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Foreword

This year is the tenth year of the Polish deposit insurer activity. Fortunately, we could join the summing up of the BGF's experience and the second annual meeting of the European Forum of Deposit Insurers.

During the international conference, which took place in Warsaw on 13–14 October 2005, the Fund's representatives had opportunity to share their ten years' experience with the deposit insurance experts from other European countries, underlining the BGF's active role on European level.

The ten years' experience of the Bank Guarantee Fund is definitely complex and seems to be worth analyzing. On the one hand, the Fund had the opportunity to take part in many law amendments changing the methodological base for the Polish banking safety net model. On the other hand, the Fund has also great practical experience in dealing with the banking problems using an extensive scope of financial actions' forms from pay-outs to assistance projects.

The deposit insurance facility has a crucial position in bad times in the banking industry. However, it plays the same important, but rather invisible, role in times of banking prosperity. Moreover, the good situation in the banking sector seems to be, at least in some part, the result of the good work of the deposit guarantee scheme.

The situation in the Polish banking sector seems to be actually relatively good. We find this situation (hopefully it is not only our subjective point of view) as the result, among other factors, of the Bank Guarantee Fund's current operations.

The stability of the Polish banking sector in the last years has not been as obvious as it looks from today's perspective. The economy transformation in the early nineties brought to end the one tire banking system with the only presence of state banks and state guarantees. The real problems in the banking sector resulted in the significant lowering of the public confidence. Those days uncertainty of bank customers created an important systemic obstacle in establishing a modern and stable banking sector.

The situation definitely required the strong performance of safety net institutions. As a result many different actions have been undertaken by the Bank Guarantee Fund, the National Bank of Poland and the Ministry of Finance. The practice and law amendments have changed the Polish safety net model. BGF together with the Commission for Banking Supervision after the years of safety net modifications became the main safety net players.

From its early beginnings in 1995 the evolution of the Fund was driven not only by internal factors but also by the EU's accession perspective. At the time of joining the EU – in 2004 – Polish regulations were fully compliant with the EU deposit guarantee directive. However, it does not mean that everything was done. The majority of the deposit insurers in the world are very young institutions with relatively little experience. This brings us to the conclusion that in the process of gathering common experience many new solutions improving the functionality of deposit insurance could be implemented.

The theory and practice of banking are still in progress, resulting (among others) in changes in the perception of the role, functions and mandate of banking safety net entities. Thus we should be ready for discussions about the future of deposit guarantee institutions in the European Union.

The best way and at the same time the best base for such discussions is sharing information among European banking practitioners. The European Forum of Deposit Insurers gives the opportunity for such kind of cooperation. Many of us consider the EFDI as one of the key institutions which ought to create the safety European net, and especially in the sphere of the deposit insurance. The issue of the expected shape of the EU deposit insurance is particularly important when the possible amendments to the EC/94/19 Directive are discussed.

As we know there are different paces and various depths of integration in the European Union, depending on the focused area. Such situation offers a lot of possibilities for discussed concepts of the future European DIS development. Deposit insurers themselves, because of their experience, should play a major role in the planning of a safe and efficient European banking system. How hard it is to meet two goals (safety and efficiency) at the same time we know the best.

This year the Bank Guarantee Fund had the honor to host the second annual EFDI's meeting. The Bank Guarantee Fund is a member of the EFDI from its early beginnings. The EFDI is a very functional vehicle to underline the role of the European deposit insurers in the financial sectors inside the EU, of the more and more integrated Europe.

The main task of the EFDI's meeting was the achievement finalization of the new form of the EFDI's constitution. Except the very important organizational issues there was also the opportunity for some theoretical and practical input during conference. The first part of the conference was dedicated to the BGF's 10th anniversary, the second one to the discussion about the newest ideas of the European (and not only) banking industry including the influence of Basel II, investor compensation schemes development and, of course, the issues of deposit guarantee schemes.

The following publication presents the ideas discussed during the conference. This publication gives us the opportunity to gather and distribute the conference's results among participants but also among the people and institutions that could not join us in Warsaw. The effect of the two-day discussion is multidimensional in terms of the range of described topics. Thanks to our respectable guests, their professional experience and variety of discussed topics we can provide this publication to readers. At the end, I would like to express the hope that the readers will share our opinion about the conference and this publication.

Ewa Kawecka-Włodarczak
President of the Bank Guarantee Fund
Management Board

Conference's presentations and speeches

The EFDI Annual Meeting held in Warsaw on 13–14 October 2005 gathered many distinguished guests from various international financial institutions, such as the International Monetary Fund or the World Bank, and the European Union institutions, representatives of the deposit guarantee schemes from all over Europe and other banking practitioners. Both regulators and commercial banks' representatives were present.

Thanks to their great knowledge and experience the range of topics covered during this two-day conference was really broad. Among others, the following topics were discussed:

- EFDI new constitution;
- review of the Directive;
- financial stability problems;
- future of deposit insurance;
- and also more regional initiatives like the „convergence program" in South-Eastern Europe.

The publication consists of two parts. The first one is mainly dedicated to the 10th anniversary of the Bank Guarantee Fund. It starts with the speech of the President of the National Bank of Poland considering the development of the financial sector in Poland. It is followed by the presentation of two pictures – the past of the BGF in terms of so far experience and the future of the BGF, especially the possible scenarios of changes. These two views were prepared and presented by the members of the BGF's Council.

The structure of the publication in its second part reflects the miscellany of discussed topics. Thus there are 5 themes: deposit insurance from the ECB point of view; the EU's Directive and EFDI; investor compensation schemes; Basel II and future of the banking system and deposit insurance.

This publication is based on the speeches of the conference participants and consists summary information only.

International topics were compiled by Agata Dunaszewska, Agnieszka Kujda, Monika Szymańska – employees of the BGF's Deposit Guarantee Department.

Prof. Leszek Balcerowicz
President of the National Bank of Poland

FINANCIAL SYSTEM DEVELOPMENT

Introduction – Does the financial system development matter for economic growth?

The first important point that needs to be made is that financial development does matter for economic growth in the sense that the high financial assets to GDP's ratio describing the role of financial sector in the entire economy constitute such a stimulus. This assessment stems from the newest economic and empirical research, not just meaningless theorizing, which proves that financial development influences economic development in a very positive way, mainly through its impact on productivity growth[1].

Secondly, so far it has not been empirically decisively proven that the difference in structure, assuming the same level of financial development, is of relevance as regards economic growth. It does not necessarily imply that it may not matter, just that there is no, as yet, definite empirical research to support that hypothesis. Many researches indicate that the structure of financial system seems irrelevant from the point of view of growth, and a quality and an availability of financial services is something that really

[1] World Bank (2001).

matters, while the structure of the system is of secondary importance[2)]. The others point out that there is a nonlinear relationship between financial structure and pace of economic growth. According to them direct market-oriented financial system should be more beneficial to economic growth[3)]. On the other hand, the impact of financial development in general, definitely positive over the long run, may turn out over short horizons because of higher volatility[4)].

Thirdly, it is of importance to point out macroeconomic factors which exert influence on development of the financial sector. First and foremost – it is inflation. It hampers financial development, as higher inflation in the long run has a negative impact on the overall condition of the financial sector[5)]. The so called financial infrastructure can be considered as the second relevant factor. It includes legal framework, however not just the written laws, but also the actual enforcement of law and the extent and level of protection of investors' rights (creditors, shareholders)[6)]. One can say that financial sector is a legally intensive one as it requires a good, sound legal framework to function properly and to expand.

It was shown empirically that a large and persistent share of state-owned banks tends to block financial development and hampers the growth of the financial sector just as higher debt slows down economic growth[7)]. It can be closely associated with higher interest rate spreads, crowding-out of private credit, more concentrated credit allocation, less activity in the stock exchange and less non-bank financing, which in turn are all conducive to creating more room for financial instability.

Institutional convergence

We know from literature that there is a schematic, but a rather useful categorization of the financial sector into two distinct kinds, namely bank-based or indirect and market-based – direct systems[8)]. Bank-based systems (continental model) are defined as such where banks and banking services

2) Rajan, Zingales (1998); Beck, Levine (2004).
3) Erungor (2003).
4) Lopez, Spiegel (2002).
5) Rousseau, Wachtel (2001).
6) World Bank, IMF (2005), p. 223; Levine, Loayza, Beck (1999).
7) La Porta et al. (2003).
8) Merton, Bodie (2004); Ergungor (2003, 2004).

are dominant. Market-based systems (Anglo-Saxon model), by definition, are those where the capital market prevails. Traditionally Germany, Spain and China epitomize bank-based systems, whereas Chile, USA, UK, Mexico, Finland and Switzerland are representatives of the second group. However, elements of convergence can be observed between the two systems in the sense that some countries with a bank-based system have moved closer to the market-based ones due to an accelerated development of stock exchanges. The gradual abolishing of separation between commercial and investment banks in the US caused by the creation of financial conglomerates, as well as the shift towards the so called universal banking can be regarded as another visible sign of continuing convergence between the two models. We have been observing a tendency towards institutional convergence for the last 20–30 years. This process is far from complete and still progressive in nature.

Furthermore, there is a tendency to expand the role of financial sector gradually. This phenomenon can be identified not only in less developed economies like Brazil or Poland, but also in more developed ones like Spain. Malaysia should be considered here as an exception. Even in Switzerland the ratio of domestic credit plus stock market capitalization, measured as percentage of the GDP, has increased apparently. But there are structural differences between countries. Austria and Finland display a very different structure of their financial sectors as measured by the share of stock market capitalization to GDP. In Finland we have one special factor in play – namely the Nokia Company, heavily influencing the stock market capitalization.

Other tendency that can be observed is growing liquidity of the stock market, measured as a market turnover to GDP. In some countries stock market turnover exceeds capitalization (a tendency visibly predominant in countries like United Kingdom, Taiwan or Turkey); also the number of listed companies steadily increases across many countries, with a sharp increase observed in Canada[9)].

As it was already mentioned, so far the empirical research has not revealed strong and unquestionable evidence of links between the actual structure of financial sector and the recorded pace of economic growth. Moreover, countries with similar level of financial system development can grow at a similar pace regardless of the fact whether they have a direct, that is market-based, or indirect, that is bank-based, financial system. However, one may think that it should be of importance to avoid monoculture. It seems

9) NBP (National Bank of Poland).

good not only to have banks, but also capital market institutions, especially from the point of view of venture capital developments. It is also a positive factor to have an additional access to the sources of funding via the stock exchange. Not every company can go public via New York, Frankfurt or London and smaller local or regional stock exchanges might also be useful.

Initial conditions of financial system development

Let us now focus on the experience of post socialist economies, excluding China for the moment. The initial conditions were very specific, because Soviet type socialism was the most extreme form of statism in which private property in principle was not tolerated, the economy was dominated by state ownership and the market was distrusted and replaced by central planning, which was an extreme version of state control. But it is not possible to completely replace the market in any society. It still existed, mostly as a grey economy or a black market. In a situation where market was suppressed and a private property in principle was an offense, which was a direct legacy of Marxism – still popular in some circles in the West, there was not much scope for the very existence and development of the financial sector as we know it. In fact there was not such a thing as a financial system whatsoever, unless we call as such a system where monobank structure prevails in the banking sector, no independent credit decisions are taken and no such thing as risk management is in place. There were organizations called banks, but the underlying institutions were different than in the market economy. There were neither real commercial banks nor central banks. One of the moves that were done at the initial period of market oriented reforms in Poland in 1988 was the split of this monostructure into a central bank and separate commercial banks. The prudential regulation was also not needed, as there were no independent financial institutions. All this had to be created from scratch. There was no money market, no stock exchange and a very limited range of financial instruments available at hand, namely saving accounts. Of course no such thing as external and internal currency convertibility existed and domestic currency played only a very limited role.

From the institutional point of view socialist economies did not differ much from each other. There were however some very distinct and important differences in initial macroeconomic conditions. Firstly – inflation. There were countries where open inflation was relatively low as in the likes of Romania, Czechoslovakia and Hungary. In Poland, however, before the outset of reforms, the inflation rate amounted to 20–40% on monthly basis. Even a worse situation was prevalent in the Soviet Union, where hyperinflation persisted. But there was also repressed inflation due to price controls. Its most visible symptoms were queues, shortages and black market premium, which was sizable in some countries, including Poland.

Financial system transformation

There were some divergent developments as far as the subsequent moves aimed at the gradual expansion of the financial markets during transition were concerned. Some countries, like Czechoslovakia, started with a relatively high level of stock market capitalization resulting from coupon privatization accomplished in early nineties, but then the capital market weakened. In other countries a more systematic growth could have been observed. As far as domestic credit is concerned, China is a good example that more does not necessarily mean better. In terms of domestic credit China looks much like Switzerland, but one should keep in mind what stands behind this extremely high ratio of credit to GDP – the high ratio of nonperforming loans. What is the conclusion? In Central and Eastern Europe there is a lot of room for catching up. Financial deepening is proceeding. This means that in the long run the growth rate of the financial sector will be faster than that of the GDP and the ratio of the financial sector assets to GDP is going to grow.

As it was already mentioned, there are different speeds – we have a monotonic systematic growth of credit in Hungary and in Poland, but there is also some weakening observed in the Czech Republic and Slovakia. Because they suffered from banking crises which were closely linked to some fiscal problems, as a result the financial market development stopped and it took much time to recover. So a simple conclusion can be drawn and that is to avoid banking crises.

At the beginning of the reforms all countries in transition recorded a substantial share of nonperforming loans, as some loans granted under socialism turned out to be nonperforming after reforms. It is fair to add that mistakes were unavoidable at the very beginning; the banking sector is usually far from being perfect.

As a more general explanation of what matters for healthy growth of the financial sector, one must point out sound general policies and the importance of fiscal discipline. The observed differences in the development of the financial sector across the wide spectrum of post-socialist economies were less due to different initial conditions and more due to differences in the quality of general and sector policies. By general policies I mean fiscal and exchange rate policies, the effective enforcement of the rule of law, protection of creditors' and minority shareholders' rights and liberalization, allowing for free interplay of market forces. It should be stressed that the lack of fiscal discipline will always have a negative impact on the condition of the financial sector. Undoubtedly, the rule of law is a crucial factor for those operating in the economy, especially as it protects economic freedom. So these are some of the general conditions which – if in place – positively contribute to the development of the financial system. One other thing that matters is privatization, as one cannot be successful with a large share of state-owned banks in place. Privatization allows for more effective prudential regulation and supervision as well as the restructuring of nonperforming loans.

Current status

Now, let us focus on what is peculiar after those 15 years. It is really striking that we have moved from a totally repressed financial sector to a fully open market oriented one. It is an enormous progress. If one compares it to the progress achieved in the reforms of the mining sector for example – it is absolutely remarkable. If one looks at the former Soviet Union and countries of Central and Eastern Europe one can clearly distinguish two approaches to bank privatization. Firstly, there was that may be called the Russian approach which basically meant "be slow with privatization". At the beginning there was no private capital or expertise as no one could become an entrepreneur under socialism. Basically, if one wanted to privatize, an open attitude towards foreign investors had to be adopted. Without such an attitude a very high share of state-owned banks is the result[10)]. If you look at the data from 2001 the share of state-owned banks' assets in total bank assets amounts to 99% in China, 75% in India and 70% in Russia. The second group of countries, including all new EU Member States (NMS), opted for a different approach. They privatized fast and as a result of such a policy the share of total bank assets controlled by foreign investors, as reported in 2001, ranges from 34% in Slovenia to 98% in Estonia.

10) As presented in central banks' Annual Reports and BIS Paper No. 4, *The Banking Industry in the Emerging Market Economies*, BIS 2001.

The present relative position of the financial sector of the new EU Member States economies is still small or moderate. It is smaller than in the EU-15 and other developed economies, lower than it is in the case of Asian tigers, Chile, Israel and China. To some extent this can be considered as a function of time. However, no shock therapy is advisable here. If one tries to accelerate a process artificially by means of state intervention, it may end up with getting a higher share of nonperforming loans. So there is a lot of space for catching up, but this requires the rule of law, maintaining macro-economic stability and low inflation.

As far as the type of the financial sector is concerned, it is bank-dominated across the New Member States, with limited importance of capital and commercial debt markets. The ratio of credit to stock market capitalization is similar to that in the economies of bank-based developed countries (Germany, Japan, Portugal, New Zealand) and much lower than in Austria.

Bond market in NMS is dominated by treasury bonds, as a consequence of high fiscal deficits. There is so far not much development in the domain of corporate bonds.

Stock market capitalization in the NMS is much lower than in advanced economies and similar to that in Indonesia, Mexico or Brazil. Interestingly, their present situation is alike the one observed in some developed countries a dozen years ago, that means NMS seem to follow similar pattern.

Stock market turnover in the New Member States is very low, much lower than in all advanced economies, and relatively lower than stock market capitalization, which shows a certain concentration of stocks of listed companies in the hands of strategic investors.

If we look at the level of credit to non-government in the NMS we will find out it is comparable to that in other developing countries (except for Chile, Israel, the Asian tigers and China) and still much lower than in the developed countries (except for Denmark, Greece and Finland). It is also lower than the level of GDP per capita would indicate.

