Articles

The Contemporary Deposit Insurance Through the Perspective of Bank Resolution and Moral Hazard

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Summary:

The deposit protection limit was a key issue in October 2008, when member states started randomly raising its level, which created unequal conditions for banks of different countries. That gave rise to the need for a common fixed level of protection in the EU, but its value was not connected with the real deposit amounts and the ability to bear the potential cost of payments by the guarantee schemes. Such an inconsistence created problems, especially for countries like Bulgaria, where the average amount of the protected deposits is less than 20,000 euro. As a result, excessive costs were imposed on the guarantee schemes and respectively on governments. Furthermore, an increase in the moral hazard in this field was observed. It is argued that the deposit protection limit should be reduced and a new concept for deposits should be introduced. The contemporary deposit insurance is analyzed in the light of the existing financing problems, the increasing moral hazard, the new responsibility for bank resolution and regulators' negligence to resolve these problems.

Key words: deposit insurance, limit, moral hazard, resolution.

JEL Classification: G21, G28

1. Introduction

One of the worst outcomes of high-profile institutional failure of the banking system is the bank run, where panic and massive withdrawals of deposits is the common behavior. Diamond and Dybvyg (1983 cited in Hogan, at al 2014) proposed a model which claims that although banks can reduce individual risk by acting as financial intermediaries, they create systemic risk in the potential for bank runs.

Diamond and Dybvig (1983) consider that bank runs can play a major role with regard to the economy's contractions than money supply because usually they cause pre-term loan demanding, which ceases the investment and leads to falls in the GDP.

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Deposit insurance is one of the instruments used for preventing the banking system from suffering a bank panic. Its main function is to contribute to boosting the confidence of depositors in case a bank experiences problems. However, this protection raises many issues for debate. Bank deposit insurance has been originally established to tackle bank runs, and yet unexpectedly it has important role in deciding problems of bank runs. The world financial crisis was felt initially in the EU in the late 2008 and provoked large-scale changes in the deposit insurance sector. After the collapse of Lehman Brothers in September 2008, depositors showed signs of fear and uncertainty and accordingly started shifting their savings to banks that were largely seen as safer. As a result the deposit insurance limit was raised from 20,000 to 50,000 euro for all member states with the goal of reaching a common fixed level limit of 100,000 euro by the end of 2010. This step was followed by a survey of the European Commission published in July 2010, upon which a number of amendments to the deposit insurance directive were tabled. A new perspective of the deposit insurance framework was prescribed in view of increasing the uniformity of the models across the EU and their harmonization.

The problems which arose refer mainly to some differences among member states in terms of financial development, culture-related needs and specificity. This divergence provoked heated debate and it was hard to reach an agreement between the member states and the EU authorities for several years. However, a new deposit insurance directive was announced in June 2014, which gave member states one year to have it transposed in their national legislation.

Although there are several amendments which would bring significant changes in the functioning of the deposit insurance schemes, there is one which seems to be the most challenging and questionable – the limit of deposit protection.

In this paper it is argued that 100,000 euro fix level limit of deposit protection is too high for the majority of member states and for Bulgaria in particular. It is even contended that this decision will result in a significant increase in the costs in a case of bank liquidation which could be dangerous for state's financial position. Along with the analysis of the insurance limit, some other provocative issues as moral hazard and bank resolution are also raised.

2. Preconditions for raising the limit of guaranteed deposits

On 20 September 2008, just five days after the collapse of Lehman Brothers, the Irish government decided to raise the limit of protection for deposits from 20,000 to 100,000 euro and 10 days later it decided to provide unlimited guarantee for deposits in several Irish banks (Irish Central Bank, 2008a, 2008b). What made the Irish government take this important step was the mass-scale transfer of deposits towards banks which were thought to be safer and more stable.

These changes inevitably impacted the British depositors, who also showed actions of changing servicing banks in favour of banks with higher guarantee. The reaction of the UK government was an increase in the deposit protection limit from £35,000 to £50,000 in October 2008 (FSCS, 2014). Simultaneously, other countries reacted to the changes in the compensation limits by also increasing their protection limit to 50,000 euro, 100,000 euro or to unlimited protection. Finally, shifts of deposits between differently protected banks were observed around Europe or at least many media outlets released items to this effect. It was obvious that different compensation regimes were no longer possible to exist in the EU. Thus, a new regulation was introduced which considered minimum a 50,000 euro deposit protection and a fix level of 100,000 euro limit to be reached consecutively, but no later than December, 2010 (European Directive, 2009).

