

How we can reform the deposit guarantee scheme - a solution for increasing confidence in the banking system

Author:
Dumitru Pintea

■ Why the national deposit guarantee scheme should be reformed

The banking sector is the basis of a modern economy, which any national financial system depends on. Considering its importance for the financial stability of a State and especially that banks use resources attracted from the population in their work, the methods of supervision and regulation should be more prudent than for other businesses. In addition, the banking activity is one of the riskiest economic fields. Besides the direct risks of any business, it also involves customers' risks, which may occur in a variety of forms. Thus, any modern banking system is based on a **bank deposit guarantee framework**, aimed to maintain both the individual financial stability of people, and the collective stability of the entire system.

According to the international approach, the deposit guarantee schemes fulfil two basic functions:

- protection of private personal wealth;
- minimization of the systemic risk (extension of depositors' distrust in other banks).

Deposit guarantee systems (called also guarantee schemes) aim to protect not only depositors, i.e. bank customers, but also to protect effectively the banking institutions. On the one side, deposit guarantee aims at ensuring depositors that they will not end up in a difficult situation caused by the impossibility of using their own resources deposited in a commercial bank. On the other side, this protection strengthens the general confidence in the whole banking system, respectively, for banking institutions it minimizes the risk of spreading people's mistrust from other problematic banks.

However, these functions can be only provided in the context of a protection system appropriate to economic realities, or **a guarantee system based on the current model from our country can't ensure any of the above mentioned functions**. Actually, the current guarantee system is totally outdated, the coverage level of MDL 6,000 reported to the minimum living standard being one of the lowest in the world. In addition, the current system has provided its inefficiency during the national banking crisis of 2014-2015, being completely unable to prevent or to solve the crisis.

The national deposit guarantee scheme is based on the Deposit Guarantee Fund (DGFBS) in the Banking System and the Law on guaranteeing deposits of individuals in the banking system¹. The DGFBS takes care of the money of individual depositors, the biggest part of which are small amounts saved over time for any future personal needs. Given the attractive interest rates in the last years, bank deposits are still the most important saving method. Furthermore, as the national financial market doesn't offer other saving methods, bank deposits is one of the most convenient method of saving, with savings "under the mattress" being literally the only available alternative.

The last developments in the banking sector and the recently launched comprehensive reform denote the need to restructure the national framework of bank deposit guarantee. A good understanding of the determinants also shapes the reform of the national deposit guarantee scheme, with the ultimate goal to create a suitable instrument for preventing crises and maintaining financial stability, both individual - personal, and collective - the whole sector. Thus, the following are among the most important factors:

(i) Bank recovery and resolution Law. Though depositors have not been affected by the liquidation of a banking institution since the creation of the national banking system, the bank deposits are not one hundred

¹ Law No 575 of 26 December 2013 on guaranteeing deposits of individuals in the banking system.

percent secure any more, especially with the adoption of the bank recovery and resolution Law². This Law provides legal support for the internal recapitalization tool - "bail-in" that allows the resolution authority to use, ultimately, the depositors' money in order to save the bank from bankruptcy;

(ii) The current coverage level doesn't correspond to the economic realities. Theoretically, if a bank fails, depositors should be protected by DGFBS – institution created to guarantee bank deposits. However, in the present context, when the guaranteed amount reaches the level of only MDL 6,000 (around EUR 280), the safety of bank deposits seems to be just an illusion. Also, taking into account the ability of capital to migrate towards more "protected" areas, it is important to examine the practices in the region (e.g. Ukraine - UAH 200,000, Russia - RUR 700,000, Romania, EU Member States - EUR 100,000);

(iii) The small role in the maintenance of financial stability. The recent banking crisis confirms the inability of the Fund to absorb the actual losses resulting from the bankruptcy of some banking institutions with systemic impact. The limited capacity of the Fund, reported to the size of the frauds from the three banks, made it impossible to get involved in the process of solving the crisis, which led to the need to extend emergency credits under State guarantee and transfer the costs on taxpayers;

(iv) The current fee model doesn't reduce the banks' risk appetite. According to the legal provisions, the Fund resources are formed from the permanent contributions made by commercial banks. However, the size of these contributions depends only on the volume of deposits covered by Law, not on the risk profile of every bank. This creates an imbalance in the functioning of the banking system – the banks with a greater risk appetite are not charged properly for possible implications on the entire financial system;

(v) The volume of guaranteed deposits. At the end of 2015, the total share of guaranteed deposits was only 7.1%, or guaranteed deposits amounted for MDL 2.5 billion from the total amount of MDL 35 billion. Moreover, the deposit guarantee scheme does not cover the deposits of legal entities, which could affect their confidence in the system and could lead to a disastrous financial situation in case of impossibility to use the deposited funds. One of the most convincing examples is the resources of insurance companies, which are mainly invested as bank deposits that are not guaranteed by DGFBS.

