DEPOSIT GUARANTEE SCHEMES JOIN FINANCIAL SAFETY-NET

Eugen Dijmărescu*

Abstract: *Deposit Guarantee Schemes (DGS) become more visible under the current conditions of the world financial markets. If those have played in the past a rather discreet role for social stability through the function of pay box following a bank failure, the recent crisis put them in a new light, once the guarantee ceiling for eligible deposits grew in order to make for the accumulation of wealth worldwide and the increased risk incurred by the leverage of banking operations. Consequently, the resources accumulated by the DGS from the member banks and their proper management make possible their involvement in pre-emptive actions aimed to avoid bankruptcies via special administration and purchase of assets and assumption of liabilities. These new attributes give DGS a role in the mechanism of financial safety-net, along the supervisors of the market. Hence, an increased preoccupation for applied corporate governance has developed and Core Principles for Effective Deposit Insurance Systems have been adopted by the Basel Committee on Banking Supervision together with International Association of Deposit Insurers. Concurrently, the EU Commission has put forward a process for reviewing the Directives 94/39 and 09/14 EC, in order to make the European DGS more prepared to deal with above mentioned issues and bestow increased confidence upon depositors.*

Keywords: *deposit guarantee scheme, deposits, banking system, surveillance, risks*

Recent developments in the World financial market, touched deeply by the first outburst of the globalization crisis, have brought upfront the search for reassessing the role of the deposit guarantee schemes (DGS) within the broader task of achieving a new monetary order sought by G20 for the past two years. Indeed, the DGS, especially in Europe, have primarily assumed up to now the role of compensating the loss incurred to customers by the insolvency of banks. Hence, their prime task was to back up the social stability, as their competence was to provide liquidity mainly to natural persons and, to a more restricted scale, to corporate.

The huge amount of money raised mainly out of taxpayers revenues and spent since 2008 by those policies seeking to put a brake to the derailment of the international banking system, have unveiled the capabilities of DGS, especially in those countries where by their powers and organization the DGS are the alternative or the complement to scarce resources of public treasuries. Almost all political and scientific forums have highlighted the support of the

* **Eugen Dijmărescu**, PhD, is currently the CEO of the Bank Deposit Guarantee Fund (FGDB) in Romania, the sole such organization in the local banking market since 1996. Before joining the FGDB he served as Deputy Governor to the National Bank of Romania, responsible, a.o for financial stability and open market operations. He has also been a member of the Board of the Central Bank. He is an associate professor to the Romanian-American University of Bucharest and an associate fellow to the National Institute for Economic Research of Romania. Opinions expressed herein belong to author and they do not bear any responsibility of the Romanian Bank Deposit Guarantee Fund. E-mail: eugen.dijmarescu@fgdb.ro

head of states and government of G20, of the institutionalized watchdogs for financial stability (IMF, BIS, ECB), or even prominent economists for the "market solution", i.e. for a search for mechanisms and instruments to intervene, if needed, within the mechanics of the market. This is a normal choice for preserving the system that brought prosperity to all and has endorsed the competition. In this context the legitimate question is: are the DGS ready for assuming a role towards the future? Are they ready to assume new responsibilities to the traditional task of being a "pay box"?

Within the European Union the DGS are organized according to national regulation and with the support of the common guide represented by the Directive 94/19 EC and its subsequent amendments (Directive 09/14 EC). The organization of the European DGS goes from entities located within the central banks to independent bodies, either public or private, one or more for the same banking market, with resources derived from ex-ante or ex-post contributions of the member banks. Until now the EU has not succeeded to give DGS the feeling of cohesion from the functional point of view (even the term "scheme" generalizes the variety). Moreover, the different chain of their command has not entitled the DGS to the position of a partner to EU bodies and even their professional association, the EFDI (European Forum of Deposit Insurers) is only consulted by the EU divisions, if deemed necessarily. This is an outdated behavior compared to the BCSB/ IADI approach recognizing that "a deposit insurance system clarifies the authority's obligations to depositors, limits the scope for discretionary decisions, can promote public confidence, helps to contain the costs of resolving failed banks and can provide countries with orderly process for dealing with bank failures and a mechanism for banks to fund the cost of failures".[1]

Nevertheless, a noted realignment of politicians from the trenches of claiming new public debt to cope with bank insolvency increases the attraction for DGS involvement. This is due to the insurer capability of DGS which, by collecting annual premiums from the banks, gather resources from the banking system which spares thus public treasuries and the taxpayers from new constraints.[2] From this point another discussion may be opened about the availability or scarcity of DGS resources, the timing for their collection and the related costs to the banks of the insurance extended to their customers by another entity.