Furthermore, the European Commission set up a working group for the elaboration of a proposal in the European Directive for deposit insurance schemes, the result of which was announced in July 2010. As a consequence of the recommendations, in the so called De Larosiere report (De Larosiere, 2009) a reform in the EU financial sector was carried out. In addition to the greater investor protection, an extention of the bank saving procedures was proposed and in 2010 a new directive for bank resolution

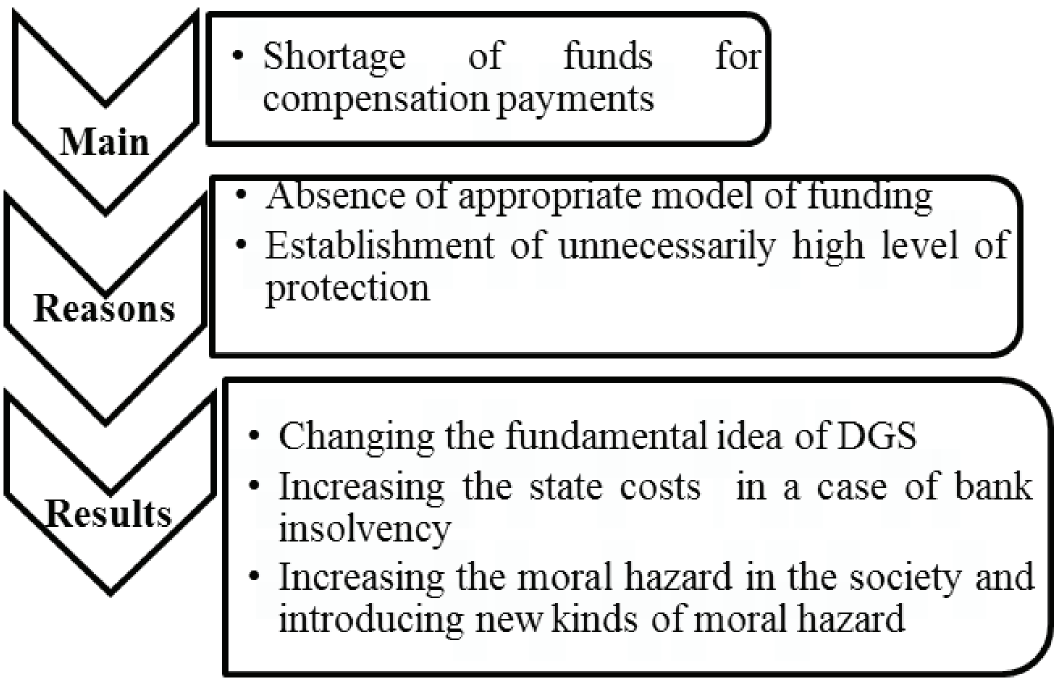

Fig. 1. Problems of Deposit Guarantee Schemes (DGS) in the EU

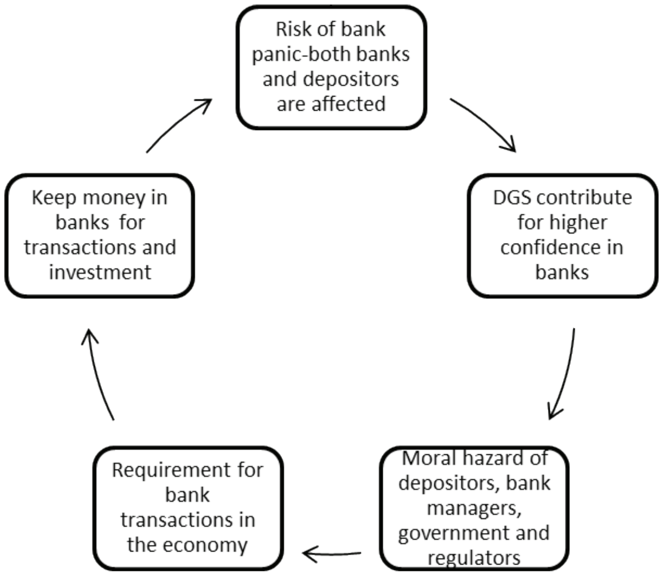

Fig. 2. The relationship between banks, depositors, insurance and regulation

mechanisms was adopted, which will also affect the deposit guarantee schemes as a possible option that the resolution authorities could resort to (Directive 2014/59/EU, 2009).

