temporary suspension, postponement, or relaxation of certain requirements and delayed implementation of scheduled stress testing of insured institutions;
4. Increased surveillance and monitoring of licensed financial institutions, including the revision of risk assessment frameworks on a periodic basis and extensive monitoring of banks' liquidity condition;
5. Review in the level and scope of deposit insurance coverage for contemporaneous adequacy;
6. Increased campaign on public awareness about deposit insurance and the safety of insured deposits through relevant social media platforms such as Facebook, Twitter, Instagram, YouTube, and Linkedin, as well as TV/Radio;
7. Increased Information Sharing with other participants in the safety net; and
8. COVID-19 Depositor Public Awareness Campaign on Radio and Television.

10.5.3 DIS and Resolution Mechanism: Role in Financial System Stability

Resolution is the use of resolution tools by resolution authorities to restructure banking institutions in order to protect public interests, such as the important continuing operations of the bank(s), and to ensure financial system stability. In line with its mandate, one of the main responsibilities of the NDIC is to make sure that failing, and failed institutions are resolved as soon as possible in an orderly manner to: maintain critical function, protect public money and maintain financial stability. It is, however, noteworthy that the responsibilities for bank failure resolution is shared between the Central Bank of Nigeria and the NDIC.

Bank Resolution Phases can be divided into two:

a. Initial Resolution Phase, which involves reimbursing insured depositors and resolution of failed banks.
b. Post-Resolution Phase, which involves the sales of physical assets and recovery of debts owed to the failed banks.

The NDIC derives its resolution power from the NDIC 2006 Act, which granted the power to the NDIC to carry out the following resolution options:

- The Act Open Bank Assistance;
- Depositors Reimbursement;
- Purchase and Assumption;
- Bridge Bank; and
- Assisted Mergers and Purchase of Assets.

The bank failure resolution authorities could also employ the following tools:

- Holding and withholding action
- Guarantee
- Removal and appointment of Management
- transfer the bank (whole or part of the banking business) to third-party private purchasers

However, Section 34(3) of BOFIA 2020 states that the CBN shall have power at any time to acquire the shares of any failing bank up to a level that guarantees its control by the bank. Provided such equity shall be disposed of at the earliest suitable time.

10.6 Conclusion

COVID-19 has thrown the world economy and banking system into disarray. Its consequences harmed many countries' growth prospects, and the enormous losses are still being counted. It is difficult to estimate the complete cost of the pandemic across countries as policy responses to the pandemic are still changing. However, the economic and financial system outlooks, on the other hand, have been brightened as a result of coordinated policy initiatives across jurisdictions, especially in Nigeria. The function of Deposit Insurance in maintaining financial system stability and addressing issues during the pandemic is one of these key endeavours. Deposit insurers' efforts around the world, particularly in Nigeria, have proven effective, as seen by the banking sector's resiliency during the pandemic.

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