Conclusions

Overall, the financial system of the New Member States is already highly integrated with the European Union. There is a high degree of legal harmonization, as banking directives from the wake of the transition have been the hallmark on which basis the national legislation and prudential regulations have been modeled. Most of banks operating in the NMS are controlled by banking groups mainly from EU-15 (Germany, France, Italy, the Netherlands, Austria, Sweden and Belgium). Foreign investors are also active in other financial services, namely insurance and investment funds. The largest domestic companies have been making use of foreign financing, either through direct loans from parent companies abroad or loans from EU banks or through issues of debt securities and GDRs/ADRs on the European financial markets.

Finally, EU membership should continue to exert a positive impact on the pace of economic growth of the New Member States and therefore on their capital markets. There are certain features of EU framework in place that could allow these countries to grow faster. These need to be strengthened. Positive features include among others fiscal stability (thanks to provisions of the Growth and Stability Pact). Additionally, crucial for further acceleration of economic growth seems to be the expansion of common market (mostly that of services). Obstructing of the services liberalization directive is against the heart of the EU as it is primarily about freedom of conducting economic activities and providing services. Can the EU compete with China or the US without the liberalization of its largest economic sector? The third feature of the framework should be the reduction of subsidizing of enterprises. It is important to keep in mind that there are no national champions who are being subsidized. Therefore excessive subsidizing may preserve non-competitive modalities in the NMS economies, which – as a consequence – could lead to dampening of competitive forces driving economic development and slow down catching-up process of the development of the region.

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THE FUTURE OF THE POLISH DEPOSIT GUARANTEE SCHEME IN CONDITIONS OF INTEGRATION AND GLOBALIZATION

1. Introduction

In market economy banks may fail and have failed. Additionally integration and globalization processes, within financial market infrastructure, bring not only benefits but also threats and even a systemic risk "without frontiers".

During integration and globalization processes the Polish financial market is subject to various transformations. Taking into consideration its institutional structure and the volume of transactions, the more and more important role play securities transactions and insurance services. Simultaneously, processes of markets' integration within the European Union lead to an expansion of foreign companies with the commercial presence in host countries and the cross-border activity. Interdependencies between companies operating across different financial markets (in respect of a subject of transactions and a territorial scope), establishment of pan-European banking groups and financial conglomerates, and finally increasing integration of market infrastructure, they all not only bring benefits to customers, but also various threats and even a systemic risk. That is why the financial system stability is carefully observed by different UE bodies and international institutions.

The specific character of credit institutions together with practical experiences from banking crises led to development of regulations, the aim of which was and is defined as increase of the banking sector stability (stability of the banking sector as a whole and stability of an individual bank), bigger transparency of the banking market and investors protection and at the same time assurance of the necessary competitiveness level. That leads to searching for optimum between efficiency and stability.

In practice, there is a game of interests between banks' owners and management (who strive for maximization of return on investment) and state institutions, e.g. the legislator or regulator (the aim of which is safety of financial transactions on the market). However, depositors' trust in banks is based mainly on their belief that regulators supervise the complex clearing system and bank risk. Moreover, they protect from crimes resulting in bank bankruptcies or financial crises. When the main goal of the game is the stability of the banking system as a common good, it leads to prudential regulations limiting investment risk of banks and establishment of guarantee schemes. Deregulation makes a chance for flexible management of credit institutions on competitive market that increases their effectiveness, but exposes them to higher risk.

In spite of criticism connected with a side effects of guarantee schemes activities (e.g. moral hazard), there is no indication that conception of depositor protection could be rejected by international practice, at least in the predictable perspective. On the contrary, the improvement of international

Table 1. 10 top banks in Poland by share of deposit volume and dominating shareholders

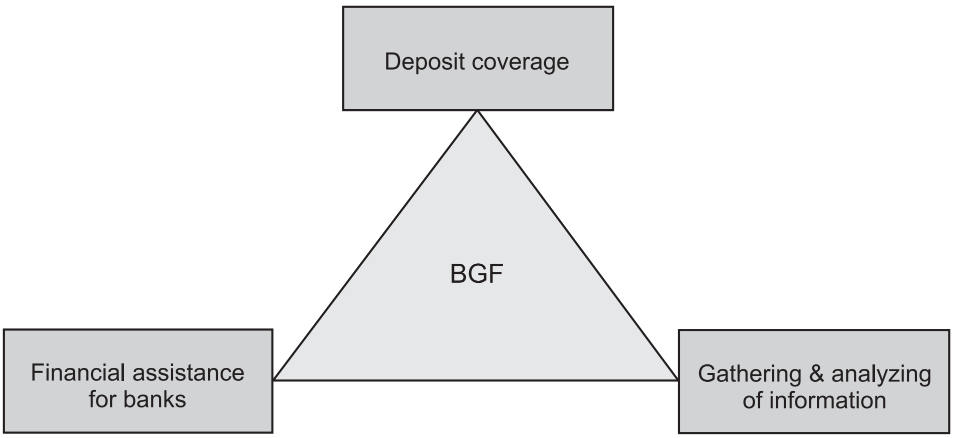
BANKS AND SHARE OF DEPOSIT VOLUME		DOMINATING SHAREHOLDERS
PKO BP S.A.	(20,0%)	**PL State Treasury**
PeKaO S.A.	(12,9%)	UniCredito Italiano
BPH S.A.	(10,2%)	HVB (D)
ING Bank Śląski	(8,4%)	ING (NL)
Bank Handlowy S.A.	(5,7%)	Citigroup (USA)
Bank Zachodni WBK S.A.	(5,6%)	AIB (IRL)
BRE Bank S.A.	(5,3%)	CommerzBank (D)
Kredyt Bank S.A.	(5,1%)	KBC (B)

and domestic consumer protection infrastructure on the financial services' market is more than likely. There are dilemmas yet, in which way to ensure protection for depositors when infrastructure of domestic and international financial markets is changing and cross-border transactions are developing.

2. The BGF – the actual and the future functions

Statutory objectives of the Polish guarantee scheme constitute a triad with specific functional connections. Taking into consideration international trends, two of them are inalienable. These objectives are namely, deposit coverage and linked with it analysis of information about member institutions.

Picture 1. Objectives of the Polish guarantee scheme according to Act on the BGF



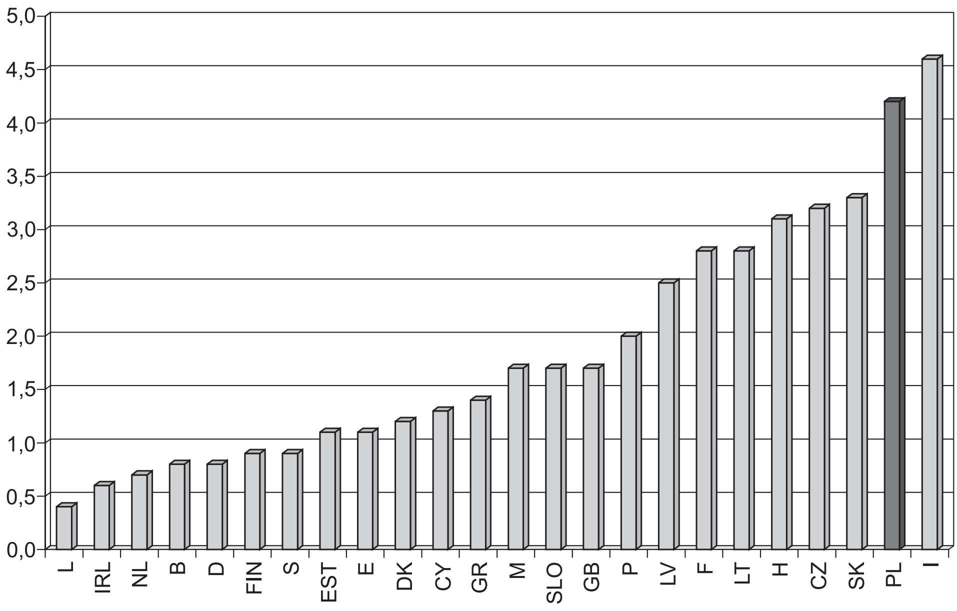
Deposit coverage has a superior character and originates from social paradigm of customer protection. With reference to banking system that paradigm concerns first of all so-called small depositors, for which loss of savings or funds entrusted bank is a difficult experience of life or business and may cause an essential perturbation in realization of their basic functions as individuals or economic subjects. Depositors' protection limited to a certain amount – irrespective of the amount of deposits entrusted in a given bank by depositor – constitutes consent of legislator for protection of customer financial resources deposited in a credit institution.

In connection with the single European license and tendency to provide banking services on cross-border basis, arises a problem whether differences in level and scope of coverage are or may be one of the main factor of competitive superiority of credit institutions in the field of attracting deposits.

The level of depositors' protection differentiates strongly in individual countries, both in absolute value and in relation to GDP *per capita*. Under normal circumstances (namely under financial system stability) differences in guarantee limit in countries creating integrated financial services market has the marginal impact on attracting deposits and keeping them within banks chosen by depositors. The guarantee arbitrage may be important in the situation of decrease in depositors' trust. Depositors' experiences and their knowledge about protection rules are additional factor for flow of funds and even banking panic.

In situation of stable trust in banks and banking system safety net and when in Poland the average level of balance of the bank account is about EUR 1,500, Polish guarantee level, which fulfils the EU minimum (4 times

Picture 2. Coverage limit/GDP *per capita* in EU Member States



as high as the Polish GDP *per capita*), will not be a main factor of customers' migration to foreign credit institutions with the similar or even significantly higher guarantees. Simultaneously, the realization by the BGF its function of stabilization of banking sector throughout granting financial assistance to banks, which prevent their bankruptcy, is the substitute for increasing of the guarantee level. Leaving the risk minimizer model requires adequate buffering risk of deposits' outflow to institutions, which belong to schemes with higher guarantee, in case of threat of bank bankruptcies especially. In crisis situations relevantly high level of protection constitutes buffer for potential run on banks, especially for those depositors for who the loss of deposits could be a threat to satisfying their basic needs.

The principle of the law harmonization in Member States of the EU together with freedom of use of exclusions from the coverage stated in the Directive EC/94/19 lead to substantial differences in the scope of coverage in individual states. It is also important that in accordance with the Directive legislation of individual countries excludes from the coverage certain groups of deposits (deposits of credit institutions, instruments qualified to the category of own funds, deposits arising out of transaction in connection with money laundering). However, other categories of deposits (14) may be but do not have to be excluded. The variety and complexity of depositors together with dynamic changes in their formal-legal status lead to practical problems in separating the subset of beneficiaries from the subset of depositors excluded from the coverage. Such problems are experienced by the national deposit guarantee schemes and the situation from the cross-border perspective looks even more complicated.

The analysis of the table 2 indicates that among 16 categories of deposits from the list of possible exclusions determined in the Directive EC/94/19 in 11 cases the Polish solutions correspond with the majority of solutions used in the EU countries. In five cases the Polish solutions are in the minority group.

While comparing data from the table 2 one may deliberate on the argument of the Polish legislator to exclude from the coverage entities which are not permitted to draw up abridged financial statements or treating organization units of local and regional authorities as one depositor (for example houses for social care, health care centers). At the same time the Polish legislation treats relatively liberally such categories of depositors like relatives of depositors, who are excluded from the coverage, or deposits taken on an individual basis. The above-mentioned examples illustrate certain inconsistency in the doctrine of deposit protection. From the perspective of

Table 2. Comparison of applied exclusions in the EU Member States

No	Directive EC/94/19 on deposit-guarantee schemes List of exclusions to art. 7 (2)	Poland	EU Member States	
			with exclu-sions	without exclu-sions
			Yes	No
1	Deposits by financial institutions [Art. 1 (6)]	Yes	22	2
2	Deposits by insurance undertakings	Yes	20	4
3	Deposits by government and central authorities	Yes	17	7
4	Deposits by provincial, local and municipal auth.	No	16	8
5	Deposits by collective investments	Yes	22	2
6	Deposits by pension and retirement funds	Yes	21	3
7i	Deposits by a credit institution's own directors, managers, members personally liable	Yes	19	5
7ii	Deposits by holders of at least 5% of the credit institutions capital	Yes	19	5
7iii	Deposits by persons responsible for carrying out statutory audits of the credit institution accounting doc.	No	19	5
8	Deposits by close relatives and third parties acting on behalf of the depositors referred to in 7 (i,ii,iii)	No	14	10
9	Deposits by other companies in the same group	Yes	16	8
10	Non-nominative deposits	Yes	21	3
11	Deposits [...] which have helped to aggravate its financial situation	No	8	16
12	Debt securities issued by the same institution & liabilities arising out of own acceptances & promissory notes	No	15	9
13	Deposits in currencies in other than those of the Member States, ecus.	No	8	16
14	Deposits by companies [...] which are not permitted to draw up abridged balance sheets	Yes	10	14

works on the new Act on the BGF it is worth considering arguments in favour of the *status quo* or introduce amendments.

Substantial differences in the scope of used exclusions in the countries become more and more important especially in the context of cross--border provision of banking services and practical use of the single banking license in the EU member states. They also require solving problems, which may occur in case of payment of compensation in the cross-border context, according to the principle of deposit guarantee scheme transparency (especially for depositor). Providing for the changeability and dynamics of the situation in the identification of those entitled to compensation, practical indication for establishing subset of bank customers – who cannot be qualified as depositors as defined by guarantee scheme – may be statutory determination of the principle or criteria for exclusions in turn saving the competence of detailed solutions for the minister responsible for financial institutions, who in cooperation with the domestic safety net players and counterparts from the EU or others international organizations could shape these solutions. This solution could favour *inter alia* increased stability of regulations on guarantee scheme and at the same time it would take into consideration the specific character of the situation in individual countries.

Basing on available information one may contend that differences in the scope and level of coverage are not the main factor of competitiveness in concentration of savings in credit institutions, even in these countries of the "15", where cross-border banking activity already has more experience.

Taking into consideration a special role which credit institutions play in efficient functioning of national and international social-economic system with reference to the deposit guarantee scheme suitable is the analogy to fire administration which says "better prevent than put out fire". Nevertheless, doctrinal objections of believers of "invisible hand of the market", prevention of bankruptcies of insolvent banks thanks to granting them financial assistance for restructuring (in the form of takeover or self-rehabilitation with participation of strategic investor) or liquidation (particularly in the form of so called controlled closing down of business) is much better implementation of the idea of credit institution's customer protection than just guaranteeing of deposits.

From the perspective of the Polish law the second aim of the guarantee scheme and at the same time an element of the before mentioned triad refers to those kinds of activities which may be undertaken in connection with granting financial assistance to the member institutions of the obligatory guarantee scheme. Limitation of the value of all types of assistance available to a credit institution up to the amount of guaranteed funds causes that this aim may be treated as functional one in relation to depositors' protection and simultaneously connected with treating the banking system as the common good. However, in case of success of the financial assistance program dedicated to remove the threat of insolvency, such activities, at total lower systemic cost, give a larger external effect than payment of guaranteed funds. Such activities also promote stability of the financial system, more often treated as necessary condition for integration of financial markets.

In theory and in practice there is no clear evidence of the superiority of assistance over payments of guaranteed deposits. In such circumstances axiological approach to these matters or preferences of the national legislator in connection to the guarantee scheme forejudge the choice between pay box and risk minimizer model. The deepened analysis does not allow identifying explicit regularity between features of the economy and banking system and the type of the guarantee scheme. However, the specific of relatively young banking systems in transition countries and undergoing restructuring, and especially the possibility to influence shaping of domestic structures of these systems, cause that more suitable model for them is the risk minimizer model. This includes also the Polish guarantee scheme.

It is difficult to say whether in the future there will be a distinction among national schemes in connection with the above-mentioned models or they will be becoming similar, especially in countries creating the Single European Market. Taking into consideration systemic advantages coming from activities of institution – risk minimizer, one may forecast they will become common, however under condition that there will be an international or European agreement on standards of granting such assistance (criteria and forms) and working out procedures. Apart from positive experiences taken from practice (Spain, Poland) reason for projection of dissemination of this concept may be risk of importing of the insolvency crisis in conditions of globalization of the financial services market. Indispensable condition of this projection is operationalization of the least cost principle and next proving that such types of operations are systemically more favorable. Important would be also taking responsibility for consequences of a credit institution crisis by its hitherto owners and persons which activity contributed to bank insolvency.

In general all undertakings which aim at overcoming the insolvency crisis should be implemented "quickly, quietly and efficiently". Differences in approaches and perception of the banking system problems and individual banks by different institution constituting banking system safety-net delayed in the past identification of the essence of the problem and undertaking coordinated rehabilitation activities, consequently increasing costs of such operations. Taking the right decision at the right time allows to optimize necessary systemic resources for the rehabilitation of the bank or elimination of such insolvent credit institution from the market.

Taking right decisions requires and will require effective cooperation of safety net participants, especially supervisory authorities and institution responsible for guaranteeing deposits, most of all suitable legal regulations, which protecting interests of the bank's shareholders, do not invade taxpayer's interest for whose cost (at least partially) solving of the insolvent bank problem is done. Internationalization and globalization provide new challenges concerning cooperation between safety net players in international context.

At the stage of prevention activities it will be mostly exchange of information and working out of procedures of cooperation, whereas in the crisis phase efficient cooperation. The new area of such activities will be bilateral or multilateral agreements between guarantee institutions from the home and host country.

