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Systems for Guaranteeing Bank Deposits

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Abstract

The advent of the financial crisis and the latest event that occurred in Cyprus bring new light to how states intervene when commercial banks are facing the risk of bankruptcy. While until now institutions had a clear traditional role to protect depositors, currently there is a trend to transfer damage to companies and individuals that hold deposits.

Key words:
Securing deposits, guarantee ceiling, system risk, financial compensations
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1. Introduction

Securing bank deposits is a mechanism aimed to compensate small deposit holders when the banks become insolvent. There are two important reasons that justify the creation of such a mechanism:

- bank customers, as any consumers, are entitled to be compensated if the products they use prove to be inappropriate. As a normal consumer is protected by the authorities if the purchased goods are not consistent with the label specifications, bank deposit holders may receive financial compensation if the bank products they use are defective. Furthermore, these „consumers", unlike normal ones, are not in a position to be fully informed about the financial status of the banks where they have their deposits (in some cases, even if they had access to such information, understanding it would be difficult);
- system risk is significantly diminished, since holders of bank deposits, knowing that their money is safe, will not act impulsively on simple rumours regarding any hardships the financial institutions where they have placed their money are going through.

2. Systems for Guaranteeing Bank Deposits

Besides the obvious benefits, guaranteeing deposits may also generate a certain type of inadequate behaviour from customers but also from bank managements.

Thus, deposit holders may be tempted to no longer manage the risk associated with their investment, as long as the state will intervene with significant compensation in case of *default* of the bank. In this idea, the only criterion by which the bank is chosen will be the interest rate, regardless of the solidity of that financial institution. In order to counter such attitude, unlimited compensation is not usually provided, but a certain risk participation percentage (franchise) is left to the deposit holder. Currently, in Romania and most countries of the European Union, the guarantee ceiling covers 100,000 euros / depositor / bank.

Also, bank managers consider that regardless of how they manage their institution, the state will intervene if they become insolvent, so they may involve the organisation in operations aiming to achieve a high level of profitability but involving considerable risk. Such trends are „calmed down" by the supervision of the Central Bank, constantly monitoring bank activity, cautioning them when the prudential limits are being exceeded. Furthermore, there is a practice by which deposits of the persons involved in the bank management and their close relatives are not covered by the guarantee.

Theoretically, the deposit securing mechanism can be organised in two ways:

- a formal system, based on a well-defined institutional and legislative architecture, clearly defining the circumstances under which compensation is to be given out;
- an implicit system, involving government intervention to resolve each individual case of bankruptcy.

Each of the solutions has its virtues and shortcomings. The formal system is based on the existence of an institution (guarantee fund) collected in advance from commercial banks, depending on the amounts of their deposits, with the resources necessary to give the compensation. Furthermore, information is known from the start about the categories of customers that will receive compensation, the types of deposits that are subject to the guarantee, the compensation ceiling, the periods during which the payments are to be made and so on. Most banking systems use explicit formulas, with an institutional background, for securing deposits.

The implicit system is characterised by the fact that the state intervenes with compensation whenever a bank becomes insolvent. It has the advantage of not requiring allocation of resources in advance and at the same time eliminates the cost required for a formal mechanism. Additionally, the authorities have flexibility in their intervention, having the freedom to choose the optimum solution for each case: the deposits of the affected bank can be transferred to a healthy bank, or the affected bank can receive the necessary subsidies to overcome the difficult situation, etc. The greatest difficulty of this system is finding the necessary financial resources when needed.

A first option would be to allocate resources from the national budget, but the solution could prove unrealistic under budget constraints. Furthermore, exceeding the budget deficit target by increasing expenses can have a serious negative impact on the economy and jeopardizes the authorities' undertakings with international financial bodies.

Another possibility would be a loan from the Central Bank, but this may be against the monetary policy goals or even the law on its statutes.

Beyond the theoretical aspects, it is interesting to observe the actual behaviour of governments when one or more financial institutions are facing serious problems. In this respect, the solutions used in the US and Europe seem to contradict all economics handbooks.

Students learn in the university that in capitalism economic entities are born, evolve and disappear according to the rules of the free market; whoever does not have sufficient performance will fail to adapt to the demands of competition and will be out of the game. Well, decision makers probably considered the disastrous economic and social impact that the collapse of credit institutions holding significant toxic assets would have and chose to become massively involve to avoid a bank crash.

With few exception, albeit quite infamous, (see Lehman Brothers), banks in trouble were bailed out, even though this required an intervention from the public authorities that passed "financial packages" that knowingly distorted the rules of the market. One can discuss about the prevalence of the "implicit system" of deposit security over the formal one, while a few years ago this would be unimaginable.

The infusion of money by which the problematic banks were recapitalised has been a lifeline that has proven its effectiveness only in the short term. While the initial difficulties had started from the subprime crisis and the derivative financial instruments included in the investment portfolios, another problem appeared shortly, one that is eating away at the foundation of the credit institution's solidity and implicitly of the entire financial construction: the sovereign debt crisis.

During the last years, banks have been lending massively to governments, always looking for resources to cover chronic budget deficits, so exposures of this kind ended up having a significant weight in the asset structures. Investments in state titles are very welcome, and their risk is almost zero, isn't it? This is a theoretical assertion that reality has started to contradict: in Greece's case, for instance, creditors were even forced to give up part of their receivables.

Even though during the last months the governments of countries such as Italy or Spain, gravely affected by the debt crisis, have passed austerity measures aimed to restore their finances to an acceptable position, the problems are far from being solved, and their impact on the banking systems is hard to predict.

In the Eurozone, one can speak about a uniformity of intervention procedures in case of problematic banks. Such process would bring more predictability for all depositors regarding the actions to be taken in case of bankruptcy of a bank. The first targets in rescuing credit institutions would be large companies, with deposits exceeding 100,000 Euros. They are considered to have the necessary resources and information to correctly assess the risk exposure of the banks with which they do business and have the necessary mobility to transfer their funds in time to institutions that are financially healthy. Also in the same line of the victims that would bear the unpleasant consequences are investors in bonds. Then come companies with less than 250 employees and turnover under 50 million Euros.

A crucial change intended to be implemented is related to the guarantee for deposits up to 100,000 Euros. While currently the guaranteed deposit is considered to be intangible, the near future might bring significant changes. A proposal in this respect is introducing a provision according to which depositors who have amounts under this ceiling will be the last to be affected by the bank's restructuring/liquidation process. In other words, national guarantee funds will no longer cover depositor losses if the depositary institutions are bankrupt.

3. Conclusions

Concluding, the current trend is that institutions that had a traditional role in protecting depositors would largely be released of this duty, and the creditors of the banks would bear the losses.

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