The debate on the new role of DGS was initially, not to say properly, supposed to end with a revised and updated text of the Directive 94/19 EC before the end of year 2009. At least that was the spirit of Pittsburgh and London of G20 Summit. But another year has elapsed without much progress. On the contrary, an icy analysis of the changes brought to the proposed text of the EU Commission by the member states in the second half of 2010 enlightens the setback from the pan European view of comprehensive approach to a mere national behavior that will further deprive Europe of the power to pair with other major players in dealing with the issues of the globalized financial market. Examples that may be quoted are: EU regulators and

[1] Basel Committee on Banking Supervision/International Association of Deposit Insurers - Core Principles for Effective Deposit Insurance System, June 2009.

[2] "Taxpayer money should not be used again to cover bank losses" - Ana Maria Tarantola, Strengthening Financial Stability: The Contribution of Deposit Insurance, IADI/EFDI Annual Conference, Rome 2010. See also Pittsburgh G-20 meeting, September 2009.

supervisors have authorized banks to offer their customers the freedom of choice between currencies for their deposits and banking operations, but when it comes to whatever form or repayment, derived from insolvency of a bank, the limitation to national currency is preferred; another example is the reduction to "non-prevented" possibility of borrowing/lending among EU DGS which is a straighter indication of refraining from further rise of money in the domestic market via floating treasury bonds or other securities sold to taxpayers. The inconsistence stemming from the setback from the idea of fostering similar regulation of DGS throughout EU will unavoidable affect the dynamics of European solidarity while confronted with common threats that may occur also in the framework of cross border banking activity. The debate about which of the approaches bear a higher risk should be moderated by the forward looking attitude required for better mastering of financial market developments in the aftermath of the recent drop offs.

However, related to the proposed amendments one issue needs to be mentioned: the more ambitious, deepen shift of the DGS from its current "pay box" statute into a responsible component of financial stability, by the endowment of DGS with the P&A function (Purchase and Assumption, in which all deposits – liabilities - are assumed, via intermediation of the DGS, by an open bank, which also purchases some or all of the failed bank's loans - assets). At least, with reference to this issue, it should be remarked the *European vision* addressed by the Commission to national regulatory authorities, with the prospect for a better cohesion of DGS, thus making them partners to the monetary single market of Europe and to free capital movement.

The EU Commission project may be considered as up to the day minimum consensus possible. Nevertheless since the European road toward finalizing any document is so much lengthened and as the prospect for viewing the phenomena which raised the initial interest repeated seems to be fading away, the chance for getting a final text so much different from the original is no longer a surprise. This might be another proof that Europe is so much keen to commit public authorities even if solution is deemed to be more expensive than of freeing the market more.

With respect to deposit insurance, the main issues are: (a) a unified guarantee ceiling of € 100,000 shall be applied by all member states, which establishes equal opportunities to customers in choosing their bank, as well as to local and foreign branches of banks from other EU members. Worth mentioning is the provision that this ceiling shall be applied by all credit institutions present in a market, so that branches are either affiliated to a DGS outside the host country applying at least the same ceiling, or they shall join the DGS from the host country which endorses the EU ceiling; (b) shortening of payout deadline to 20 workable days for the guaranteed amount of the restitution, so that social tension and possible contagion that may occur shall be contained at an earlier stage; (c) introduction of an automated system of payout for the restitution amount by the insurer, thus sparing the customer from queuing for getting his right; (d) introduction of a non-discriminatory and equal treatment to all natural and legal persons, meaning that all corporate enjoy the same benefit as the natural persons; (e) the assumption by the DGS from a host country of the function of proxy to depositors at branches set up by credit institutions from other member states, on behalf of the scheme from their home state.