For the system of financial assistance for banks it is fundamental to identify the essence of the problem. It is important whether the reason of crisis is the threat of insolvency or maybe the reason for not paying liabilities – are problems with liquidity. In both cases the way of solving the problem should differ. The classical function of the central banks as participants of the safety net is the function of the lender of last resort, called today as Emergency Liquidity Assistance. "Recently more and more popular is the concept that the central banks should avoid realization of the function of the lender of last resort by way of bilateral operations"[1]. According to this concept liquidity assistance, as a consequence of extraordinary increase in demand for reserve money, should be granted by the central bank in the form of open market transactions.

Traditionally the function of the lender of last resort was realized by central banks at the stage of management crisis. However, banks more and more engage themselves in preventing of financial system destabilization especially throughout analysis of systems immunity for shocks and materia-

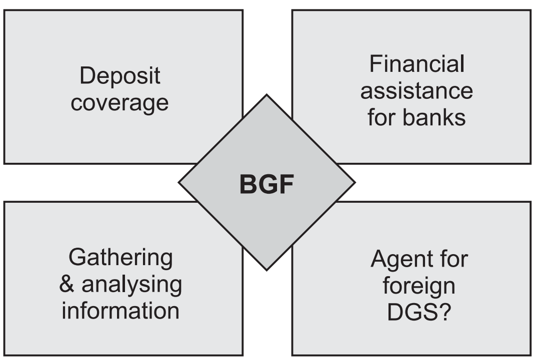
[1] Szczepańska O., Podstawowe przesłanki, założenia i struktura sieci bezpieczeństwa finansowego w świetle teorii i doświadczeń międzynarodowych, the BGF's seminar: Deposit guarantee schemes in financial safety net, Warsaw, 2004.

lization of risk. This issue is connected to the division of competencies and exchange of information between the National Bank of Poland, Commission for Banking Supervision and the Bank Guarantee Fund. In specific situation referring to for example crisis in systematically important banks, whose owner could be a foreign bank from the country, which is in the Euro zone, the European Central Bank should be taken into consideration. This entails the requirement of change in its function by assigning appropriately determined function of the lender of last resort.

The third aim of guarantee schemes, encompassing gathering and using of information about member institutions, has mainly operational dimension, and in practice in Poland mainly internal character. In future its meaning in the context of discussed triad of aims – most probably – will increase. It will mainly refer to identification and monitoring of risk level generated by member institutions, and its including in calculation of contributions paid by member institutions for an appropriate fund managed by guarantee institution. It will also play very important role in the *ex ante* system when reaching set target level and adjusting of payments situation in the banking sector. Probable is also development of the function which aim is to inform member institutions about current tendencies from the point of view of banking system stability or indicating a threat.

Moreover, advancing integration of the EU financial services market, and especially cross-border provision of banking services, creates a new systemic context for the statutory aim being analyzed. The context not connected directly with the direct responsibility for guaranteeing deposits but with exchange of information with deposit guarantee schemes (DGS) from home countries of credit institution providing services on cross-border basis on the territory of Poland. It is also important to inform appropriately customers of foreign credit institutions about the level and scope of coverage.

Picture 3. BGF – International risk minimizer-square



Taking into consideration the depositor's interest and potential problems with payments of compensation in case of bankruptcy of a foreign bank providing its services on cross-border basis, it may be justified for the BGF to act as an agent in case of payments of compensation to depositors (for instance on contract basis). The issue, which requires deepened analysis – especially legal ones – is whether the national guarantee institution (BGF) should represent – in relations with foreign institution – depositors or towards depositors – guarantee institution from the home country – bankrupt credit institution. Undertaking such tasks in Poland would require appropriate amendments in the Act on the BGF, and with reference to institution from member states in the Directive EC/94/19 or in the appropriate bilateral agreements.

It is worth mentioning that the conducted analysis of the BGF's aims is based on the assumption that the national character of the institution will be preserved. Possible process of transitional integration of guarantee institutions or establishment of international reguarantee institution may lead to modification of redefinition of these aims. The modification or rather extension of aims will take place also in case of consolidation of sectoral guarantee institutions in connection with financial services market (investor compensation schemes etc.)

3. Structural and organizational dilemmas of deposit guarantee scheme

The 10 year period of the Act on the BGF being in force, practical experiences, results of discussions on the amendment to the Act on the BGF as well as information about foreign solutions induce to analysis of the Polish deposit guarantee scheme principles. The part of those principles, connect-

Table 3. Analysis of principles constituting deposit guarantee scheme

Principle	Comments
Generally binding membership in the scheme	Against a background of comparative analysis, in the new Law on the BGF one should consider issues of possible exclusion of a bank from the scheme – also the issue of covering credit institutions (i.e. credit unions) arises in the case of glaring violation by this entity of prudential regulations or persistently conducting activity with use of moral hazard.
Territorial membership in the scheme	Banks' migration between guarantee institutions in different countries, as a result of cross-border consolidation processes of banks, creates new information and control func-

Principle	Comments
	tions in terms of observance of prohibition of using level and scope of coverage in the advertising campaign as well as problems referred to coexistence of various schemes in the territory of the host country, but also a problem of transfer of accumulated guarantee fund while transferring guarantee obligation to another guarantee scheme – when they operate in the different financing regimes (*ex post* and *ex ante*).
Equal rights of member institutions	In the currently binding structure one cannot make any critical remarks. However, in the case of certain systemic changes it would be modified and converted into a principle of entities equality within the confines of specific sectors of financial market: credit institutions, investment companies and other financial institutions (sector segmentation of guarantee scheme within one organizational structure).
Participation of member institutions in the financing of BGF's goals	The principle of proportionality in the financing of guarantee institution in correspondence with gathered deposits or risk-weighted assets, supported by the principle of solidarity of member institutions in the face of danger of banking crisis, is justifiable in the initial stage of deposit scheme development and may be modified. The direction of search is to link participation in the financing of guarantee institution's goals with risk generated by entities (included behaviours typical for safe hazard).
Least cost of liquidation of insolvency crisis	The least cost principle may be considered at least on two levels, a consequence of possible methods of BGF's intervention towards banks threatened by insolvency. In the first place, it is the following alternative: to pay out guaranteed amounts to depositors or to rehabilitate a bank (through takeover, self-rehabilitation, liquidation – in the classic formula or so called closing down of activity). The second level, as far as rehabilitation option is concerned, is to choose a method and instruments for elimination of the state of a bank's threatened solvency, on the basis of the least cost principle, given limitations of the law. In the circumstances of decreasing interest rates, an exploitation of the conception of market differences in the "money price" and favourable interest on the BGF's assistance increases systemic costs of elimination of banks' threatened solvency. In order to protect depositors one should widen options for financial support of banks or raise the equity capital. One should express in the Act only principles of assistance or so called open catalogue of meth-

Principle	Comments
	ods and instruments. That option has to take into consideration an unconditional order for limitation of systemic costs incurred in connection with threatened banks' rehabilitation or liquidation. A combination of the assistance fund with the fund for protection of guaranteed deposits might be one of results of such solution. In the case of widening the range of assistance and introducing its new forms, the problem arise in connection with legal limitation of assistance value (net), but not a loan value (gross).
***Ex ante* financing**	Taking into account experiences as well as the fact that it is better to gather guarantee funds in a planned manner than in a crisis situation rapidly burdening entities with costs (limitation of procyclicality), one should determine the minimal level of target ratio as well as the "reaching path". It is essential to settle if BGF is operating in the regime of two funds (guarantee and assistance – with or without the NBP participation) or one fund designed for realization of statutory functions in banks. *Ex ante* financing persuades to solve the problem of so called "free riding" of institutions newly joining guarantee scheme as well as settlements of contributed fees in the case of banks' migration to other guarantee schemes.
***Ex post* financing**	In the case of an acceptance of *ex ante* financing, an *ex post* formula could be sustained exclusively for extraordinary situations and fall under the resolution of the Council of Ministers, having sought the opinion of the President of the National Bank of Poland (article 34, paragraph 4 of the Law on the BGF), or be in the nature of loan with the repayment obligation.
Minimal level of coverage and coinsurance	The Polish guarantee scheme is consistent with the requirements of the EU Directive in terms of minimal level of coverage (minimum EUR 20,000 without the coinsurance). The maximum level of coverage is not a subject to indexation (however, it is a subject to consultation), and the coinsurance mechanism is used by the minority of guarantee schemes. Considering this fact the Polish solution is original, combining protection of small deposits in 100% up to the PLN equivalent of EUR 1,000 with 10% coinsurance, which contributes to limitation of moral hazard with respect to guaranteed amounts over EUR 1,000 up to EUR 22,500. In the situation of decrease in trust towards banks, given the ave-

Principle	Comments
	rage level of deposits held in banking accounts in Poland, the coinsurance with respect to the guaranteed amounts above the equivalent of EUR 1,000 may be a stronger factor of inclining customers to the guarantee arbitrage than differences in the level of coverage.
Limited access to information on member institutions	The Polish legal arrangements limit the BGF's analysis with regard to banks threatened with insolvency but not using the BGF's assistance. In consequence, decisions made with reference to the establishment of the fund for protection of guaranteed deposits and gathering the assistance fund, are dependent on information obtained from the Commission for Banking Supervision and the General Inspectorate of Banking Supervision. Moreover, the decision on the assistance and its amount is conditioned on the results of financial statement audit, which have not always turned out to be adequate.

ed with basic goals of deposit guarantee scheme, has been already discussed. In this section other principles with regard to the most significant aspects of the BGF's performance will be discussed.

The principle of statutory regulations with respect to forms of financial assistance needs to be discussed separately. Taking into consideration the BGF's experiences as well as other countries' experiences, given dynamics in the changes of situation on the financial services market, it is reasonable to consider the limitation of statutory regulations with regard to forms of assistance and specifying only general principles.

Such a solution (similar to some countries' practices) would give the BGF freedom in the choice of appropriate methods and instruments. The BGF's inspection carrying out in an applying bank as well as a diagnosis of its organization and financial condition should constitute an integral part of the assistance granting procedure. The possible limitation of the financial assistance activity conducted by the BGF could result from the Commission for Banking Supervision's initiative, expressed in the resolution on undertaking the assistance activity. However, the BGF should have right to refuse to undertake such an activity, which would result in pay-out of guaranteed deposits according to the pay-box model.

The open formula of methods and assistance instruments would require determining internal regulations with regard to their usage, issued for instance by the minister responsible for financial institutions, or/and adopting the catalogue of such instruments by the Fund Council. The described solution would lead to the appropriate Fund Council structure regarding the mandates of the representatives appointed by the safety net players and other parties as well as determination of their members' competencies.

Innovation processes on the financial services market cause that the methods of monitoring insolvency threats, which were used in the past, become inadequate. Both relatively young and the most mature safety nets experience this. Then, it turns out that bank crisis may occur "as suddenly as a thunderstorm in the mountains". The improvement in the estimation procedure with regard to the demand for the BGF's assistance funds should lead to work out and apply formulas of calculation based on the risk models and capitalization scenarios. Advanced analytical studies and already used procedures of banks' monitoring make an original contribution to the development of instruments used by the safety net players. They should be verified not only on the basis of Polish databases, but also in cooperation with similar foreign institutions.

4. The separateness of deposit guarantee scheme (based on Directive EC/94/19) and the investors compensation scheme (based on Directive EC/97/9) and other guarantee schemes on financial services market

The majority of guarantee schemes was established in different periods of 20^{th} century and encompassed mainly deposit coverage in credit institutions. Gradually, the scope of protection was expanded to investor compensations or funds entrusted to mutual investment companies. Looking at foreign practices one may distinguish various organizational models of guarantee schemes. For instance, in some of the EU countries the deposit guarantee scheme and the investor compensation scheme are managed by the same institution (Belgium, Denmark, Estonia, France, the Netherlands, Ireland, Lithuania, and the Great Britain). It is justified by the integration of financial markets or the development of financial conglomerates, providing services typical for various segments of financial market "under one roof".

The changes in the Polish banking system and the capital market, especially regarding intercountry consolidation processes and merger processes resulted from foreign consolidations or incorporation of banks licensed in Poland and being subsidiaries of foreign credit institutions, make reasonable to consider the conception of organizational integration ("guarantees under one roof") of domestic guarantee schemes. It is worth mentioning that also effectiveness considerations, such as limitation of administrative and management expenses, or economies of scale are strong arguments for the organizational integration of guarantee schemes. In the first place it applies to the integration of deposit guarantee scheme with investor compensation scheme, in the long perspective also other guarantee schemes (i.e. mutual investment funds) or from the radical point of view also insurance guarantee schemes. The integration of deposit guarantee scheme with investor compensation should not be problematic. The integration with insurance guarantee scheme may be much more complicated, especially in terms of the conception and organization.

However, the organizational integration should not mean consolidation of relevant guarantee funds. It could be possible to manage separate funds in a way aiming at optimizing of guarantee systemic costs within the confines of the wide-expressed conception of customer protection (i.e. temporary transfer of means between funds in the form of secured loans).

Taking into account the stage of organization development as well as the organizational potential of the Polish guarantee schemes, the Bank Guarantee Fund could be an institution responsible for integrating schemes. In the case of integration of guarantee schemes, which requires amendments in legislation, it will be necessary to determine the fund's structure of combined guarantee institutions as well as principles of management. The integration will have impact on the composition and desired structure of qualifications of the institution's authorities as well as distribution of mandates of the supervisory body between safety net players and representatives of entities covered by the guarantee scheme.

In the face of internationalization processes with respect to banking systems as well as an expansion of cross-border activity, the problem arises as to the stabilization activities regarding systematically significant banks which have problems. This substantially applies to the Polish banking system, where the share of foreign capital is high with reference both to ownership and bank assets. From the formal point of view the problem is solved by the membership of the subsidiary bank in the host country's guarantee scheme. However, one cannot ignore the risk of costs incurred by this scheme, connected with possible transfer of domestic deposits abroad in the case of a crisis, and especially the bank bankruptcy.

While preparing international standards in reference to extending financial assistance to banks, one should make an analysis of purposefulness as to the exclusion or allowance of so called self-rehabilitation (Open Bank Transactions), defining of bank characteristics (i.e. TBTF or TITF) and conditions, on which such an assistance would be acceptable.

5. Comments on guarantee schemes' integration – the international approach

In order to implement the conception of guarantee schemes' integration (horizontal consolidation) it may be necessary to undertake activities towards the establishment of cross-border guarantee institution (for credit institutions and/or investment companies) in the EU. Initiators of such activities may be, first of all, countries with high share of foreign capital in the national financial market and those, where the tendency of deposit emigration appears (negative balance of cross-border flows of deposits and loans *via* institutions, which registered offices are in those countries).

Table 4. Problems of burden sharing arising out of cross-border banking crisis

(Hyphothetical case)

EU Member State X	EU Member State Y
Home country	Host country
A-Bank in X – "mother" bank	B-Bank in Y – A-Bank subsidiary (TBTF)
X Regulator accept transfer from Y	B-Bank profit and assets
A-Bank becomes insolvent	B-Bank sound & profitable
X Regulator wants to shut down A-Bank	Y Regulator wants B-Bank to operate
A-Bank depositors are paid off before	B-Bank depositors got a look-in
WHO SHOULD COMPENSATE B-BANK DEPOSITORS?!	

The problem of cross-border guarantor involves the fact, that the more penetrated is the national financial system by foreign strategic investors, the higher the risk of "paying someone else's bills". Since the degree of liberalization and penetration of Polish banking system by foreign capital is high, the stability of the whole banking system depends on the subsidiary companies. Therefore, the essential problem is that, who will incur fiscal costs when it is necessary to restore the stability of the banking system. This is of great importance since the EU institutions are not prepared for a crisis in the transnational financial institutions, and the stability of the financial system is perceived as the common good of national markets, not the single European market.

Subject to controversies of practitioners and theorists of financial system safety net is a question whether the cross-border integration (vertical) should lead to the typical centralization of guarantee schemes, using the community method (i.e. ECB), or to the establishment of the collegial guarantor, using the national method based on the international coordination. Another dilemma refers to the question whether the cross-border guarantor would act on the basis of the exclusiveness principle or the subsidization principle. Taking into account the advanced state of the works on such a conception as well as heterogeneous national interests, one should not count on the quick progress, especially that numerous issues still need the harmonization in the EU-25 countries or the agreement as to the common standards.

With reference to the option of the international integration of guarantee schemes, the pace of this process may be relatively fast and depends almost exclusively on the adequate amendments in legislation. The possible timely extension of that process could depend on the initiatives and symptoms of cross-border integration and centralization of guarantee institutions. The similar processes in the cross-border context are more difficult to forecast and they involve harmonization of principles, coordination of activities, institutional consolidation of national systems.

The alternative for the cross-border guarantee institution may be a conception of reguarantor, connected or not with the European conception of the lender of last resort. The significant dilemma of the establishment of the cross-border guarantor or reguarantor will be organizing it in the regime of private or public institution. The possible attributing the function of reguarantor to the European Central Bank or establishment of the separate institution will require detailed analysis and consultations between member countries of the Euro zone.

So far, various conceptions have been formulated with respect to the future institutional and regulative architecture of the common financial market. One of them is assigning the ECB role of the arbiter, which in the case of destabilization of the national financial system caused by external factors would determine participation of every national safety net player in the crisis costs. However, it is essential that the ECB would not be equipped with the legal or financial sanctions, but its decisions would influence the reputation of the interested parties.

