

THE DEPOSIT INSURANCE IN BULGARIA: IS THE TIME FOR CHANGE?

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Abstract

During 1997 Bulgaria has experienced one of the most deep financial crises in CEE countries. The combination with currency crisis, widespread bank failures, hyperinflation and government crisis has a very negative affect over the whole Bulgarian economy. Parallel with the introduction of currency board, as part of measures for improvement of bank system soundness and public confidence has been enact a law for deposit insurance. In this paper are discussed base principles for deposit insurance system design and Bulgarian deposit insurance system is assessed according it.

Introduction

The deposit insurance system is usually introduced as a subsequent measure for increase of bank system confidence after systemic problem such as: confidence decrease, mass deposit withdraws, bank failures, bank crises, and very rarely as preventive measure. Typical evidence for this is Federal Deposit Insurance Corporation (FDIC) in USA, which is established after bank-runs in 1930-s¹. The Law of state protection on deposits and accounts, held in commercial banks, for which Bulgarian National Bank is required starting of bankruptcy procedure, passed in 1996, also is one of the measures for 1996-97 bank crisis resolving. Although the occur stabilization in the Bulgarian banking sector, and the aptitude to forget the past banking crisis, the author is put the questions as “Is accepted deposit insurance system in Bulgaria is accordance with the best practices in this aria?”, and “What is the need to change it?”.

¹ <http://www.fdic.gov/about/index.html>

Deposit Insurance System Design

The deposit insurance is one of measures, accepted to limit the bank crisis consequences and/or bank sector restructuring. Its main aim is to increase the confidence in banking system, to limit the bank runs scope, as well as to take part of restructuring cost, including reimbursement of depositors' compensation.

The design of the deposit insurance system is of particularly importance for its future effectiveness. The first steps in this direction are: public policy objectives define, and situational analysis making. Through defining of public policy objectives, the policymakers must clearly define what are aims of the deposit insurance system, which will be developed. The main objectives are maintained of confidence in the bank system and protected less-financially-sophisticated depositors, but there may be includes also such as: increasing of market disciplines, reducing of moral hazard, etc.

When the situational analysis is conducted, the policymakers have to take into account all country-specific factors, which must find reflection at deposit insurance system design or actualization. The analysis has to stress on economic factors, the state and structure of the banking system, public attitudes and expectations, the state of legal,

prudential regulatory, supervisory, accounting and disclosure regimes, etc.

The results of the situational analysis must be reflected in deposit insurance system design. In this phase, the attention must be directed to questions, connected with the mandate, powers and structure of the deposit insurance system, as well as features such as membership, coverage, funding, etc.

A mandate is a set of official instructions or statement of purpose, whereby is determined the role of deposit insurance in safety net framework. The existing practices range from narrow, “paybox” systems to systems with broader power and responsibilities. The choice of the mandate must be correspondent to objectives, powers and responsibilities, given to the deposit insurer.

Other question to be answered is “Which institution will be execute the deposit insurer functions?”. It is possible to be created separated department at some existing entity, such as Central bank for examples, or to be established a completely new authority. In the first case, advantages are connected with usage of resources and skilled staff from the main organization, but potential problems with separating “deposit insurance” function from others functions and responsibilities are main disadvantages.

Regardless of organization solution, the governing body of the deposit insurance system should include individuals with the requisite knowledge and which have the authority to make decisions, connected with organization's activities. Very important is the guarantee of legal protection on the employees against lawsuits for their actions, taken in good faith. The lack of such guarantee will reduce incentives to be watchfulness, particularly in connection with early detection, intervention and closure of trouble banks cases.

It is also very important for effectiveness of deposit insurance system is the closely connection, coordination and cooperation with others participants in safety net. When all safety net functions are concentrated in a single organization, then coordination, information exchange and emerging problems are resolved between the departments in the organization. But in the case when safety net functions are separated between different organizations, issues related with information sharing, allocation of powers and responsibilities, as well as coordination between participants, must be clearly and explicitly defined.

In general, the membership in deposit insurance system must be compulsory, although voluntary membership is possible too. The disadvantages of the second one is connected with the fact, that banks may do not have enough incentives to be part of the system, or they are too strong, and then they may to opt out. In this case, the positive effects

of the existing deposit insurance system will be limited or totally eliminated.

Other aspect of the banks' membership is connected with the way of which they are granted to the system. The possibility resolutions are automatic membership and requiring banks to apply for entry. The choice depends of factors such as: whether deposit insurance system is introduced at first or it is in process of reforms; current economic conditions – economic growth or financial crisis; banking sector structure, etc. The chosen approach must contribute to achievement of deposit insurance system objectives.