According to data available for Q III 2010, the impact of the raising of the guaranteed ceiling from € 50,000 (valid during 2010) to € 100,000 (valid since January 2011) for the deposits to credit institutions member of the Romanian Bank Deposit Guarantee Fund, increases the value of insured deposits by 8.3 p.c., which might be assimilated to a similar growth of confidence. These data cover currently eligible deposits, according to local regulations, without measuring the potential impact of enlarged, under discussion, area of deposits to be covered under the revised Directive.

As it seems to be no dispute among the EU Commission and the member states with regard to the level of the guaranteed ceiling, in other areas the harmonization has fewer supporters. If the reason for DGS is primarily of being transparent and able to respond to customers need with less delay versus their emergencies, the authorities are called upon to forget bureaucratic arguments and replace them by commitment. This should be more obvious since the savings of the customers are the perennial and healthy source for economic growth and financing public debt.

The second set of proposals which are deemed to increase transparency and confidence in the insurance mechanism and to support the DGS power to intervene when needed concerns the way resources of DGS are built and their size. The long term target for each EU member is to reach resources at a level of 1.5 p.c. of the overall covered deposits of the member banks, collected through an ex-ante contribution policy, with the supplementary possibility of getting an additional ex-post contribution equal to another 0.5 p.c., if needed. Before venturing into the debate about the sufficient level, the possibility for a big bank failure should be reassessed together with the alternatives for increased financing of DGS.[3] The general prevailing view is that resources gathered by DGS are considered reliable to cope with a medium banking crisis and they shall be sufficient in order to prevent it, but those are not supposed to be high enough to resist a systemic outburst. As EU proposal for revision of the Directive 94/19 EC speaks out, "the share of irrevocable payment commitments...shall not exceed 30 p.c. of the total available financial means".

It is fair to say that for Romania the proposed target has reached (for the deposits selected as eligible by current rule) the level of 1.25 p.c. in 2010. Hence, noting that contribution level for 2011 has been set at 0.3 p.c. of eligible deposits[4] and the net revenue from the proper management of resources is added to the overall available fund, it is foreseeable that the target shall be achieved sooner compared to those countries where the financing applied till now has been only ex-post.

Europe is a land of diversity when speaking about DGS resource building: from ex-ante contributions from the banks (which equals to deposit insurance) to ex-post (drawing when needed) there are approaches which are impregnated with national content. Confronted with the dangers highlighted by the crisis, the EU Commission favors the idea of ex-ante contributions, at least once a year (but not preventing additional financing from other sources), coupled, if deposits become unavailable, with extraordinary contributions not exceeding 0.5 p.c. of the eligible deposits per calendar year (ex-post). The coherence of the proposals is sometimes weak: while the December 2010 revised text

---

[3] The debate around „Too big to fail" rose along the strengthening of the crisis retreat signals, but solutions for another governance of banking practice, a priority claimed by G20, has not been envisaged yet, thus „best practices" remaining less regulated.

[4] Romania – Letter of Intent and Technical Memorandum of Understanding, IMF, September 2010.

of the changes to be brought to the Directive invite member states to ensure that DGS have in place adequate alternative funding arrangements to enable them to obtain funding on short notice where necessary, the Stand-by arrangement of Romania with the IMF/EU speaks unilaterally about compulsory drop-off of any stand-by credit lines opened to the DGS by banks, although this instrument may have been the answer to the EU concern.

Moreover, exactly because wrongdoing has characterized most endeavors to deal with banking resolution, the proposal of letting the DGS to use part of their financial means in order to avoid a bank failure is central to the new role to be entrusted to DGS as partner for financial stability. This is an indication marking the appreciation for the FDIC experience and a closer approach of dealing with the banking sector on the two shores of the Atlantic. Purchases of assets and assumption of liabilities provides for both social benefits and financial stability inputs, as savings compared to compensation payout and a bank failure. However, the involvement of a DGS in P&A operation shall comply with the need of maintaining its available financial means above 1 p.c. of eligible deposits, after such a measure, without other restrictions to financing the transfer of deposits to other credit institution.