In the case of establishment the separate guarantee institution for the EU countries, both in the cross-border and reguarantor option, it will be necessary to determine financial participation of member institutions, which may be, depending on the conception, guarantee institutions, banks offering cross-border services, banks with branches or subsidiaries in the host countries, last but not least – transnational financial institutions.

Considerations on the new guarantee architecture have been concentrated on the national solutions and with reference to the integrating EU financial market. The development of globalization processes may be a decisive factor as to the preparation of the conception that goes beyond borders of the EU market. The symptoms are, for instance, activities of the International Monetary Fund, aimed to the creation of the lender of last resort for the countries suffering from a crisis (*Contingent Credit Line Facility*). To say nothing of the problems referred to the participation of entities in the accumulation of necessary loan capital, it is worth to underline that in the modern conceptions of crisis management, access to the adequate capital flow by the entity managing the crisis is more important than accumulation of the capital resources.

It is difficult to pass judgement on the course of the integration process or guarantee schemes centralization, in the global perspective. However, if such an integration (principles and procedures) and afterwards centralization (organizational consolidation of schemes) took place, it would progress at least in a few phases. The first phase would involve integration of schemes, based on the integrated national markets, forming economic group (i.e. Lisbon Strategy). The second phase refers to the integration of guarantee schemes on the close territorial markets or which are connected by significant financial flows – at least one of them belonging to the economic group (i.e. Poland–Ukraine, Turkey–EU). The third phase would involve the integration of schemes in the transnational scale. The last phase, not very likely in the predictable perspective, refers to the establishment of the global guarantor. These phases may lead either to isolation of functions and tasks from national organizations and, as a result, gradual transferring them to the transnational institutions or to the establishment of international guarantee institution(s) whose responsibilities would be similar to those belonging currently to national guarantors.

Dr Grzegorz Wójtowicz
Member of the Council
Bank Guarantee Fund

THE BANK GUARANTEE FUND – 10 YEARS OF EXPERIENCE IN CREATING THE BANKS' SAFETY AND STABILITY IN POLAND

The Polish Bank Guarantee Fund (BGF) was established in 1995 (the Act on the Bank Guarantee Fund was enacted on December 14, 1994, but it became law on February 17, 1995). Pursuant to that the BGF has become one of the most important elements of the financial safety net, apart from the National Bank of Poland, the Commission for Banking Supervision, and the Ministry of Finance.

The Act empowered the Bank Guarantee Fund with two functions – assisting banks threatened with insolvency, and guaranteeing bank deposits (risk minimizer model). The assistance activities of the BGF are complementary to guaranteeing deposits because their direct effect is limiting the extent of banks' bankruptcies. Such a role of the Fund is well established historically, as it results from and is closely intertwined with the development of the whole Polish banking system.

The banking sector before 1989

Until 1989, the Polish banking sector was a part of the centrally planned economy. It was the government who set the interest rates and decided on the directions and scope of banks' credit activity. The National Bank of Poland had the dominant position in the system as it combined functions of both a commercial bank and a central bank. Additionally, at that time only a few state-owned banks were operating, dealing with specific sectors of the national economy and not competing with each other at all (Bank Handlowy w Warszawie SA, Powszechna Kasa Oszczędności – Bank Państwowy, Bank Polska Kasa Opieki SA and Bank Gospodarki Żywnościowej). Another part of the banking sector was the net of around 1,660 small, locally operating cooperative banks, all of them obligatorily grouped under the umbrella of the state-owned Bank Gospodarki Żywnościowej.

Deposit insurance in the centrally planned economy

As far as the deposit protection was concerned, in the cases of banks' failures, in the centrally planned economy, the State Treasury was responsible for individual deposits kept in banks, with no limits set to the deposit levels. Such state guarantees had been introduced as part of the Law on Banking Reform of 1948. They were then sustained in the legal acts passed in the following years: in the Banking Acts of 1960, 1975, and 1982.

The banking system and deposit insurance in the transition period

Since the beginning of the nineties, Poland was taking a hard but at the same time successful road from the centrally planned economy to a market oriented economy. One of the crucial moments of that process was creation of the banking industry, a very important component of the market economy.

The establishment of the new framework of banking system took place in 1989 when the Bill on the National Bank of Poland and the Banking Act were passed. In conformity with these legal acts, the National Bank of Poland, acting as the central bank, was charged with functions of an issuing bank, a central credit institution, a clearing house and a foreign currency exchange institution. Within the previous banking system, the National Bank of Poland carried out nearly all bank activities, and the roles of other banks were significantly curtailed. Therefore the first objective during the transition was to create a competitive banking environment.

During the first phase of the banking transformation, nine commercial banks were created emerging from the branches of the National Bank of Poland (at the beginning their only owner was the state, later on they were systematically privatised). Those nine banks took over the obligations of the NBP connected with the credit and deposit activities. A two-tier structure of the banking system was introduced, where the central bank was separated from the commercial banking activities. The next step was to allow for creation of private banks. Over the period of 1990–1992, 67 new banks were set up and commenced their operations. In order to ensure a free competition, the Polish banking authorities adopted the following two specific guidelines:

- no geographic or market segmentation was set for most banks;
- no entry restrictions (barriers) were introduced apart from minimum capital requirements and an overall principle of conducting bank operations in accordance with the specific banking regulations.

The Banking Act adopted in January 1989 sustained the State Treasury's responsibility to insure deposits of physical persons in state banks and a few other banks which were subject to the law before 1989 (these were 6 state banks, 1 private bank and 9 banks separated from the National Bank of Poland). As a result of the amendment to the Banking Act in 1994, the State Treasury's guarantees were expanded to cover also cooperative banks and the banks affiliating the cooperative banks. That caused an unequal treatment of banks and their customers: the banks mentioned above were fully protected while the newly established commercial banks were not covered by any guarantees at all. Such an inequality significantly weakened their position on the market and negatively influenced the confidence of depositors in the banking sector as a whole.

In 1993, the first problems appeared in the Polish banking system undergoing the transformation. Because of a quickly growing demand for banking services and a substantial liberalization of entry conditions into the banking market as a result of a liberal licensing policy, since 1989 the number of new banks has grown rapidly. At the end of 1993 the Polish banking system comprised 82 commercial banks (most of them privately owned). At the same time, the transformation of the economic system has weakened many businesses, among them the ones that took loans. The consequences of that situation were problems with loans repayments and later on – a huge amount of doubtful and lost loans in the banks' portfolio. In the years 1992–1994, the nonperforming loans amounted to *circa* 30% of the total loan portfolio. As a result, some of the new banks lost their solvency, while a few others were declared bankrupt. To counteract the critical situation and to solve the problem of bad debts, the Act on the Financial Restructuring of Enterprises and Banks was adopted in February 1993.

Cumulatively over the period of 1992–1996, 4 commercial banks and 121 cooperative banks were declared bankrupt. At the same time, other 25 commercial banks had to be taken over by another banks because they were unable to continue operating on their own.

In order to avoid panic and destabilization of the financial system, the decision was taken to introduce temporary deposit guarantees. Based on the Parliament resolution on monetary policy for 1994, the President of National Bank of Poland was entitled to guarantee 100% of individual deposits in banks up to ECU 1,000 and 90% worth deposits ranging from ECU 1,000 to 3,000. This system of temporary guarantees was to remain in force until respective acts were adopted which would comprehensively regulate the issue of bank deposit guarantees. Deterioration of conditions of the banking sector and a growing pressure to introduce formal guarantees made for the expeditions introduction of the respective regulations.

Establishment of the Bank Guarantee Fund

According to the Act on the Bank Guarantee Fund, enacted on December 14, 1994, deposit guarantee system was established covering all banks operating in Poland, irrespective of their form of ownership and the date of their creation. The system became mandatory, setting the individual guarantee limit at ECU 3,000 with a plan of reaching the upper limit of EUR 20,000 in 2003. Also the legislation defined the types of action that could be undertaken in order to assist banks in case of becoming insolvent. The mechanism of the deposit guarantee scheme adopted in Poland complied in most fundamental aspects with the European Union Directive EC/94/19 on deposit guarantee schemes.

The initial period of BGF's operations (1995–1996)

It should be emphasized that the Bank Guarantee Fund started its operation in a very difficult period when numerous banks' failures took place.

In 1995 courts declared bankruptcy of 60 banks – 3 commercial and 57 co-operative ones (including 2 commercial banks and 48 cooperative banks during the period when the Act on the Bank Guarantee Fund was already in force). In 1996, there were subsequent 31 bankruptcies – 1 commercial bank and 30 cooperatives collapsed. So the basic task was to ensure disbursement of guaranteed deposits to the lawful depositors. Simultaneously, the BGF commenced its financial assistance activity – in the years 1995–1996, it extended 9 loans to the banks.

Over the years of 1995–1996 the Bank Guarantee Fund made pay--outs to almost 150 thousand depositors. Disbursements of guaranteed deposits amounted to EUR 38.2 million, out of which the guaranteed deposit pro-tection funds covered EUR 32.7 million, or 85.6% of total disbursement. The remaining 14.4% came from liquidating the assets of the bankrupt banks and money recovered from bankruptcy estates. Certainty of pay-outs and the effectiveness of disbursement of guaranteed deposits prevented a panic occurring on the banking market. Therefore, one can say that the activity of the Fund played a significant role in stabilizing the banking system in Poland.

The years 1995–1996 witnessed many bank bankruptcies and marked a closing of the first phase in the functioning of the Bank Guarantee Fund. During that time the attention of the Fund was centered on the distribution of the guaranteed deposits. As of 1997, the Polish banking system started to improve. Over the years of 1997–2005, the number of bank bankruptcies has substantially dropped: only 13 banks went bankrupt, including 1 big commercial one, compared to 91 banks in the years 1995–1996. That is why the basic operations of the Fund shifted to its assistance function – i.e. granting financial assistance to the banks in the form of repayable loans.

Financial assistance – objective and principles

The objective of assistance operations is to support the restructuring of banks threatened with insolvency, and to protect depositors from the loss as of deposits kept in those banks. Pursuant to the Act on the BGF, the assistance may be extended in the form of loans, guarantees or endorsements and, from 1999, in the form of purchase of bank debts. Conditions and terms of the assistance are more favourable than those available on the market.

The Bank Guarantee Fund conducts its activity in accordance with the following principles:

- ❖ equal treatment of all banks in their access to assistance by applying uniform and clear criteria and procedures;
- ❖ supporting activities aimed at removing the threat of insolvency in banks with participation of strong capital investors;
- ❖ inspiring the applicants to seek additional sources of financial support to fulfill the rehabilitation programs, beyond the assistance offered from the BGF's means;
- ❖ ensuring high effectiveness of assistance, among other things, by specifying such conditions in the loan agreements that will allow the banks to regain permanent solvency;
- ❖ expeditions availability of the assistance funds to the banks that fulfil the criteria of assistance.

Pursuant to the Act on the Bank Guarantee Fund, the amount of the loan, guarantee or endorsement, cannot be higher than the total amount of guaranteed funds in a particular bank. These are calculated as the sum of total guaranteed funds on depositors' accounts. In the event of an application for granting financial assistance designed for takeover or merger with another bank – the maximum cannot be higher than the total of guaranteed funds on the depositors' accounts in the bank being taken over. Decisions to grant assistance are preceded with the analysis of restructuring programmes and the assessment of viability of the assumptions applied, the fulfilment of which will guarantee the improvement of the bank's standing.

The purse of the assistance fund is composed of the mandatory annual fees paid by the banks. Starting from 1998, the National Bank of Poland has been also participating in building the assistance fund. In 1998, its share amounted to 30%, during the years 1999–2000 it increased to 40%, and since 2001, it amounts to 50%. Moreover, the repayments of the loans received by banks in previous years also go to the Fund.

Assistance activity of BGF (1996–2004)

The first loan paid out of the assistance fund was forwarded to the recipient bank in 1995 (payment took place at the beginning of 1996). During the years of 1995–2004, a total of 97 loans were granted for the amount of EUR 800 million. This includes:

- loans for the purpose of self-recovery – the sum of EUR 506 million to 11 commercial banks and the sum of EUR 45 million to 29 cooperative banks;
- loans amounting to EUR 224 million to 32 commercial banks for takeovers:
  - of 19 commercial banks (EUR 189 million),
  - 13 loans (in the sum of EUR 35 million) for takeovers of cooperative banks;
- 25 loans in the amount of EUR 25 million for takeovers of cooperative banks threatened by insolvency.

Beneficiaries of 97 loans can be classified according to the following criteria:

- by entity type:
  - 54 loans were received by cooperative banks,
  - 43 loans were granted to commercial banks;

and

- by objective:
  - 40 loans were granted for the self-restructuring banks,
  - 57 were granted to financially viable banks that undertook to restructure the banks threatened with insolvency by incorporating them into their organizational structures or by becoming their strategic investors.

At the beginning, the Fund concentrated its efforts on supporting the banks that found themselves threatened by insolvency but undertook self-restructuring. Most of the loans for self-restructuring, in respect of their number and value, were granted to the banks in the first three years – i.e. 30 out of 40 such loans. Starting from 1999, the Fund has increased financial assistance to banks that undertook the task of acquiring the threatened banks. In the years of 1999–2004, the Fund granted 43 loans; 33 of them were granted to the banks taking over other banks. In 2001, the first case was noted when the Fund granted a loan to a commercial bank for the acquisition of shares of another bank threatened with insolvency.

In 2003, the assistance activity of the Fund characterized a differentiated approach. And so, in order to prevent bankruptcy of a commercial bank, a group of 12 major banks became jointly its strategic investor. The Bank Guarantee Fund supported this initiative by granting loans to the investor-banks for the purchase of shares. Furthermore, the bank threatened with bankruptcy received a loan in order to restructure itself. The second interesting case was providing assistance to 2 banks in which commissioner receivership was instituted. This process went differently than others. First, the banks were consolidated, and then, in the restructuring phase, a loan was granted to rehabilitate one subject.

In 2004, the Bank Guarantee Fund granted financial assistance to one commercial bank in the form of a repayable loan, in the amount of EUR 110,3 million. Like in the previous years, applications submitted in 2004 related to granting of assistance only in the form of loans. Furthermore, in the case of one bank, which had already received the loan from the Fund, financial assistance was restructured due to the fact that the bank was taking over another bank threatened with insolvency.

To sum up:

- numberwise, 45% of loans granted by the Fund were to support consolidation and restructuring processes in the Polish banking system;
- 41% went to self-restructuring banks;
- 13% went for the purchase of shares.

Taking into account the number of loans, the cooperative banks were major beneficiaries, while in respect of value – the commercial banks took the major chunk.

Modification of assistance strategy pursued by the Fund and seeking new forms (instruments) of aid stemmed from the structure and the needs of banks operating in Poland, in particular the consolidation trend in the banking sector. Small, weak, very often one branch banks were economically inefficient. Such banks had no chance of development in the modern banking sector. Moreover, the major factors prompting processes of consolidation and mergers in the Polish banking sector were: the obligation to reach capital thresholds as set by the Act for cooperative banks and the imminent strong competition by foreign banks after Poland's accession to the European Union.

The consequences of financial assistance

As mentioned before, the main objective of assistance activities of the Bank Guarantee Fund is to prevent banks from going bankrupt when threatened with insolvency. In attaining that objective, BGF applies the least cost approach. The assistance granted to banks has important financial and social consequences. The measures of financial effects are:

❖ amount of guaranteed deposits that the Fund would have to payout in the event of the banks' bankruptcies;
❖ amount of deposits which are not subject to protection pursuant to the Act on the Bank Guarantee Fund and which would be lost by depositors in cases of banks failures.

In assessing the efficiency of the BGF's financial assistance activities, one has to stress that if the BGF had not granted assistance in the sum of EUR 800 million during the years 1995–2004, it would have been necessary to pay guaranteed funds higher by approximately EUR 637 million than the actual amount of the financial assistance given by the Fund during that period. Assistance operations of the Fund contributed to effective protection not only of guaranteed deposits but also of not guaranteed means, i.e. those gathered by depositors not entitled to protection or exceeding the upper limit of the guarantee amount.

Apart from the financial results, the BGF's assistance activities have important economic and social consequences. In macroscale, assistance operations contributed to:

❖ strengthening of confidence in the banking system and in the Polish currency;
❖ increasing of propensity to save in banks, especially private and smaller banks;
❖ strengthening the stability and safety of the Polish banking system.

In microscale, it is worth to mention the following:

❖ saving of over 1,900 branch offices – oftentimes located at municipalities where the restructured bank was the only provider of banking services;
❖ saving of about 64 thousand jobs, what is especially important in view of the unemployment rate in Poland amounting to 18%;
❖ improving the quality of banking services and the efficiency of banks' operations.

The BGF's financial support of restructuring processes contributed to removing threats of insolvency in the banking sector as well as strengthening the banks' capital base. Starting from 1997, both the capital adequacy and the solvency ratio in the banking sector have been improving. In recent years, the solvency ratio grew dynamically and at the end of 2004 the Cooke's ratios of only one cooperative bank and two commercial banks were below 8%. Also, the evidence of usefulness and efficiency of the BGF's assistance activity is the fact that the last bankruptcy of a big commercial bank happened as far back as 2000 (in 2001 only one small cooperative bank collapsed).