As a result higher protection, scope and regimes are now in place for the banking sector in the EU. Unfortunately, there are some problems arising from the new regulatory measures, discussed hereafter.

The main challenges of deposit guarantee schemes could be summarized as shown on figure 1. First of all, there is sufficient evidence for shortage of the financing of the deposit insurance schemes. The main reason for that is not only the inappropriate financing approach used by the majority of the guarantee schemes in the EU, but also the new limit of protection which is argued to be far too high. This inconsistency results in increasing compensation payments and indebtedness of the member states. Moral hazard issues have been causing confusion.

The new credit resolution regimes are not the key issue in this paper but, however, they are another evidence for the expanded protection framework in the financial sector, which comes to show that this sector plays a crucial role in ensuring economic stability. The resolution regimes have one key negative aspect with regard to the moral hazard they create in the management of credit institutions, as well as in government and regulators.

In fact, the process of interrelation and interdependence between banks, depositors, deposit guarantee schemes and the necessity to keep money in banks to perform transactions, is like a vicious circle (see figure 2). The risk of bank runs is managed and reduced by the existence and protection of the deposit guarantee schemes. On the other hand, these schemes could not guarantee the total amount of deposits, though they nonetheless guarantee a good portion of deposits (usually above 90%). Afterwards, being protected depositors take moral hazardous actions when choosing banks offering higher interest rates. Reasons for deposit protection could be observed from the perspective of national requirement for transaction payments, where most of the income and payments in one economy should be done through banks. This fact changes the definition of deposits.

Looking from the perspective of money evolution and development of payment systems, deposit classification is even more complicated. Current accounts as an alternative to keeping cash money in the wallet should not be classified as deposits, from the point of deposit insurance. From this perspective deposits are rather not a type of a financial instrument but a way to fulfill the main money function – a medium of exchange to convert cash money into electronic payment instruments. Following this logic, we can assume that only term deposits could be viewed as a type of financial investment as they are an alternative to financial instruments and investments such as stocks, derivatives, mutual funds investment etc. In other words, deposits which describe the money function "store of value" are the one to be treated as financial instruments and to be protected by the guarantee schemes up to a certain limit. The current accounts or money in banks kept for performing daily transactions should be covered in 100% from the deposit insurance schemes. Of course, there also arise moral hazard issues and some difficulties could appear in the clear rules for distinguishing this type of accounts. If a 0% interest rate applies and if there are legal restrictions with regard to banks using them for other purposes that could decrease the

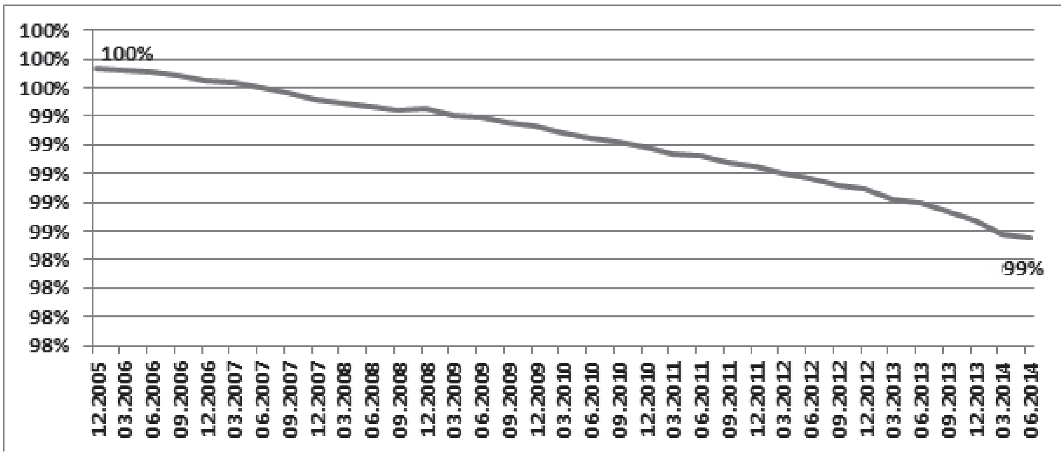

Fig. 3. Volume of household deposits of up to 20,000 euro
Source: data from the BNB statistics, accessed on 10.10.2014