When it comes to risk based contributions the suggested model is a discussion around the combination of non-risk and risk-based elements. The non-risk based element of the contribution should be based on the amount of the covered deposits, while the risk based element of the contribution involves a number of indicators reflecting at least the capital adequacy, the asset quality, liquidity and profitability. Everybody understands that globalization has developed within the banking entities a lot of financial instruments bearing different risk. When it comes the time of charging insurance premium for the deposits taken based on the degree of risk exposure of individual member banks one should not favor any room for speculative rumors instead of transparency. Even if the issue requires further analysis, proper information would enhance the trust of depositors into the DGS exposure versus the banks, but also into the offer of the banks themselves.

As the BCBS/IADI Core Principles for Effective Deposit Insurance Systems claims, the reform of deposit insurance systems requires them to become part of a well-constructed financial system safety net, including prudential regulation and supervision, a lender of last resort and deposit insurance[5]. The Core Principles require the approval of IMF board in order to make them the linchpin for future FSAP reviews. Even if the Core Principles are a non-compulsory framework for DGS conduct, they testify of the will to establish best practices by national authorities committed to enhance or put in place effective DGS. Their implementation will be further tested during 2011 by joint mission of IADI/IMF, following the pilot cases of 2010 and the comprehensive methodology for evaluation of compliance that has been developed.

As outlined during the EFDI Annual Conference of 2010, three problems lie at the root of great issues concerning DGS governance: a) who selects the targets; b) who is responsible for pursuing them, and

[5] Basel Committee on Banking Supervision/International Association of Deposit Insurers - Core Principles for Effective Deposit Insurance Systems, Preconditions, BIS, June 2009.

c) who is responsible for checking that the tools are appropriate. The proper response to those issues makes clear that: 1) the choice of targets should lie in the competence of democratic institutions, of which the DGS is an integral part as they are intermediate structures that produce public goods; 2) while management responsibilities for a single bank crisis shall be oversight by authorities, it cannot be dissociated from the decision making powers. Hence, the acceptance of full responsibility can become possible only if those mastering the funds contributed by the banks for avoiding systemic crises are also given the task of co-managing them[6].

The 18 Core Principles for DGS are broadly categorized in 10 groups: setting objectives, mandates and powers, governance, relationship with other safety-net participants and cross-border issues, membership and coverage, funding, public awareness, legal issues, failure resolution, reimbursing depositors and recoveries. Undoubtedly, their implementation by local authorities and due review by IMF FSAP analysis may turn the Core Principles into a standard for confidence measurement.

A special note should be made about principles 15 and 16 related to the early detection and timely intervention and effective resolution in case of bank failure. DGS involvement in the determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on a basis of well defined criteria by safety-net participants with the operational independence and power to act. These are the layout for an effective resolution process meant to reimburse depositors promptly and accurately, minimize resolution costs and disruption of markets, as well as maximize recoveries on assets.

In order to accomplish its duties and become an authentic insurer for depositors, the DGS "should be operationally independent, transparent, accountable and insulated from undue political and industry (banking) influence" (item 5 of Core Principles). All of the above said elements of good governance and implicit integrity, enhances the capacity to support each other and of being equal in importance. This gives consistence to public awareness requirement because trust can be built only if the public is informed on an ongoing basis about the benefits and limitations of the deposit insurance system with impact to entire mechanism of financial safety-net.

Since the DGS rationale is from the very beginning that of serving the public, the consumers, more room shall be made for appropriate consultations with depositors, along the negotiations that EU bodies carry with national regulators and surveillance authorities. This is more valid for the EU market where cross border banking activities are wide and same bank brands operate across many of the 27 member states. This will probably put more light to the costs and benefits of designing a pan-European DGS, alone or along with the existing national schemes.

---

[6] Paolo Savona, Deposit Guarantee Schemes: Targets, Tools and Outstanding Issues, IADI/EFDI Annual Conference, Rome 2010

References

- Basel Committee on Banking Supervision/International Association of Deposit Insurers - Core Principles for Effective Deposit Insurance System, June 2009

- Ana Maria Tarantola, Strengthening Financial Stability: The Contribution of Deposit Insurance, IADI/EFDI Annual Conference, Rome 2010. See also Pittsburgh G-20 meeting, September 2009

- Romania – Letter of Intent and Technical Memorandum of Understanding, IMF, September 2010.

- Paolo Savona, Deposit Guarantee Schemes: Targets, Tools and Outstanding Issues, IADI/EFDI Annual Conference, Rome 2010