Loans from the cooperative banks restructuring fund

An important novelty in the operations of the Fund were the tasks defined in the Act dated December 7, 2000, regarding the functioning of cooperative banks, their associations and the associating banks. The Bank Guarantee Fund was made responsible for providing financial assistance in the form of loans to the banks that were solvent but incurred the costs of merger processes. The cooperative banks' restructuring fund was equipped with means left after liquidation of the Cooperative Banks Development Fund managed by BGŻ SA, and the amounts paid to banks by the budget for servicing the D series of the restructuring bonds which were redeemed on the day that the Act came into force. The means transferred to the Bank Guarantee Fund amounted to EUR 31 million.

Financial assistance from this Fund can only be granted to banks which meet solvency criteria and have the ability to repay the loans. Banks which have merged with other banks not later than 3 years before the Act came into effect, i.e. after 28 January 1998, and those merging currently, can avail themselves of the assistance.

Pursuant to the Act, the BGF grants loans from the cooperative banks restructuring fund for financing the costs of mergers of the cooperative banks and cash outlays associated with that process. In particular, for consolidation of computer systems, unification of the products and services etc. From the restructuring fund loans can also be granted for purchases of shares in the associating banks. As a result of the adopted procedures, banks applying for the loans are supposed to submit information on their current financial standing, projection of their situation during the period of assistance, and documents indicating the incurred or planned costs involved in the merger processes. Then the Fund makes an assessment of the banks' standing and their ability to repay the loans with interest.

Over the period of four years, the BGF granted 161 loans to cooperative banks in the amount of EUR 52 million. The bulk of loans (127 out of 161 totalling EUR 51 million) were designed for the purpose of financing the costs of mergers and the associated investments. The remaining 34 loans (EUR 2 million) were granted for the purchase of shares in the associating banks. In spite of relatively small amounts of individual loans, the loans that were given out successfully supported cooperative banks and enabled them to finance the costs of current or earlier mergers. It is worth noting that financial assistance from the cooperative banks' restructuring fund did substantially contribute to alleviating the consequences of mergers and to strengthen the capital base of associating banks.

Monitoring and controlling financial assistance from the BGF

The Bank Guarantee Fund monitors the proper utilization of loans granted to banks as well as the implementation of their restructuring programs. The monitoring is conducted on the basis of monthly operational reports submitted by the banks as well as the quarterly reports on performance of the assistance utilization plan. The reported data are analyzed from the standpoint of assumptions adopted in procedures of the restructuring programs.

Pursuant to the results of analyses of bank situations, on-site verification plans are developed quarterly, and monitoring *ad hoc* on site is conducted in the banks who are recipients of the Fund's assistance.

The scope of the on-site verification includes assessment of:

- conformity of the use of assistance funds with statutory objectives and objectives as specified by loan agreements;
- effectiveness of the use of assistance funds;
- implementation of rehabilitation or restructuring programs in banks that were taken over;
- financial situation of banks including the trends of basic economic indices as compared to the cooperative or commercial banks sector averages;
- fulfilment of obligations stemming from loan agreements.

In banks that received loans from the cooperative banks restructuring fund inspections embrace to the assessment of:

- conformity of the use of assistance funds with the Act on the functioning of cooperative banks, their associations and the associating banks;
- solvency;
- capacity to repay loans;
- fulfilment of financial forecasts as presented by banks during the loan application phase;
- fulfilment of obligations resulting from loan agreements.

It was established that all inspected banks, that had received loans from the assistance fund, used and protected the funds in conformity with provisions included in the loan agreements. Likewise, in the majority of cases satisfactory results of implementing rehabilitation programs were noted. In the case of banks that received loans from the cooperative banks restructuring fund, no reserves had to be created to secure the loans and no threat was noted to the repayment of liabilities to the Fund.

Collecting and analysing information

Attaining the proper level of financial resources for the BGF to fulfil its deposit guarantee functions and to grant assistance necessitates getting the information on the banking sector, particular banks and the state of economy and its development tendencies. The primary source of information are banks reports that are subjected to thorough analysis in order to properly calculate the percentage rates for the creation of guaranteed deposit protection funds and the annual mandatory fees to be paid by the banks.

Pursuant to the Act on the Bank Guarantee Fund and the agreement concluded with the National Bank of Poland, the Fund receives the bank reports from the National Bank of Poland. Banks that are recipients of the assistance from the Fund submit their financial reports directly to the Bank Guarantee Fund (independently of information forwarded by the National Bank of Poland). The system of collecting and analysing information developed at the BGF is the basis for the short- and long-term policy of guaranteeing deposits and performing the assistance activities by the BGF.

Assessment of the situation in the banking sector

The BGF has devised its own methodology of assessing the situation of banks and the risk to the safety of deposits accumulated by them. Based on the analysis of pertinent indices in all areas of bank activities and supplementing it with qualitative information, the banks receive individual appraisal (rating). Depending on the rating, the banks are then qualified in groups of high, average or low risk to the safety of their deposits. This is how the so called risk matrix is constructed, which provides a reading available information on the situation of every bank and the level of risk generated in the banking sector. Banks assessed as being in high risk of insolvency are subjected to a detailed assessment aimed at identifying the source of risk. Analysis of data in all bank reports allows to assess the safety of the banking sector as a whole.

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As mentioned at the beginning, the Bank Guarantee Fund is an important segment of the financial safety net in Poland. The effective operations of the Fund would not be possible without good working relations with other institutions forming the safety net. Thanks to the cooperation with the National Bank of Poland, the Ministry of Finance and the Polish Banks' Association, the Bank Guarantee Fund was able to successfully fulfil its statutory mission of improving the safety and stability of banks, as well as strengthening the confidence of the public in the Polish banking system.

ESCB about Deposits Insurance

Frank DIERICK
(European Central Bank)

"Work by the ESCB's Banking Supervision Committee in the area of deposit insurance"

The European Central Bank is a specialized and independent organization, established in order to conduct monetary policy in the Euro area. The European System of Central Banks (ESCB) is an institutional framework set up mainly to insure cooperation between the European Central Bank and different national central banks of the EU-25 countries. The Eurosystem comprises the ECB and the national central banks of the Euro area, so it is a sort of a subset of the ESCB.

The ESCB among other issues concerning European financial systems is interested in deposit insurance. Basically the interest is rooted in the responsibilities of the ESCB which are connected with financial supervision and financial stability. In addition to that, the ESCB also supports the general policies of the European Community, for example the objective of financial integration. Deposit insurance schemes might promote or hinder financial integration, for example in the form of cross-border banking.

The accomplishment of the tasks of financial stability and financial supervision is organizationally done through two different ways. Internally in the ECB there is Directorate, called Financial Stability and Supervision, with two divisions: Financial Stability and Financial Supervision. A second dimension refers to cooperation with national authorities and is fulfilled through the Banking Supervision Committee. The BSC is a high-level ESCB's committee which assists the ESCB in the accomplishment of its tasks in the area of financial stability and supervision, where the ECB is not only represented, but also the national central banks and banking supervisor authorities of the EU-25 countries. It is particularly important for the deposit insurance that the European Commission and the CEBS (Committee of European Banking Supervisors) are observers. In consequence they are fully aware of the work of the BSC, and of all initiatives in the area of deposit insurance.

Basically the composition of the BSC and the CEBS is very similar, however the CEBS is supervisory orientated and banking supervisors have the primary word. In the BSC the central banks take the lead, so it is more macroeconomics and financial stability orientated.

The ESCB has been involved in the work on deposit insurance as a result of a request by the General Council. The General Council wanted to investigate what implications are of more cross-border banking in Europe from the policy point of view. To meet that request of the General Council the BSC was the most appropriate committee to be involved because of its composition of central banks together with banking supervisors. Deposit insurance was selected as a part of the research since it proved to be an important element in the restructuring of Nordea.

The work on deposit insurance included to a large extent a data gathering exercise about the features of the deposit insurance scheme in different the EU-25 countries. The main results of the BSC's survey:

- number of schemes – it appears as a rule that there is one scheme per country, although in some countries there are more than one scheme (from 2 to 6 in some countries) – that is related to the institutional set-up of the banking system in that particular country (different schemes for different types of institutions like cooperative banks, saving banks etc.);
- functions of schemes – some schemes are more than pure pay-boxes, so that they also have certain power they can exercise on banks (they can in some cases intervene in the management of the banks);
- the management of the investor scheme is in general separated from the management of the deposit insurance scheme, although in some countries there is a close link between the two;
- coverage level – in terms of coverage, most schemes adhere to the minimum level of EUR 20,000, mentioned in the Directive – most of them have coverage between EUR 20,000 and 25,000. There are 5 countries which have higher coverage, and there are some countries in Europe that have adopted a lower level (the Baltic countries in particular), but under

the transition regime they also have to adhere to mentioned above level over time;

- coinsurance – is a quite frequent phenomenon and very often it is set at the level of 10%;
- exclusions from coverage – in the Directive some exclusions from the coverage are provided: mandatory (for example interbank activities) and optional. Most of the optional exclusions have been adapted by the countries, although there are some countries that are not quite generous in the sense that they do not use frequently the options of exclusions provided by the Directive (for example Finland and Sweden);
- topping-up arrangements – they are in a limited number in Europe and the majority of them seems to be connected with the UK as a host country (probably due to the fact that it is an *ex post* scheme, offering quite generous compensation in terms of coverage level);
- funding – the dominant model in Europe is a low-funded *ex ante* scheme or mixed scheme – about 80% of deposits are covered by such type of scheme;
- administration of scheme – is mostly mixed, meaning that both public and private entities are involved in the management; in general the central bank involvement is limited, basically due to the restrictions in the EU Treaty regarding central bank independence and monetary financing.

The BSC provided input to the European Commission in terms of giving background materials; it also sent a separate note to the European Commission focusing on the conclusions of the survey.

Additionally, there is a joint task force between the BSC and the CEBS in the area of crisis management – the BSC provided its input in terms of deposit insurance to that. That task force was instrumental in developing the technical advice the CEBS provided to the European Commission in the review of the Directive. Finally, the General Council also expressed an interest in the further work in the future in the area of deposit insurance, obviously because it has a close link with financial stability and central banking functions. It is a topic that will be on agendas of the ECB and the ESCB in the future.

Deposit Insurance, EU Directive and EFDI

Herman DEBREMAEKER
(Fonds de Protection des Dépôts et des Instruments Financiers)

"Principles of the legal status under Belgian Law"

According to earlier arrangements, the EFDI's members are intending to give their organisation legal personality. It can be achieved by conversion into an association created on the basis of the Belgian law. Being an association with legal personality has some advantages such as:

- greater weight of organisation;
- limiting members' liability;
- easier access to subsidies and gifts;
- easier accomplishment of some practical formalities like e.g. opening banking account.

The negative point is that the legal requirements have to be met: requirements concerning registration, financial reporting and publication. In the Belgian law the legal act regulating operation of non-profit organisations is the Law of 27 June 1921 (its last revision was in 2002). There are 10 articles of the Law applying to an international non-profit association (INPA).

INPA is characterised by pursuing a non-profit making aim of international utility, not conducting/pursuing industrial and commercial activities and not striving to procure material gain to its members. In the law there are no nationality requirements for INPA's members. In case of INPA, for faults resulting from the activity of its bodies or appointees the association itself is liable. It means there is no personal liability of persons who were entrusted with the daily management. Such liability does not apply to the members either.

Regarding the management structure of INPA, the organisation has to have/create at least two bodies: a general assembly and a board of directors. There is only one restriction concerning powers of these individuals/organs: the board of directors has the obligation to prepare the annual accounts of the past financial year and the budget for the next one and these documents have to be approved by the general assembly.

The registration of INPA requires applying documents/file to the Ministry of Justice in Belgium and approving by royal decree. The association's statutes have to be established by a notary public authentic deed. The creation of association ensues with the day of the royal decree's publication in the Belgian Official Journal. With regard to book-keeping rules, an association such as EFDI intens to be has to apply simplified accounting records. As a minimum movements in cash and on accounts should be disclosed. Because of the subject of the EFDI's activity, the association revenues will not be taxed.

In case of INPA, there are also some publication requirements. They concern the statutes and their modifications, state of accounts, financial reports and information about nomination and revocation of directors. There is no publication obligation for the official register of the organisation's members. At this moment in Brussels there are about 2000 registered international non-profit associations.

Panel discussion
"The Review of the Directive on Deposit Insurance"

Caitriona O'KELLY **(European Banking Federation)**
as a chairman of the panel discussion, started with information on this institution. The FBE unites 27 national banking associations from the EU, representing around 4500 banks. The FBE looks at the review of the Directive in the context of their broader objectives connected with the banking supervision. It would like to achieve fully consolidated supervision for cross-border banks in the next five years and promotes a building block approach to achieve more streamlined supervisory framework. On review of the Directive on deposit guarantee schemes, the majority of the FBE organizations assumes that this is not the most urgent issue at the moment. There is a need to talk about crisis management arrangements before considering in details the deposit guarantee scheme arrangements. There is room for the review, but the benefits will not outlay the costs at this stage.

Dirk CUPEI
(Association of German Banks, Vice-chairman of EFDI)

The position of the German scheme is clear: it would not like to have amendments to the Directive as there is no need for the change at the moment. There are some minor points like *de minimis* clause; the German scheme is in favour of but it can be done not through the change of the Directive itself but for example through recommendation of the Commission allowing every Member country to introduce *de minimis* clause. However, if there was any change of the Directive, the German scheme would support the idea of abolishing the topping-up clause or, if it was not be abolished – the idea of the strong home country principle with home country topping-up. As far as contributions are concerned, the choice of the funding regime should stay on the decision of each scheme and it should not be regulated by the Commission. Before discussing any changes to the Directive, the need and benefits of such a change should be confirmed. As for now the German scheme does not see such benefits. At the same time one should take into consideration costs that could arise from the change of the Directive for the banking industry.

Geoffrey BEZZINA
(Malta Depositor Compensation Scheme)

The Malta scheme is one of the most recent schemes, it was established in 2003. The opinion of the Malta scheme is that there might not be an urgent requirement for lots of changes to the Directive. However, the Malta scheme is in favour of introducing *de minimis* clause and has requested the Commission to study the implications of having high funded *ex ante* schemes. At the same time, it is concerned about the introduction of risk-based premiums since simple pay-box schemes would require additional investments and resources. Furthermore, the obligation of risk assessment goes beyond the main role of the deposit guarantee scheme, which is compensating depositors in the event of a bank failure. With reference to the Directive review, one should not loose sight of the purpose of the deposit guarantee scheme – depositors are not interested whether the scheme is *ex ante* or *ex post* financed, depositors want to be compensated immediately in terms of the requirements of the Directive in the event of a bank failure. From depositors' point of view the issues of the definition of deposits as well as set-off rules are of greater importance. The current definition of deposits is wide enough to include numerous deposit products, however it seems that in some schemes it is not incorporated properly. In terms of funding arrangements, banks would prefer *ex post* than *ex ante* contributions, especially that according to Basel II and the Capital Requirements

Directive banks are required to allocate substantial capital for risk, which is to minimize the risk of default.

Dermot FINNERAN
(Irish Deposit Protection Scheme)

The Deposit Protection Scheme in Ireland is not a separate agency, but is administrated by the central bank. In regard to the review, the Irish scheme is satisfied with the binding Directive and does not see compelling reasons for major changes. In terms of coverage there is no need to increase the minimal level set by the Directive since in existing arrangements there is a possibility to offer higher coverage. Ireland offers EUR 20,000 of deposit coverage. As to the coinsurance principle, the Irish scheme prefers to remain it below level of EUR 20,000. *De minimis* clause does not cause any great difficulties either. Consumers are probably broadly aware of differences in the level of coverage, but they might not be so aware of differences in the scope of the coverage. In the future, if the cross-banking becomes more relevant, depositors may have coverage from different schemes and do not realize the certain deposits are covered or not covered. This issue is worth considering in the future.

If the differences in the level and the scope of coverage still exist, topping-up will probably remain relevant. In the case of topping-up remaining, the Irish scheme is against the idea of home country topping-up and prefers the current arrangements of host country topping-up. Home country topping-up would raise operational, consumer and level playing field issues. It also requires one has to have a lot of local knowledge and expertise on the laws in the host country. From the consumer protection perspective it will be questionable to have two-tier system of coverage offered by the same scheme.

As for financing, the majority of schemes are *ex ante*. The position of the Irish scheme is in favour of moderately funded *ex ante* schemes. In terms of risk-based premiums, from the perspective of the simple pay-box scheme this issue raises a lot of concerns regarding complexity of risk-based premiums' calculation.

As to home-host country arrangements, the Irish scheme considers the existing cooperation between competent authorities as satisfactory and supports even greater cooperation in that area.

Fernando MINGUEZ
(Bank of Spain, Committee of European Banking Supervisors)

One of the most important functions of the Committee, apart from promoting convergence of supervisory practices, is providing the European Commission with the advice in its legislation production process. Therefore, the CEBS delivered technical advice on the review of the Directive on deposit guarantee schemes. This task of producing the advice for the Commission was assigned by the CEBS to its task of crisis management – the joint task with the BSC.