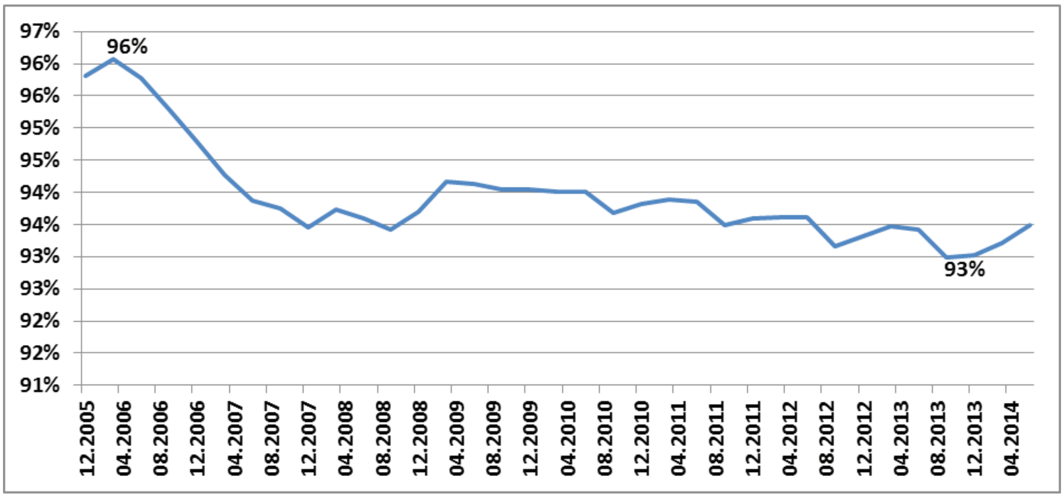

Fig. 4. Volume of nonfinancial companies' deposits of up to 20,000 euro
Source: data from the BNB statistics, accessed on 10.10.2014

moral hazard and help distinguishing these funds from "real" deposits (term deposits). This is important, when providing protection to people or entities using banks as payment service providers, on the one hand, and investors storing their excess funds in banks for interest, on the other. A possible decision could be if banks are no longer allowed to undertake excessive risk with funds used for daily transactions. The bravest ideas for possible future transformation in order to avoid these problems could be the creation of institutions which only serve as electronic transaction bodies which do not take on the risk of money loss nor pay interest to fund owners. These institutions could exist along with banks but not performing other inherent bank services.

Last but not least, if people have money which is not protected they are actually more likely to withdraw them if there is a risk for a bank run which will definitely result in bank panic if these actions become ubiquitous. Another fact states that the higher the protection is, the higher the costs it will raise, the riskier the bank managers will become and the higher the probability for bank runs will be. It looks like a vicious circle with no way to solve it.

3. Deposit protection limit

As reviewed earlier the major reasons for increasing deposit insurance limit were connected with some actions of the Irish and UK governments. The later established higher limit of protection at 100,000 euro level was not supported by any economic or financial evidence.

To prove the inconsistency of the applied deposit protection limit, the case of Bulgaria will be analyzed. It is argued that countries like Bulgaria, where the average amount of deposits of below 20,000 euro do not gain benefits from the 100,000 euro limit of protection.

On figure 3 the number of households' deposits at amount less than the previous protection limit (20,000 euro) is presented for the period 2005-2014. Averagely 99.24% of the households' deposits in Bulgaria for the period 2005-2014 are less than 20,000 euro, which means that the previous protection limit used to provide significant and sufficient protection. However, there is a stable tendency of a decrease in this number, which means that the amount of deposits held by households has been growing all the time. As of June 2014 this amount is still low enough to have the need of increasing deposit protection limit as 98.6% of deposits are fully covered. Upon further calculation, an average of 99.56% of household deposits will be fully covered, if the limit is set at 25,000 euro.

Figure 4 shows the number of nonfinancial companies' deposits for the same period (2005-2009). A different trend and numbers is observed in respect of households' deposits.

A sharp decrease in nonfinancial companies' deposits after 2005 is observed but the share in the last five years is rather about the same average level of 93.5%. However, the protected deposits of less than 20,000 euro still hold a certain share of over 93%. If we make the same calculation for all deposits of nonfinancial companies of up to 25,000 euro (approx. the equivalent of 50,000 BGN) the results show that their share is 94.80% on average in the period 2009-2014. Indeed, the ratio in this group is smaller than in the households' group but still 95% is a good coverage level, especially considering that usually companies should be treated in a different way than households because of their qualification and abilities for investment assessment.