(vi) EU Association Agreement. Another essential fact that literally forces the Republic of Moldova to both amend the legislation and change the coverage level is the European Union Association Agreement. According to the commitments assumed under the Agreement, our country acknowledged the responsibility to harmonize the legislation in the financial area as provided in Annex XXVIII-A³ to the Agreement. Regarding the deposit guarantee scheme, the Government committed to transpose Directive 94/19/EC⁴ on Deposit Guarantee Schemes into the national law within 5 years since the adoption of the Agreement. However, the provisions of Article 7 regarding the minimum level of compensation for each depositor are an exception, thus it should be implemented within 10 years since the adoption of the Agreement. At the same time, in 2014 the Directive No 94/19/EC was amended significantly, and for purposes of clarity it was reformulated as a new regulatory act - Directive No 2014/49/EU on Deposit Guarantee Schemes.

Respectively, according to the schedule, the Republic of Moldova has about three years to implement the provisions of the new Directive into the national legislation. Thus, taking into account the recent developments in the banking sector and the need for a considerable period of time to develop a new

² Law No 232 of 13 October 2016 on bank recovery and resolution

³ Annex XXVIII-A to the Association Agreement - Rules applicable to financial services.

⁴ Directive No 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes.

national framework on bank deposits guarantee, we believe this process should start in the immediate future, at the same time with the implementation of bank recovery and resolution Law. These two processes need to be coordinated, as the bank recovery and resolution Law envisages the establishment of a Resolution Fund managed by DGFBS, following approximately the same principles as the Deposit Guarantee Fund.

The listed factors confirm that the current bank deposits guarantee framework (both legal functions and maximum coverage level) is not appropriate to maintain the financial stability or prevent crises. Regarding its reform, any attempt to increase and extend the coverage to include more types of deposits also means higher expenses for banks that contribute to the formation of the Fund. However, this will have an important economic impact by strengthening the confidence in the banking sector, and hence, ensuring an optimal level of capital in order to maintain the necessary funds for further lending and economic development.

■ How the national deposit guarantee scheme should be reformed

Considering the main determinants of the inefficiency of the current deposit guarantee scheme, we believe that its reform should take into account the newest provisions of the EU Directive⁵, as well as the technical guidelines developed by the European Banking Authority on the calculation of contributions to deposit guarantee schemes⁶. At the same time, the reform should take into account the features and capacities of the national financial system, allowing for a long period of time to ensure a level of protection similar to the European one. Thus, given the provisions of EU Directive, the reform of the national deposit guarantee framework should focus on the following key directions:

1. Involvement in maintaining the financial stability;
2. Extending the protection to cover more types of deposits;
3. Determining the specific risk of each banking institution;
4. The stage of the economic cycle;
5. Appropriate coverage level;
6. Suitable formula for contribution calculation.

1. Involvement in maintaining the financial stability. The DGFBS should not limit itself only to the function of reimbursing the guaranteed amount in case of bankruptcy, it should use its available financial resources to prevent bankruptcies. Thus, the Fund will have an important role not only in resolving banking crises, but also in their prevention and maintaining financial stability. Hence, the Fund needs to be actively involved in the works of the National Financial Stability Committee, in the dialogue and information exchange with NBM, and in the research and monitoring of early warning mechanisms. At the same time, the costs of measures taken in order to prevent the bankruptcy of an institution should not exceed the reimbursement costs of the guaranteed amounts for the same institution;

2. Extending the protection to cover more types of deposits. The protection of depositors should be extended to cover a larger group of depositors, such as legal entities or other categories of individuals. At the end of 2015, only 7.1% of total deposits were guaranteed. In addition, only 29% of the guaranteed deposits were under the maximum coverage level;

3. The risk level of the bank institution. The contributions to DGFBS should be based not only on the amount of covered deposits, but also on the risk level of each individual bank. Accordingly, the contributions should be calculated proportionally to the banks' risks that reflect different business models. The risk groups need to be established in cooperation between the banking system supervisor (NBM) and DGFBS in order to compute the indicators that best reflect the peculiarities of the national banking system and the cyclical position of the national economy. The following indicators could be considered as a basis for risk groups:

- capital adequacy
- asset quality
- liquidity
- business model and management

⁵ Directive No 2014/49/EU on Deposit Guarantee Schemes.