Taking into account opinions of various authorities, it seems that there is not much support for a change in the current structure of the deposit guarantee schemes. On the one hand, we should recall that a homogenous landscape (the absence of differences) within Europe is the aspiration of the European Commission. Furthermore, the differences between the deposit guarantee schemes are frequently mentioned as a typical valley to financial integration within the common market. Moreover, regionally in such places like the Nordic countries the current structure is already leading to difficult situation (the Nordea case which nowadays is the most important example). Finally, various reports regarding the evolution of the European market point out to possible future problems with the heterogeneity of deposit insurance schemes. At the same time, we should recall that trends are still only trends (currently most cross-border banking activity in the EU is carried out through subsidiaries and the problem of significant branches is not yet a very important concern). Every change bears costs and therefore the desirability of changes may not be enough intense to proceed. Moreover, the guarantee scheme of a country is highly dependent on the economic and financial structure of that country. Whatever theoretical or abstract discussions we might have, deposit guarantee is an issue which is closely linked to other features that are very national. Possible changes in the financial guarantee schemes would require previous harmonization of other features. Taking all the above mentioned issues into consideration, the CEBS advised cautiousness to the Commission. According to the opinion of the CEBS, there is room for some change, but possibly it is not yet time to go for an in-depth reform of the actual structure.

Conclusions of the CEBS's advice may be summarized as follows:

❖ there is moderate favour for *ex ante* funding schemes, although it needs further technical refinement;

- there is a possibility of reaching common definition of deposits (harmonization of the scope of coverage);
- there is consensus about the benefits that may be gathered from exploring risk-based premiums;
- regarding the home-host relationships, the CEBS recommends the Commission to stick to the current regime. There are only few topping-up arrangements in place now in Europe, and from those few arrangements the CEBS has got some news about misfunctioning or difficulties that probably would be a good base for exploring an alternative, but that alternative is not clear yet. Moreover, some alternatives pose important legal concerns and technical difficulties;
- as to the level of coverage, if all deposit guarantee schemes pay the same amount of compensation to depositors, possibly most of the problems would be solved. According to the CEBS findings, most European countries stay around the harmonized minimum level of EUR 20,000, but there are significant outliners to this rule (countries that have much higher levels of coverage and countries that are still on the course to achieve the harmonized minimum level). This situation might lead to incredibly difficult discussion on which the new harmonized level could be.

Dr Uwe EYLES, Kai Andreas SCHAFFELHUBER
(Latham & Watkins)

"Review of Directive EC/94/19 on deposit guarantee schemes: Coverage of costs for bank restructuring processes vs. exclusive restitution of deposits"

The core question of the entire Directive EC/97/19 reviewing process is to asses the current balance between the consumer confidence and competition in the banking market as adequately balanced. In the context of that question, the Commission has asked the CEBS whether deposit protection schemes should be limited to pay off compensations in the case of bank insolvency or whether they might intervene before the insolvency scenario and actively participate in the restructuring process.

The CEBS said that it might seem logical that funds collected to pay back deposits in case of a bank failure cannot be applied to a different use.

But the answer might not be so straightforward, considering how deposit guarantee schemes work in practice. In a crisis the deposit guarantee scheme normally reimburses depositors and takes the position as creditors of the bank. The cost for the deposit guarantee scheme will automatically be the difference between the amount of deposits covered by the scheme paid to depositors and the assets the scheme is able to recover. When a bank fails, the deposit guarantee scheme will always bear some, if not all, of the cost of restructuring, at least indirectly. While the use of deposit guarantee funds for restructuring might reduce costs, it may create a situation similar to granting subsidies and may raise legal concerns. The competitors that pay in the fund may not be so eager to subsidize the failing bank and give it the occasion to further participate in the competition process.

In Germany there is a two-tier system which consists of the mandatory deposit protection scheme and the voluntary deposit protection scheme. The mandatory deposit protection scheme is a pay-box scheme covered by the European Directive, managed by the private law institutional body, but subject to the supervision and to the instructions of the BaFin (German bank regulator). It insures deposits up to EUR 20,000, in 90%. The voluntary deposit protection scheme had been operated long time before the deposit protection Directive was transposed into German law. It covers the remaining 10% or all amounts of deposits exceeding EUR 20,000 maximum. The protection which the Fund provides to the customers is quasi-unlimited – the maximum is 30% of the liable capital of the bank, per creditor. The mandatory protection scheme has to step in, and thereafter the private law Deposit Protection Fund covers the rest. The Deposit Protection Fund is a self-regulating representing the banking community (German private banks) institution. It has implemented numerous mechanisms to ensure high level of quality, i.e. shareholder control procedures in the case if someone wants to acquire a member bank, rating procedures which have also impact on the amount of contributions banks have to pay to the fund. In a crisis scenario the Fund may grant financial and nonfinancial assistance to problem banks in order to prevent imminent or actual financial difficulties.

Latham & Watkins have been involved in a number of restructuring processes for the German voluntary Deposit Protection Fund. These processes significantly lowered the costs for the deposit protection scheme by restructuring banks before they would actually fail. In the restructuring processes the Fund uses a number of tools and measures. Among them there are innovative risk mitigation tools (the Fund acquires shareholdings or partnership interests in a problem bank), corporate restructuring mechanisms (spin-off, split-off, merger of problem banks, change of legal form of a problem bank, squeeze-out of a problem bank's minority shareholders), ring-fencing strategies, voluntary liquidation of a problem bank, sale of a problem bank or its subsidiaries.

The first example of how the German private deposit protection scheme was active is the SchmidtBank case. The SchmidtBank was the second largest private bank in Germany. It was a local regional bank, family-owned company with a long tradition, owned by Dr Schmidt, who was a CEO of the management company SchmidtBank Geschäftsführungs GmbH (one of the two general partners SchmidtBank KgaA, what means limited partnership by shares). The SchmidtBank was the owner of ConSors Discount Broker, of which 25% shares were listed at the stock exchange. It had a lot of problems derived from its loan portfolio, in particular two commercial customers, and in 2001 bankrupted. The restructuring of the SchmidtBank was done by very sophisticated steps – the idea was not to compensate the deposits but to gain control over the bank and then sell it on the market. The first step was a sale of the SchmidtBank shares held by the family, which was a 65% portion, to a special purpose vehicle company SPV1 which was set by the Federal Association of German Private Banks. SPV1 also acquired 100% of the shareholdings in the management company of SchmidtBank. In the next phase the Deposit Protection Fund provided the guarantee for parts of the bad debt portfolio of SchmidtBank to avoid risk reserves on that portfolio. In 2002 the management of SchmidtBank has sold SchmidtBank minority shares. A large number of depositors or investors in the SchmidtBank shares claimed for prospectus liabilities and practice advice. Therefore, to mitigate that risk which could have ended in the insolvency, irrespective of the fact that the part of portfolio was guaranteed, the Fund set up the second vehicle company (SPV2) which made a tender offer to the minority shareholders to acquire additional shareholdings. The second reason to acquire these minority shareholdings was that the SchmidtBank had to undergo structural changes, capital reduction and subsequent capital increase. Capital measures had to be taken to ensure sufficient time to diversify the portfolio and afterwards to sell both the good part and the bad part of the portfolio. As a more technical step, the management company was merged to the SchmidtBank itself. Then, SPV 2 acquired from the majority shareholders another 21.9% and the shares acquired by SPV1 were sold to SPV2, in order to make SPV2 the majority shareholder. As a majority shareholder SPV2 executed the capital reductions, restored the capital of the bank, changed the legal form of the SchmidtBank into a stock corporation. In the next phase, there was a squeeze-out of the minority shareholders and then a change of the legal form of the SchmidtBank into GmbH. The two special purpose vehicle companies were merged. That gave the Deposit Protection Fund a lot of shareholder control over the SchmidtBank to continue the restructuring process. After that the SchmidtBank was split by separating "the good bank" (the branch network) from "the bad bank" with concentrated risk from company loan portfolios. The branch network was sold to a member bank of the Federal Association of Private Banks – Commerzbank AG, one of the largest banks in Germany. "The bad bank" was sold to Delmora Bank GmbH, a wholly owned subsidiary of the Deposit Protection Fund. As a result of the restructuring process, costs of the deposit protection scheme were significantly reduced compared to a pay-out scenario.

Another case was the Delbruck/Delmora Bank case. Delbruck was a private bank with long tradition. It significantly suffered from distress debt portfolio and almost went bankrupt. Discussions had been made with various potential investors to acquire that bank and ultimately the ABN AMRO was chosen. The owners of Delbruck sold shares to ABN AMRO. ABN AMRO, however, did not want to take the risks derived from the distress debt portfolio of the Delbruck & Co. Therefore, a ring-fencing strategy has been introduced. Delbruck & Co., which was renamed as a limited partnership, was indemnified against all risk derived from the portfolio on the basis of the guarantee provided by the Fund. The ring-fencing strategy was combined with a corporate structure, what means from the corporate law aspect the bad debt portfolio was separated from "the good bank" which ABN AMRO was interested in. This was done technically by way of the spin-off of the "virtual bad bank" onto the Delmora Bank GmbH. The shares generated by the spin-off were sold by Delbruck & Co. to the Federal Association of German Private Banks and then Delmora Bank became a wholly-owned subsidiary of the Deposit Protection Fund.

Another case refers to the Falke Bank. Falke Bank was a very small investment bank providing investment services to medium sized and family-owned companies. The Falke Bank was owned by the Falke family (51%) and other minority shareholders (49%). Dr Falke was the CEO. In 2002, the Falke Bank acquired from another German bank a relatively large Westfalenbank AG, a former subsidiary of HypoVereinsbank. This bank was much bigger and had active business, while the Falke Bank was more acting as a holding company with a very limited scope of banking operations. In 2003 the Falke Bank incurred significant losses. Auditors indicated that the shareholding in Westfalenbank, reflected in the Falke Bank balance sheet, has significantly diminished its value which would have resulted in over- indebtedness of the Falke Bank. Then certain restructuring actions has been considered taking into account a large number of minority shareholders. First of all the Falke family with their 51% shareholding gave a power of attorney to saving banks in Germany which at the same time had some business connections with the Falke Bank. They acted as a proxy who was entitled to cast 51% of the votes. In the next phase they entered into the voting pool agreement with some minority shareholders to make sure that certain restructuring can take place. The goal was to put the bank on voluntary liquidation in order to avoid insolvency proceedings. Westfalenbank AG should be sold at the fair price which is at least close to the book value reflected in the Falke Bank balance sheet. An additional source of financing the liquidation was a subordinated loan given by the Deposit Protection Fund. Currently, the Falke Bank is in the process of liquidation.

Presented cases reflect performance of the deposit protection system in a wider sense, based on the very flexible ground with sufficient tools given not only to compensate depositors but also to carry out restructuring activities which are necessary to avoid insolvency and decrease costs.

In these cases the Deposit Protection Fund dealt with overindebtedness scenarios and due to the flexibility of accessible instruments was able to avoid insolvencies. In conclusion it may be said that a public law deposit protection scheme, which must be based on the statutory law, would be more inflexible in preventing bank bankruptcies since it cannot apply such various restructuring instruments and mechanisms as German private Deposit Protection Fund is able to implement.

Ferruh TUNÇ
(Savings Deposit Insurance Fund in Turkey)

The Turkish Saving Deposit Insurance Fund (SDIF) is a new member of the European Forum of Deposit Insurers (EFDI). The SDIF was established in 1983 to insure savings deposits in banks. Initially, it was administrated by the Central Bank of Turkey. In 2000, the task of administrating and representing the SDIF was given to the Banking Regulation and Supervisory Association. Since December 2003, the decision-making body of the SDIF is the Fund Board.

The Turkish financial safety net consists of three main players: the Central Bank of Turkey (CBT) as a lender of last resort, the Banking Regulation and Supervisory Association (BRSA) and the Saving Deposit Insurance Fund. In addition, the Treasury provides necessary funds to institutions in the case of systemic risk.

In 2000, financial crisis occurred in Turkey. At that time there were 61 members of the deposit insurance system. As for the end of the year 2002, this number decreased to 40–20 banks went bankrupt. In the failed banks there were about USD 26 billion in savings deposits, which had to be paid out to depositors either through resolutions or by new owners. The total cost of the restructuring operations was approximately USD 27 billion, which constituted 9% of Turkish GDP. Approximately USD 50 billion was the total cost recalculated by taking into account the interest and foreign exchange rates.

Therefore, since the year 2000 SDIF has been busy with resolution activities. Almost 600 of 700 SDIF employees have been involved in these activities. According to SDIF's strategic plans 90% of resolutions will be closed by the end of the year 2007 with recoveries around USD 10 billion out of USD 27 billion paid out. After that, SDIF will be operating as a normal deposit insurance institution.

Mandates of SDIF consist of two main parts: protecting small depositors and providing formal mechanism for resolving failed banks. Membership is compulsory for all deposit taking banks. However, the deposit insurance system is going to be expanded also to special financed houses (kind of Islamic banks) which have had separate system so far. The level of coverage is NTL 50,000 (about USD 30,000). Saving deposits equal or less than the coverage limit represent 58% of total saving deposits and 99% of total number of depositor accounts. The biggest three banks hold almost 50% and the biggest ten banks hold almost 87% of total saving deposits.

The Turkish deposit insurance system is financed through collecting differential premiums. Premiums are calculated on the basis of a flat rate which is then adjusted depending on the capital adequacy ratios of banks.

Daniel JANOSSY
(National Deposit Insurance Fund of Hungary)

"Changes in the Hungarian Deposit Insurance System"

Until early nineties explicit unlimited state guarantees were in force in Hungary. In 1993 wide mandate (risk-minimizing) deposit insurance scheme was introduced – responsible for pay-outs and prevention activities according to the least cost test. Since 2006 deposit insurance scheme in Hungary is planned to transform into narrow mandate (pay-box type) DI.

National Deposit Insurance Fund of Hungary is a legal entity, regulated by the Law on Credit Institutions of 1996, with further amendments, controlled by the State Audit Office. It is governed by the Board of Directors, which members comprise of top level financial officials, representatives of the member institutions and the Fund's managing director. It is operated through its own working organization, with less then 10 employees plus partners and subcontractors.

Core activities of the NDIF concentrate in two spheres: insurance (compensation pay-out for deposits which become unavailable, funding, recovery in liquidation) and prevention (of deposits from becoming unavailable on the basis of the least cost principle, recovery of loans and invested funds).

Until 2005 the NDIF handled two small cooperative banks failures (in 1993 and 2000–2001), and it provided open bank assistance in three cases. The planned limitation of the scheme mandate (pay-outs only) is related to some extend to the situation in the Hungarian banking sector.

Over the last 10–12 years the Hungarian banking sector was subject to numerous changes. First and foremost, almost all Hungarian banks (except two development banks) are now privatized. Furthermore, over recent years they have noted strong business performance (18% annual average balance sheet growth in 2002–2004, average return on equity at 23% in 2004) as well as high degree of stability (13% average solvency ratio, no-performing asset ratio stable below 2%).

Substantial modifications were also related to the banking and supervision regulations. Banking regulations were harmonized with the EU law. As to the banking supervision, in 2000 the integrated financial sector supervision (HFSA) was set up, responsible for all types of financial services. In consequence of the above-mentioned processes, bank failures became unlikely.

Membership in the scheme is mandatory for all deposit taking credit institution. As of 31 December 2004, 211 institutions were members of the NDIF, including 32 banks (out of which one big bank of the Central-Eastern European importance, many others owned by the big-name foreign investors-banks) and two home savings banks, 172 savings cooperatives and 5 credit cooperatives (obliged to integrate and establish institutional protection funds). In the light of such situation of the member institutions, NDIF's involvement in banking failures became unlikely.

As to the funding arrangements, the question was: who pays the bill? In the case of state guarantees (in Hungary prior to 1993) funding comes from all tax-payers. As with an active deposit insurer, mostly (up to the coverage limit) the banking community provides funds. In the case of passive deposit insurer, the bill is paid typically by the banks' shareholders or the smaller risk-sharing communities of the integrated cooperatives.

Investor Compensation schemes

Dr Leonie BELL
(Oxera)

"Description and assessment of EU investor compensation schemes"

Oxera conducted research for the European Commission on the EU investor compensation schemes. The research study addresses three important policy issues:

- the main risk exposures for retail investors and the way how the EU investor compensation schemes protect against these risks;
- performance of the schemes in providing compensation for investors;
- funding adequacy.

Investor compensation schemes have provided important protection for retail investors which would otherwise incurred significant losses. In that sense the schemes have operated well. However, according to the Oxera research results there are some areas and issues which might be worth considering. *Firstly*, compensation schemes protect only against very specific risks and some other risks are not covered. *Secondly*, there have been delays in the compensation process in some instances. *Thirdly*, although there have not been any severe problems on the funding side, there have been instances when schemes found it very difficult to raise the funds they needed to compensate investors. These issues could become more important in the future taking into account that expected growth in retail investment businesses may increase retail investment exposures to risks. Moreover, so far most investor compensation schemes had either no failure or had small failures. There is a possibility of larger failures in the future. Finally, policy makers and regulators will have to think about consequences of the new Investment Services Directive being implemented.

Oxera was asked by the European Commission to provide the description and the assessment of the investor compensation schemes, implemented in accordance with the Directive on Investor Compensation. This Directive provides minimum protection for investors (EUR 20,000 per investor) in the event of a default of the investment firm – bank or non-bank. Given the minimum protection and Member States discretion over operating and financing arrangements, there are significant cross-country differences. The first research task for Oxera was to undertake a very detailed inventory of compensation arrangements in the Member States – in a broader scope in the EU 15 countries and in narrower scope for the 10 new Member States. The inventory is supplemented by the detailed analysis of operational performance, funding adequacy and the detailed risk assessment. The ultimate research report required enormous data gathering exercise, some of the types of information referred to legal framework, structure and organization, participation of firms, scope of schemes, claim and compensation procedures, funding arrangements, history of compensation cases. In all dimensions you can observe the differences across countries.