The current limit of 100,000 euro actually covers an average of 99.95% of households' deposits and 98.19% of nonfinancial companies' deposits for the period of 2009-2014, where the numbers as of June 2014 are 99.92% for households and 98.15 for nonfinancial companies (BNB, 2014).[1]

The dilemma about the best coverage ratio is ambiguous. On the one hand the higher the ratio, the better, though, on the other hand, the costs should be affordable and deposit guarantee schemes are presumably not able to cover the full amount of deposits. It is essential that the share of guaranteed deposits to be big enough so that the banking system is protected from massive deposit withdrawals. One possible approach to determining the target level is based on the linkage between bank liquid resources and the sum of deposits that exceed the limit of protection. According to this approach if all customers who have deposits greater than the protection limit withdraw their money, then the bank liquid funds will

[1] FThe period of this observation is shorter as the Bulgarian National Bank maintains statistics for higher levels of deposits only from 2009. Before that the last group of deposits division was for amounts over 50,000 BGN (the equivalent of 25,000 euro)

be enough to cover that and this will not lead to bank liquid crisis. Naturally, such a limit will be different for each lending institution. Another possible approach is that national authorities set the level of risk coverage, though this would involve guesswork, if it is not related with the above linkage.

A research of the European Commission (EC, 2010) about deposit insurance limits, although for older period, shows that the average ratio of the number of fully covered deposits to eligible deposits for a limit of 50,000 euro for the EU is 91%, where for EU-12 it is 98.2%. This is allegedly a big share, which shows once again that the current limit of 100,000 euro is not determined on the basis of needs and on the real number of deposits, but is rather based on measures and actions in some member states.

Indeed the divergence in the number of deposits across member states is significant, which renders it difficult to establish a common fixed level of protection. However, the current level is high even having in mind the countries with highest amounts of deposits per household.

4. The impact of the higher protection limit

The increase of the limit from 20,000 euro to 100,000 euro will cost to the Bulgarian deposit insurance fund approximately 20% higher compensation costs (averagely for the banking system in total) where increasing the ratio of fully covered households' deposits from 98.6% to 99.92%. That means that insurance payments will increase by 20% for less than 1.5% of the eligible deposits. If the case of the Bulgarian Corporate Commercial Bank[2] is used as an example, we can try to calculate the costs of the higher protection limit. The preliminary information for the total amount of the guaranteed deposits in the two banks[3], announced by the Bulgarian fund's chairman (Nikolov, 2014) was 3.8 billion BGN. If we assume that the average ratio of covered deposits is the same as the one for the banking system this means that approximately 0.63 billion BGN will be the cost of the higher protection limit.[4] To show how significant this amount is, we can compare it with the Bulgarian deposit insurance fund's available resources (2.1 billion BGN as of October 2014), which have been gathered for nearly 15 years by ex-ante installments.

Conclusions

The challenges for the contemporary governance and EU environment are mainly connected with maintaining an increasing economy growth and ensuring protection from financial

[2] Corporate commercial bank was put under special supervision on June, 20th and its licensed was withdrawn by the BNB on October, 9th 2014, where deposits should be paid from the deposit insurance fund by December 4th 2014. This is the first case of triggering the Bulgarian deposit insurance fund for the last 15 years.

[3] The Victoria bank, owned by Corporate Commercial Bank was also put under special surveillance.

[4] If 20% is the average increase of the costs for households insured deposits, this means that approx. 1/6 of 3.8 billion is the share of the costs for deposits over 20 000 euro but less than 100 000 euro.

turmoil. Deposit insurance and resolution mechanism are among the main tools of the EU authorities but unfortunately they are applied in one-side perspective. No actions are in place to oppose the issues of increasing costs and moral hazard which new protection measures raised. As it was discussed, the financial system is changing, an so is the role of money and payment instruments.

The analysis in this paper showed that the new deposit insurance legislation in the EU raises serious concerns about the stability and resistance of deposit protection. Some countries like Bulgaria have paid, and will continue to cover excessive costs on deposit protection, which is another challenge to ensuring economic development and speeding up growth. The first reaction of the EU authorities to raise the insurance limit as a response to the crisis in the late 2008 established unprecedented high level of protection per depositor. The higher protection limit in the EU seems to be established permanently in contrast to USA where the deposit protection was raised only temporarily for the period of the crisis and was decreased since the crisis started to die down. As proved by the analysis, this action by the EU authorities could be classified as a wrong one as the limit does not meet the actual levels of savings especially in Bulgaria. The results of the excessive protection are connected with higher government costs, moral hazard and accordingly with smaller prospects for maintaining adequately financed deposit insurance funds.

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