⁶ Guidance on method for calculating contributions to deposit guarantee schemes, the European Banking Authority EBA/GL/2015/10 of 22 September 2015.

- affiliation of bank creditors to a certain sector
- quality of corporative governance
- shareholder's structure and quality

4. The stage of the economic cycle. According to Directive No 2014/49/EU, when establishing the target level of annual contributions and the maximum coverage level, the authority managing the Fund should take into account the stage of the economic cycle and the possible impact of the contributions on the financial stability of member institutions. In this regard, the cyclical adjustment of the annual contributions is crucial, with the target level being decreased during economic recession and increased during economic growth. At the same time, the cyclical adjustment need to take into account the risk analysis carried out by the designated macro-prudential authority and need to reflect the economic conditions and prospects for at least the medium term, as the persistent economic difficulties may not justify low contributions for an indeterminate period of time.

5. Appropriate coverage level. The international practice suggests a maximum coverage based on the average salary per economy for a certain period of time. Also, as bank deposits may represent the savings for an important social cause, such as purchasing a house, the maximum coverage level hence needs to take into account the average level of housing in the country. In such circumstances, it would be reasonable that the maximum coverage level equals the average salary per economy for a period of at least 2 years. According to AA, for our country, the coverage level should reach the same amount as for Member States, respectively EUR 100.000⁷ by 2024. Considering the realities and capacities of the national banking sector, it is unlikely that this level could be reached in the short and medium term. However, we believe that a coverage of 2 years' average salary by 2020 is both realistic and needed. Thus, the optimal coverage level should be determined and the augmentation formula/calendar should be calculated taking into account a number of factors, such as the size and capacities of the banking sector, international practice, risks generated by the banking sector, current economic realities. A mathematical calculation shows that, if reported to the current average salary⁸, the maximum coverage level needs to be at least MDL 121.000.

6. Formula for contribution calculation. Given the elements underpinning the deposit guarantee scheme, the contribution of each bank should be calculated using the same formula as the EU⁹ Member States, namely:

$$C_i = CR \times ARW_i \times CD_i \times \mu$$

where:

C_i = Annual contribution from member institution 'i'

CR = Contribution rate (identical for all member institutions in a given year)

ARW_i = Aggregate risk weight for member institution 'i'

CD_i = Covered deposits for member institution 'i'

μ = Adjustment coefficient (identical for all institutions in a given year)

⁷ EUR 100.00 is the maximum deposits coverage level in all Member States. Even if the economic conditions are different, an equal amount represents the optimum solution in order to discourage the capital migration.

⁸ GD No 879 of 23.12.2015 approving the average monthly salary per economy for 2016.

⁹ Guidance on method for calculating contributions to deposit guarantee schemes.

■ Final Conclusions and Recommendations

Increasing the deposit guarantee coverage is imminent in order to maintain the confidence in the banking sector. The current deposit guarantee scheme is unable to cover the economic costs caused by the bankruptcy of a national medium or large bank (as proved by the banking crisis resulting in the collapse of three banks). Certainly, it is unlikely that a similar crisis will occur again in the future. However, given the transposition in the national law of the European Directive establishing a framework for the recovery and resolution of credit institutions and investment firms and establishing the date of 01.01.2020 as the deadline for enforcing the bail-in instrument, the law on Bank Deposits Guarantee Fund needs to be amended, too.

The need to ensure a real protection of depositors, on the one hand, and the need to protect banks from systemic risks, on the other hand, calls for a gradual increasing of the maximum coverage level, up to an acceptable level. At the same time, this growth implies increasing the banks' individual contributions to the Fund, which could create an extra financial pressure on bank balance sheets. Even so, the aggregate profitability indicators in recent years prove that theoretically there are some resources for a significant growth.

Also, the Deposits Guarantee Fund should have a more important role in preventing crises and maintaining financial stability, having the opportunity to intervene in a bank before it is declared bankrupt.

To support the above mentioned, the following recommendations need to be implemented in the nearest future:

- initiate the harmonization of the national law to the provisions of Directive No 2014/49/EU;
- increase gradually the maximum deposit guarantee coverage to 24 average salaries per economy by 2020;
- extend the protection scheme to cover other types of deposits, of individuals, individual entrepreneurs or legal entities;
- implement a formula for contribution calculation, that will take into account the risk generated by each banking institution separately;
- establish some types of risks, taking into account the representative indicators of the banking activity, correlated with the economic realities of our country;
- grant some legal tools for early intervention to the Fund, so that it can help prevent crises and maintain the financial stability;
- ensure an efficient cooperation between NBM and DGFBS on a qualitative and quick reform of the national framework of bank deposit guarantee.