On the basis of compensation cases analysis one can notice that compensation cases are rather infrequent and comparatively small. For instance, in Denmark there was only one case dealt by the investor compensation scheme, with total cost EUR 1,6 million and 204 claims. The largest case over that period happened in Spain with total cost about EUR 30 million and nearly 7,000 claimants. More than half of the Member States have not seen any compensation cases. UK scheme experienced the highest number of cases (around 1,600) and claims of all Member States. The explanation for this is a lot broader scope of the UK compensation scheme. The UK is the only scheme that compensates for misselling of investment products and for bad investment advice.

As a part of the study Oxera undertook quite a detailed risk assessment. In accordance to the Directive the investor compensation schemes protect against very specific risk of loss of client assets in the event of default. There are two prerequisites for the scheme to start operating: there must be default of the investment firm and there must be some operational failure resulting in incapability of returning assets to the investors. The assets held on the investors behalf have to be properly segregated from assets of the firm itself. Segregation requirements differ considerably across the European Union. The cases Oxera examined referred generally to violation of segregation requirement (the main risk covered by investor compensation schemes) – fraud, theft and misappropriation of clients assets. Looking at history it seems that defaults of investment firms are not that frequently observed. However, if a default occurs then potential losses for investors can be large if the assets are not properly segregated.

The most important risk which is not covered, with the exception of the UK scheme, is the risk of bad advice on the investment decisions that retail investor make. The UK experience suggests that bad advice is the biggest risk for retail investors. Dealing with fraud, theft or misappropriations of client assets constitutes of a very small fraction of cases they dealt with. All the other cases are connected with misselling of investment products and negligent investment advice.

The issue of investment advice is important since under the new Investment Services Directive investment advice will become a co-investment service. In addition, the market for retail investment advice is expected to grow considerably. These changes raise two interesting issues. *First of all*, whether investment advisors should be required to participate in the scheme that only compensates for losses of client assets taking into account that most of them do not have an authorization to hold client assets. *Secondly*, given that investment advice becomes a co-investment service what may increase calls for regulation protection whether there should be a scheme that provides the last resort protection for investment advice. Oxera discussed this issue with a number of compensation schemes and with the European Commission.

Investment advice is one of the areas where risks are not compensated. The others are for example poor investment management (execution failures, breaches against client guidelines, churning), third-party losses, retail investment funds (failures in management and operation of fund), no contractual relationship, no proof of losses, unauthorized business. It is not to say that statutory compensation schemes should cover these losses but it reinforces the point that the risk which is covered by the compensation schemes is a very specific one.

The degree of investor protection also depends on the quality and speed at which compensation schemes handle claims, establish compensation and pay-out compensation. The time limit on the payment is three months. In general, examined schemes have operated well but there were some problems. In most cases the problems were caused by factors that were beyond the control of the schemes – delays in default declaration, difficulties in investor notification, no access to relevant information, long delays in the legal process etc. Oxera described cases when investors had to wait 3 years or more before they received any compensation.

In the examined period there have been no shortfalls in funding to the extend that investors have always received the compensation. The Funds were usually able to use the reserve funds or to collect additional contributions from participating firms. However, there have been instances of quite severe difficulties for some schemes in raising the funds. For example two of the new Member States – Hungary and the Czech Republic – were hit by a considerably large number of failures very soon after establishment of the investor protection schemes. The reserve funds were insufficient as well as enough contributions could not be collected from participating firms. In both countries the State had to step in by making direct contributions or providing a loan facility.

Difficulties have also occurred in the old Member States. For instance, in Ireland in 2001 a broker defaulted with over all EUR 6 million shortfall of client assets. In addition almost EUR 6 million of costs had to be paid to the receiver. In consequence the investor protection scheme had to reimburse over EUR 11 million. This case in Ireland let to a consultation process in regard with funding arrangements, in particular as to introducing caps on firm contributions and explicit government involvement in the funding.

Another case occurred in Spain and that was the largest case in the examined five-year period. A broker in Spain was declared insolvent in 1998 with more than EUR 30 million of compensation costs. The scheme, which only consisted of 110 non-bank investment firms, would not have been able to raise the funds. In consequence, 99% of the total cost was financed by the deposit guarantee funds.

With reference to the funding adequacy, it may be stated that in the past losses have been relatively low and infrequent. However, larger failures can occur with a small but significant probability. The reserve funds that have been accumulated so far by the investor compensation schemes seem to be insufficient – in many cases less than EUR 10 million. If a larger failure occurred, it is likely that reserve funds would be too small to cover the costs. Some schemes do not have any reserve funds as they are funded on the *ex post* basis. If a failure occurred, they would have to go out to the participating firms and collect contributions. The experiences of Hungary, the Czech Republic, Ireland and Spain suggest that the firms' capacity to pay can be stretched quite quickly. There are also concerns as to the level playing field and the extend to which contributions can affect firms' ability to compete on the market. Many schemes have introduced caps on firm contributions to limit investment firms' liability (a limit to the amount that can be raised by the participating investment firms). The solution for financing difficulties might be borrowing. Most schemes in the EU have borrowing powers but very few schemes have explicit credit facilities in place.

Therefore, schemes anticipate problems in the credit supply, in particular in finding a commercial lender that will lend multi-million EUR at short notice. State involvement in the investor compensation schemes in Europe is restricted to a few countries. Most countries do not have any explicit State involvement. But there have been calls for increased State involvement. If there is an implicit State guarantee, the question is whether State involvement should be more explicit to enhance the financing credibility of the compensation schemes.

To conclude, Oxera report was published in September 2005. The European Commission published the evaluation report – it highlighted certain issues, like delays in compensation, funding adequacy and investment advice. According to the evaluation report the European Commission is not planning to take any actions in the near future, instead they announced that they wanted to have debate with the Member States.

Basel II Accord

Prof. Riccardo De LISA

"Financial system's safety net: Basel 2 and Deposit Insurance interrelationship"

It is not perfectly correct to talk about Basel II in Europe, one should rather refer to the Capital Adequacy Directive or capital requirements. Basel II is a solvency regulation and the basic idea is that capital requirements must be correlated to the banks' degree of risk. In this way capital adequacy is much more risk sensitive in comparison with the solutions from the past. Basel II refers both to banks and financial groups, which should implement this regulation by 2007.

Generally speaking Basel II regulation consists of three pillars. *The first pillar* regards the minimum capital requirement, i.e. how banks have to measure credit and market risk and how to compute the capital adequacy. *The second pillar* regards central banks and supervisors in terms of monitoring and controlling banks' capital adequacy. *The third pillar* regards banks and disclosure process, balance sheet and all the reports that banks have to show to the market and degree of risk they take.

The implementation status of Basel II in Europe can be illustrated by the results of research carried out by the faculty of Economy of Financial Intermediaries, University of Cagliari, for the European Commission. When analysing the status of the implementation of Basel II in the EU, two sorts of implementation speed can be discovered; one speed regarding Western Europe and the other for Eastern Europe. Western Europe seems to be much more advanced in implementation than Eastern Europe, and especially new member countries. However, when assessing the implementation of Basel II, not only the geographical area but also the size of banks need to be taken into account. Again two speeds can be observed. The largest financial institutions are much more advanced in implementation the process than the smallest credit institutions. This is the case of dichotomy – small banks are going for the implementation of Basel II in a very slow way and they implement a standardised process of risk measuring – standardised and Basel II means in fact Basel I. In Basel II one can proceed with the present regulation still applying Basel I. There are small banks still applying Basel I and the largest banks going for advanced approach using Basel II. There are a lot of improvements especially in large banks in terms of assessing credit risk of loans.

The relationship between insolvency regulation and deposit insurance can be illustrated by a very simple scheme. The main question which arises when talking about banks' crisis or banks' failure is when banks go to default. There are many reasons. Firstly, they are internal reasons like financial liquidity aspects, insolvency risk – causes that belong to the management of the bank. The second group of very important events that can push the bank into default are macroevents, especially those coming from the real economy but also from the banking system. There are then internal causes and macroevents.

Default of banks means a sort of crisis that can be temporary or not temporary. For affording this crisis we can have certain solution that could be internal solution to the banks or external solution. If we are not able to cope with default we have simply no solution, and we go to the bank run or panic in the financial system. This cause – we have a circle effect – macroevents that can cause another bank failure. This is a sort of systematic effect.

If this is a financial system or a financial scheme of banks failure the main question is where to intervene in the safety net. If we would like to prevent dissolution we can identify 4 major points of intervention. The first one is an internal bank. The second one is an internal solution for banks like restructuring, reorganising, liquidity help. The third one is an external solution like deposit insurance or selling the bank to another bank, or other solutions that cannot be qualified as an internal solution. The fourth one is a try at contrasting bank run and panic. If we would like to have complete safety net we have to intervene in each of these 4 points.

The major problem is who is going to intervene in each of these points. Generally speaking we can identify two main subjects for intervention. The intervention at point 1 – internal solution – is to be made by a central bank or a supervisor – this is Basel II. So Basel II improves the solvency condition of a bank and in this way reduces the possibility of temporary crisis or a bank failure. If there is a good implementation of Basel II depositors may be safer in the future. But central banks or supervisors – strictly depending on the country – could not only intervene at point 1 but also at point 2 and 3. The deposit insurer used to intervene at point 3 with external solution. But one can also imagine a sort of solution not only at the point 3 but also at the point 4 – contrasting bank run or panic.

Now there is quite obvious consideration. If there is no solution it means not only a minor crisis with which it is easier to cope but the problem of the financial crisis. It is not the minor crisis then but the medium-level crisis or major crisis like Argentina, East Asia etc. So if we want to have very complete safety net we have to cover all 4 points but covering all these 4 points requires a deposit insurance scheme that is able to prevent not minor crisis but medium-level crisis.

Basel II is a solvency regulation that increases financial stability of intermediaries. If there is a good implementation of Basel II in the future, deposits will be safer than today. This conclusion is linked to another trend: on the one hand we have Basel II, so depositor may be safer, but on the other financial globalization and the European financial integration could decrease the financial stability. There is less risk for an individual bank because they apply solvency regulation but the country risk is obviously increasing because of globalization and the European financial integration. The overall economic situation in Eastern Europe is not the same as in Western Europe. In case of cross-border transaction a country risk and its transfer to another country has to be taken into account. In order to have safety net not only Basel II needs to be taken into account on one side and the deposit insurance on the other side but one needs to consider both at the same time. Otherwise there will be a "hole" in the safety net. If we want to have complete safety not only minor crisis but also medium-level crisis need to be taken into account. In order to avoid the "hole" in the safety net closer cooperation between supervisors and deposit insurers in terms of exchan-ging information about cross-border activities and assessing the degree of risk for cross-border financial banks is essential.

A sort of unstable financial system as it is today: increasing competition, cross-border activities should force a very close cooperation between supervisors and deposit insurance schemes.

Lastly covering all 4 points in the financial safety net, it is very difficult to agree on the pay-box system. Pay-box system works very well in a very stable financial system but if there is not so much stable system is better to go towards *ex ante* logic.

Prof. Małgorzata IWANICZ-DROZDOWSKA

"Basel II and its meaning for banking system and deposit insurance"

In late September 2005 the European Parliament approved Capital Requirements Directive (CRD), which transferred Basel II regulations on the EU level.

As far as the meaning for the banking system is concerned the presentation focused on the impact of Basel II on large banks and small banks. To this aim also the results of the survey of co-operative banks in Poland were presented. For large banks implementation of Basel II means improvement (or in some cases significant improvement) of risk management practices, especially in the area of credit and operational risks (pillar I). This step forward in risk management practices requires additional costs, which are difficult to assess. According to the research of the Center for European Policy Studies (CEPS, 2004) conducted among 54 European banks for 25% of them the costs of Basel II implementation were supposed to be higher then EUR 20 m. Applying Internal Risk Based approach (IRB) to the credit risk measurement, especially in advanced form, would make banks' capital requirements to change along with the credit cycle (so called procyclicality). During the economic boom banks would enjoy lower capital requirements, but during the economic downturn there should be a rise in their level. There are at least two more issues worth mentioning: more attention from supervisory authorities (pillar II) and more informational requirements (pillar III). Both issues are important from financial stability point of view. Additional interest from supervisory authorities towards risk management and risk profile should have positive impact on financial stability, especially in case of big banks. More reports submitted to the market participants might have positive impact for market discipline, but on the other hand the participants couldn't be able to analyze and understand all the information.

Small and medium-sized banks are supposed not to be well prepared for Basel II implementation. According to CEPS's (2004) research 64% of the banks from this group were not prepared for Basel II. One should understand that they are not prepared for IRB's methods in credit risk and for standard approach and advanced measurement approach in operational risk. This means that small and medium-sized banks would face rather slight change in risk management practices. However, the retail-oriented banks would enjoy lower capital requirements due to the change of standard risk weight from 100% to 75% for retail exposures.

The research on cooperative banks was conducted[1)] on 148 banks (number of responses in comparison to 592 to which the questionnaire has been sent). Cooperative banks in Poland started to interest in Basel II only in years 2003–2004. Retail exposures have an average share in their portfolios of about 70%. This shall lower the capital requirements deriving from credit risk by approx. 14,5%. In less than 50% of surveyed banks the credit exposures to SME's have share higher than 40%. But still this might improve the access of SME's to banks' financing. As expected, the cooperative banks shall decide to choose the standardized approach to credit risk measurement under Basel II (about 95%). They are not ready for IRB's implementation since the majority of them is not using credit scoring techniques (about 78%). Due to operational risk the capital requirements shall increase by almost 23%, what altogether shall cause the decline in solvency ratio by 1,2 percentage points. As of June 2005 the solvency ratio for cooperative banks was higher than 15%.

The last part of the presentation was devoted to the meaning of Basel II for banking system stability and deposit insurance. Pillar I shall make the capital requirements more risk-sensitive, but also more procyclical. Due to the use of statistical models there will be also more model risk. It is really difficult to assess the impact of Pillar I on financial stability before its actual implementation. As far as pillar II is concerned, both in the short and in the long run it should have a positive impact on financial stability. For Pillar III it was stated that in the short run the impact was neutral, but in the long run, if the market discipline worked properly, might increase financial stability. From deposit insurance institutions' perspective the most important challenge related to Basel II is connected with the necessity to modify principles of the insolvency risk assessment of member institutions in order to set the level of the premiums.

[1)] It was conducted within the framework of the project financed by The Committee of Scientific Research (KBN) number 1 H02C 085 26, supervised by the Gdańsk Institute for Market Economics.

Future of the banking systems and deposit insurance

Panel Discussion
"Financial stability and the role of deposit insurance"

Freddy Van den SPIEGEL
(European Financial Services Round Table)

There is a clear link between deposit guarantee schemes and other elements of the safety network. One can distinguish four levels in the safety networks. In *the first level* there is Basel II which should guarantee that banks remain solvent even in downturns of the economic cycle. *The second level* in the safety network is the lender of last resort – the central bank providing liquidity to solvent banks. At *the third level* when a bank gets insolvent (liquidity problems lead often to solvency problems) there is an intervention of a deposit guarantee scheme – pay-out to depositors. Since deposit guarantee schemes are not funded sufficiently to cope with a big financial crisis and systemic problems, *the fourth level* is the Ministries of Finance, Treasuries, central banks, private sector coming together to keep social, political and financial stability in the region. Unfortunately, the safety networks are expensive and create some negative effects disturbing the markets, asymmetric incentives and moral hazard. It means that there is no scientific optimum and it is a matter of political decisions at which level we want safety networks.

Political decisions in Europe are split between the European institutions and the national states. Given different levels in one integrated architecture it is important that the place and the role of each element of the safety networks is perfectly defined. This is one of the major challenges for the European safety networks having an architecture that is coherent, consistent, in which each of the stakeholders have the same roles and powers. Deposit guarantee schemes in Europe have divergent powers – some of them are only pay-box systems, some are very active in finding solutions and restructuring activities. It seems to be essential to achieve a coherence of safety network architectures in the whole European Union. Organizing wholly coherent architecture of safety networks is a priority in comparison with harmonizing all the characteristics of deposit guarantee schemes in Europe.

Moreover, since the deposit guarantee scheme is a sort of insurance contract it is acceptable that like in the case of other insurers the law requires only minimum levels and different insurance companies offer different services and different protection levels for different premiums.

Deposit guarantee schemes are an excellent buffer for relatively small crisis of relatively small institutions. In the safety network the deposit guarantee scheme is squeezed between the second and fourth level which are both relevant to the central bank. Therefore, the role of the deposit guarantee scheme has to be well coordinated with the role of the central bank as a level two operator and as a level four operator. At the fourth level the cooperation of the central bank together with the treasuries and the private sector has to be well organized to find solutions.

Taking into account the progressive consolidation in the financial institution sector there is an idea of creating one deposit guarantee scheme for the whole European region or at least for the Eurosystem (where the central banks are already unified in one system). This would have an effect of the largest scale of the deposit insurance scheme with more reserves which could be able to cope with more important crisis without going to the fourth level. It is not certainly achievable in the short and medium term. There are other solutions which intermediary could be helpful. There could be closer cooperation (not limited only to the memorandum of understanding) between deposit guarantee schemes of different member states but with integrated financial markets (Scandinavia, Benelux).

Prof. David MAYES
(Bank of Finland)

We have insufficient procedures available inside the European Union to protect the deposit insurer. You get down too quickly to the last level of the safety net. Ideally the banking difficulties should be cleared up by the market. This is the first level. We hope that our supervisory rules will normally be sufficient to encourage prudent and good management of risks. However, if some banks are less efficient than others we expect market discipline to solve that – either shareholders or managers have to change the way in which their bank operates or the bank is going to be acquired. Due to competition issues large cross-border banks are not able to have the second of these rules even in the European level. Sometimes, the same sort of problems refers to some smaller banks if they are part of the group or they have a structure which is very difficult to outtrade them on the market. There is also a debate whether we have enough information – even under Basel II to be able to judge the source of quality of banks behavior.

In the US there are clear rules for prompt corrective actions which are mandatory. In Europe we tend to have similar rules inside our supervisory authorities but they are less transparent and tend to much more across the supervisor. That is going to be a problem if we have one agency handling a cross-border bank because different countries are involved with different views about prompt corrective actions. It seems we have not got to that stage because our memorandums of understanding do not deal with these sorts of issues. Deposit guarantee schemes want bank's problems to be resolved before it gets to the point of insolvency. There is a difference in interests between supervisors who try to keep banks alive and deposit insurers aiming for the early and careful exit. Deposit insurers' ability to take actions may in some countries be very limited. Perhaps we need some sort of resolution institution to fill this sort of gap in European environment. Such a resolution agency would start actions at the time the bank first gets into difficulty. Level of cross-border banks is rather easy because there are not many such banks in Europe (about 20). It would be even possible to have a resolution agency for each bank.

The whole point is that authorities need to be able to step in as early as possible. In the European environment it is difficult for authorities to step in until the bank reaches zero and the shares are worthless. In the US it is possible by having bank registration done in a different way so a bank can loose its ability to be registered at the earlier stage. Such a solution could be also introduced in the European environment. It is also important to have an ability to quickly appraise of the degree of claims, then to write them down and return the bank to not-negative net worth and lastly to reopen it without any loss of operation. That is the way in which authorities should perform in the case of systemic banks if they want to avoid a systemic event.

One of Scandinavian banks – Nordea – is opting to become an European company. That means it will become a very large bank in comparison with the insurance fund both in Finland and Sweden. The other home country banks will have to cover all of the depositors, also in the other Member States where this particular bank is spread out. Nordea is a cross-border bank, the proposal is they would have its headquarter in Sweden and branches elsewhere. Therefore, the half of the Finnish banking system is going to be controlled from somewhere else. There is a problem if a central bank is responsible for systemic stability. We would have to be satisfied with the way in which market discipline, prudential supervision, prompt corrective action and resolution would be applied. We are on the way to a pragmatic solution in this particular case hoping that there will be some sort of college of supervisors so we can all have access to the same information. We have not agreed the rules for prompt corrective actions. Resolution arrangements are very unlikely to made by the time that any corporate change takes place. Partly because the government do not see the risk because of the very low probability of default.

We can have a discussion about all these issues because we are dealing with well-capitalized profitable bank. You can not have this sort of discussion when the bank gets into difficulty because you can not set the rules right in time. You change something from being technical to being political.

In conclusion, plenty of other countries have foreign banks with the major share in the market. While they may not have the same supervisory problems because they do not operate through branches but they still have the same resolution problems since a subsidiary is often not economical independent. This is true for Nordea already – the way in which it is organized it is not a free-standing organization.

Deposit insurance is a sort of reinsurance to stop runs on healthy banks. We do not assume it as a normal event, but only if everything else fails. At present we do have something which would be a threat for financial stability and we have to sort it out both by the deposit insurers and the central banks.

David S. HOELSCHER
(International Monetary Fund)

Deposit insurance schemes worldwide have recently undergone numerous changes which is connected with new challenges and new risks. In the last 5 years almost 70 countries have either introduced new systems or fundamentally reformed already existing systems. At the same time, the international authorities have become more interested in deposit insurance system issues, the common trends emerging in this area and their effectiveness. The International Monetary Fund did the survey on deposit insurance systems worldwide in 2000. The Financial Stability Forum (FSF) published its report on guidelines for deposit insurance in 2001. The International Association of Deposit Insurers did its review in 2003.

IMF investigated a number of deposit insurance systems from all over the world, trying to identify common features and common trends. As far as mandates of systems are considered, there is a spectrum which goes between a narrow function pay-box system and risk minimizer. However, there is a trend towards giving deposit insurance systems much more responsibility. In the 2000 survey 46% of systems had broad responsibilities. As for 2004 this number increased to 55%. Systems are given increasing responsibility for supervision and sometimes for bank resolution. One reason for that is the desire to have a check on supervisors. In addition, authorities believe that the mandate to protect depositors has more political support than other mandates. In consequence, there may be less affairs when a deposit insurance system is forced to take action.

Another examined area is a membership issue – compulsory versus voluntary. There is a strong trend towards compulsory membership. In mid nineties about half of the systems had compulsory membership. By 2004 over 90% had their systems which were compulsory in nature. Since the end of nineties only two system have been introduced that are not compulsory – in Russia and Sudan. There is an issue whether or not state banks and foreign banks should be included. The argument for including state banks is for example addressing problems with large state banks which are perceived to be guaranteed in 100%.

In the early reports on systems in the world IMF pointed out statistical average of coverage at the level of about 2 times *per capita* GDP. Mistakenly, it came to the literature that IMF makes recommendation that it is an appropriate coverage level. Coverage limits depend on the objectives of the deposit insurance system. For accomplishment of the objective of protecting small depositors it is sufficient to set low limits. However, the objective of enhancing financial system stability requires a broader range of coverage. In the last survey IMF found that the coverage level have not changed too much since late nineties. In general the coverage ratios tend to fall around 2 times GDP *per capita*. But the spread is quite significant. The only outliners are some small countries with low levels GDP *per capita* and very high coverage levels. There are a number of African countries which use deposit coverage to help improve confidence in their banking systems. There are also a number of countries coming out of very severe crisis when blanket guarantees were in place. There has been also little convergence in the extremes. The shares of deposit insurance systems which coverage level is more than 3 times or less than 1 time of GDP *per capita* are almost the same.

However, within the group in which coverage limit is around 2 times of GDP *per capita* there is apparent convergence over time.

Deposit insurers become increasingly concerned about the market distortions which can be introduced by deposit insurance. In consequence, there is a trend towards excluding certain kinds of deposits, i.e. interbank deposits. In mid nineties less than half of the schemes excluded interbank deposits. As for 2004 this percentage increased to almost 90%. The argument for this exclusion is that large interbank counterpartners should be responsible for monitoring the risks. In the same vane deposit protection schemes are now beginning to exclude government deposits and much more exclusively inside and criminal deposits.

The next area included in the IMF report is funding. There are both *ex post* and *ex ante* systems in Europe and in the world. *Ex ante* funding is becoming increasingly common. In 2004 70% of all systems were financed on the *ex ante* basis. The reason comes out of some proceeds advantages of *ex ante* funding and some problems with the *ex post*. A number of countries are concerned that if they rely on the *ex post* funding then in the case of financial difficulties in the banking system collecting premiums may contribute to the contagion of financial disruption. At the same time, *ex ante* systems where everyone pays premium may help increase the pressure. There is an interesting development on risk-based premiums – there are common in Europe, between 1995 and 2000 there was a burst of systems that adopted risk-based premiums as a method. However, there are some limitations to that. One of the problems is that financial indicators which are used by the deposit insurers to calculate risks are based on historical data and involve information lags. This is also a question about whether one wants to increase premiums of a bank facing problems what might make the bank situation even worse. Possibly reflecting such concerns between 2000 and 2004 there has been reduction in the numbers of systems relying on risk--adjusted premiums.

To conclude, major themes of the systems, that have emerged over the last 5 years, are the following:

- move towards explicit and compulsory deposit insurance scheme;
- mandates of deposit insurance schemes become broader;
- coverage levels begin to converge;
- concerns about potential market distortions caused by the deposit insurance schemes;
- trends towards explicit funding;
- possible concerns about risk-based premiums.

Arthur MURTON
(Federal Deposit Insurance Corporation)

"US Experience with Deposit Insurance and Trends in Banking"

The Federal Deposit Insurance Corporation (FDIC) was created in 1933 during the US Great Depression. At that time thousands of banks were failing and the FDIC was created to stop the bank runs that were occurring throughout the United States. It provides deposit insurance to both: banks and savings associations. It also supervises certain State-charted banks.

Prior to the creation of the FDIC, there were national banks charted and supervised by the Office of the Comptroller of the Currency (OCC) – the Department of Treasury. With the creation of the Federal Reserve System the certain State-charted banks which chose to become members of the Federal Reserve System were then regulated both: by the State which charted them and also by the Federal Reserve at the federal level. After establishment of the FDIC State-charted banks which did not belong to the Federal Reserve System became subject to the FDIC's supervision. The FDIC currently supervises over 5,000 of the 9,000 banks in the US, however typically small and representing only about 20% of the assets of the US banking industry. The third role of the FDIC is acting as a receiver for failure banks. The FDIC's legislation provides legal framework for the handling of a failure bank in the US. There is an alternative to the bankruptcy mechanism. The FDIC administers two deposit insurance funds: the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). As for December 31, 2004, the FDIC insured deposits of over $ 3,623 billion. At the same time the US banking industry had $ 10,000 billion in assets. The combined fund balance was around $ 48 billion. The reserve ratio (the ratio of the Fund balance to the insured deposits) was about 1.31%.

As far as funding statistics are concerned, the BIF Fund balance was increasing until banking crises in the nineties when it was exhausted and then rebuilt. In the fourties the reserve ratio was relatively high, then it decreased to under 1.50%, was rather steady for a number of years and dropped to a negative value during the crisis period. In 1991 the FDIC reported in its year financials a negative balance of $ 7 billion. However, this number is not a cash number but reflects a large reserve set aside on the FDIC's back books for the potential failures of a number of large banks. As it turned out in the early nineties the US banking industry recovered very quickly from the crisis period. Those large failures did not occur and as a result the FDIC reversed those reserves and that helped to restore the Fund.

With respect to the statistics on the premium rates, according to the original statute of 1935 every bank is to be charged the same rate for deposits insurance. The rate range was set at 1/12 to 1% of domestic deposits. Until 1950 the rate that was in effect at the level of 8 and 1/3 basis points. In 1950 the Fund balance reached $ 1 billion and the banking industry was concerned that they had been overcharged and that the Fund was building too rapidly. Therefore, there was introduced a modification in the law. If the FDIC had excess operating revenue it would refund a portion of it back to the industry in the form of the credit against next years assessment. Starting in 1950, the FDIC for the next 30 years gave back as a credit about half of assessment income each year. In consequence, effective premium rate was approximately 4 basis points. In the eighties the FDIC no longer had excess revenue each year because of bank failures and costs connected with them. In 1991, at the high of the crisis, the Congress passed the FDIC's Improvement Act (FDICIA) and changed the way that deposit insurance was founded in the US. A significant change was that the relevant setting the premium rate in the statue. The FDIC was ordered by the Congress to maintain the Fund on the certain ratio (1.25%). If the FDIC suffers losses it has to back to this level quickly. Starting in 1991, premium rates went up to almost 25 basis points, which was approximately 6 times the effective premium rate that banks had been paying from 1950 to 1990. In 1995–1996 the premiums rates fell basically to 0. The Fund reached the target level and there was introduced into legislation a clause that when the Fund is above 2.5% the FDIC is prohibited from charging any premiums to banks if they meet certain criteria (good quality of management and proper capitalization). As a part of the FDICIA's reforms risk-based premium system was introduced. Starting in 1993 it was based essentially on supervisory ratings and capitals levels.

To conclude, for 50 years there was a system that focused on having relatively stable premiums and let the fund ratio moved about. Since nineties there have been a system that focused on the Fund's ratio, keeping it steady and have premiums moved above. The current system is a procyclical one since it requires banks to pay nothing during good times when you might be building up the Fund and to pay possibly a very high amount when the industry can least afford. During most of the time over 90% of the banking industry pay nothing for deposit insurance. Therefore, the FDIC is currently working on the change in the legislation. The proposed changes are as following: to merge the Funds, to allow the FDIC manage the reserve ratio within a certain range (between 1,0 and 1,5%) and to introduce coverage level indexed to inflation.

The FDIC observes and evaluates global trends in deposit insurance. According to observations over past decade, structural changes have in various countries led to the increased establishment of explicit deposit insurance schemes. Approximately 80 explicit deposit insurance schemes have been established. Most of them are limited – coverage systems, only a few offer blanket guarantees. Average coverage ratio has increased since 1998. Membership is mandatory for 91% of all deposit insurance schemes. 84% of deposit insurance schemes are funded on an *ex ante* basis. 35% of schemes use risk-adjusted premiums.

With reference to current issues in the US banking industry the most important are:

- consolidation of the banking organizations (in the years 1998–2004 the number of FDIC-insured banking organizations decreased from around 13,000 to 8,000);
- asset and deposit concentration (in 2004 25% of the nation's domestic deposits were concentrated in 3 banking organizations, compared to 41 organizations in 1985);
- Basel II (the implementation is delayed since it has raised a lot of concerns, i.e. it may result in large banks holding significantly less capital than under Basel I and in competitive inequity for non-Basel II banks).

Over the past 25 years the trend toward deregulation has been observed in the US. There were lifted ceilings on interests (interest-rate deregulation), as well as restrictions on interstate banking and branching (geographic deregulation). In the further step banking organizations were permitted to offer also securities and insurance products (product deregulation). However, still a regulatory barrier between banking and commerce remains. There is a debate on the permission of creating affiliations between banking and commercial firms. It would be beneficial for consumers, business and the economy, but at the same time it raises concerns about conflict of interest, concentration of economic power and protection of the banks and the safety net.

Prof. Shelqim CANI
(World Bank)

"Convergence. A public-private Financial Sector Program"

"Convergence program" is the new idea aroused from the financial sectors' needs of the South-East Europe. This special facility is dedicated to promote the new way of dealing with the financial sector issues. It is based on the public-private model of cooperation among different kind of financial sector entities as banks, insurance companies, brokerage houses, business associations, consumer associations and, last but not least, authorities. The scope of countries the program is addressed to, is wide and consists of 7 countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro.

The program itself is supported by the World Bank and the Italian Ministry of Economy. The main goal of program is finding solution using the dialogue among parties mentioned above as the best tool for achieving valuable results. The key role in this dialogue plays cooperation between public and private entities of financial sectors. Very important is the indication of the real needs of various private corporations. However, private interest can be underlined in an adequate way only with sufficient position of public authorities. And this is the key role of dialogue.

The challenge for the financial authorities coming from the fast changing banking environment gets new dimensions. It seems it is not enough to respond to some public actions. The new challenge is to shape the definitions and implement the rules for the banking system and further more to produce solutions to enhance the competitiveness and synergies of the system.

Convergence may be the answer for such described financial sector challenges. It can help in many ways. First of all to engage with authorities, which means it should help to convince authorities to listen to the problems market participants are facing. However, this seems to be not a foregone conclusion in several countries. In this case the credibility of the World Bank and other International Financial Institutions' partners, senior management team should help.

The program will operate on the basis of a mandate from authorities as their continued commitment is key to exercise. Convergence is also helpful in gathering information and later on to quantify and assess this information. It can also assist decision-making in terms of understanding advantages and disadvantages of the proposed solutions.

The “honest broker” role is the key to preserving long-term credibility and influence. Moreover, market views will be represented throughout during discussions. The key point is then that the authorities want to participate actively in the dialogue. If this is the case, the convergence credibility will mean at the same time IFI’s sponsorship, quality of management team and strength of market realities.

Considering the purposes of the Warsaw conference the case of Convergence activity in Romania is worth mentioning. Romanian authorities wish to make an updated assessment of the level of banks’ contributions to the Deposit Guarantee Fund (DGF). In the letter they sent to the Convergence in May 2005 they pointed out that such assessment should fulfill the following three conditions:

- the latest developments in the Romanian banking sector;
- international practice;
- need to maintain a well-funded guarantee scheme to preserve the confidence of depositors.

The Convergence presents new approach for the deposit guarantee system analyses. It is focused on limitation of the analyzed risk of DGF only to “residual” risk. It means that real risk determination requires detailed analyses of the assets (i.e. liquid assets) and liabilities (i.e. guaranteed part of deposits) structure. The DGF’s risk is also determined by many parts of the long process leading to bank bankruptcy. Generally speaking, the nominal exposure of the DGF is much higher than real potential loss. The “final loss” focus makes possible to decrease banks’ premiums, especially in long run.

Finally, how convergence can help deposit insurers? There are three main points. First of all, it can contribute to strengthening of analytical capabilities, improving financial operations and risk monitoring capabilities in cooperation with central banks.

It can also play an “honest broker” role between deposit insurer (DI) and supervisory authorities to help design the most appropriate role for the DI within the changing banking system structure. Lastly convergence program can help exploring how market participants could contribute to more efficient deposit insurers’ activities.

Bank Guarantee Fund

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