Essential role for the effectiveness of the system plays its scope and level. For determination of its scope is important to exist clearly definition (by law for examples) of “insurance deposit”. In the range of insurance deposits usually are included deposits held by private depositors, because the lawmakers have assumption that those depositors do not have knowledge for assessment on financial condition in banks, as well as they do not have enough powers for affect influence into conducted from banks policy. As consequences, many deposit insurance systems excluded deposits, held by depositors, which are deemed capable of ascertaining the financial condition of a bank and exerting market discipline (banks, government bodies, professional investors, bank directors and officers, auditors, etc).

As next step, the policymakers must set the level of coverage on the base of statistical data assessment, as selected level must be credible and internally consistent with other design features. The limits may be applied per deposit or per depositors, as well as per bank or across all member banks. Each of the mentioned approaches has some advantages and disadvantages, and must be appropriate to the country specifics and the time of deposit insurance introduction. The most used approach is per depositors and per bank.

The usage of coinsurance also promotes market discipline, reduces moral hazard and cost of failure resolution. Unfortunately, this approach has some negative consequences, connected with depositors opt out of the banking system. To avoid this deposit insurer may apply a limit, behind it the coinsurance will be applied. In this way, the depositors, which are holding small account balances are protected fully against the risk of lost, while others still have incentives to monitor financial conditions of banks.

The decision, whether will be protected deposits, denominated in foreign currency depends on the degree of its usage in the country. If a deposit insurance system protected only deposits in domestic currency in a country with high usage of foreign currency, then it will be inappropriateness and will not achieve its objectives.

The question “How will be funded the deposit insurance system?” is critical for its effectiveness, because an inadequate funding may lead to

delay of failure bank problems resolving, to increase of costs, as well as lost of confidence in deposit insurance system. The funding may be ensured by levies or premiums from members, government appropriations, market borrowing, or a combination of them.

The levies or premiums can be assessed on “*ex-ante*” or “*ex-post*” basis. The advantage of the *ex-ante* funding is the possibility of accumulation of a fund, as well as the smooth premium payments over time. Because all banks contribute to fund formation, the fail banks also pay a part of costs of there failures.

Ex-post funding requires all members to pay levies or premiums after a bank failure. Although this funding contribute to increase of interbank monitoring, it has some disadvantages – the failed bank do not participate at costs covering, and in this way, the bank management do not has incentives for effectiveness governance. Furthermore, if give an account of that bank failures usually are connected with problems in banking sector, then accumulation of necessary funds may be strongly embarrassed or in some cases even impossible, as well as it may to lead similar problems in other troubled banks.

When is establish a deposit insurance fund, two approaches may be applied: assessment of steady premium rate over a long period; and adjusting of the premium rate, according the target level and current

status of the fund. The usage of second one may lead *de facto* to *ex-post* system, when the fund achieves the target level.

In addition, is very important to choice between usage of a flat-rate or the risk-adjusted differential premium system. The main advantage of the first one is the relative ease with which assessments can be calculated and administrated, but in this case, low-risk banks pay part of benefits received by high-risk banks. The systems with risk-adjusted premium may contribute usage of prudential risk-management practices, but in other cases they may worsen financial condition on the troubled banks additionally, as well as to engage failures of these banks.

The Deposit Insurance in Bulgaria – problems and solutions

The deposit insurance issues become actuality in Bulgaria with the start of transition processes from central-planned to market-based economy. During the socialism all banks were 100% state-owned, bank failures had been impossible and depositors held explicit blanket state guarantee. Bulgaria did not have functional deposit insurance system up to 1996. It has been introduced as a measure for bank problems resolution and for maintain of depositors' confidence in Bulgarian banking system².

The deep system bank problems in 1995-97 force policy- and law-makers to introduce 100% guaranties for all inhabitants' net deposits and 50% for firms' net deposits, independently of currency's denomination. Out of protection scheme stays financial institutions, bank directors, managers, owners and shareholders, as well as for some close relatives. With the same law the Guarantee Fund, funded by long-term guarantee state securities issue, privatization incomes, as well as bankrupted banks' liquidation, has been established.

After the bank crisis, as measures for increase confidence in banking system, in 1998 has been abrogated the Law of a state protection on deposits and accounts, held in commercial banks, for which Bulgarian National Bank is required starting of bankruptcy procedure, and has been

² Law of a state protection on deposits and accounts, held in commercial banks, for which Bulgarian National Bank is required starting of bankruptcy procedure, State Gazette, No. 46, Sofia, 1996

replaced with a fully new Law for guarantee citizens' deposits, held in banks³. The new law settles the scope and coverage of deposit insurance system, Deposit Insurance Fund establishment, as well as statute, aims, management, funding and usage of the accumulated amounts in the Fund.

The Law specifies explicit deposit insurance system with compulsory membership for all domestic banks and for all foreign banks, in which home country does not exist deposit insurance systems. The level of coverage is based per depositors and per bank, independently of currency denomination. At the first, the coverage was up to 5000 BGN⁴ - 95% of all deposits up to 2000 BGN and 80% for surplus up to 5000 BGN. As part of the negotiations for EU accessing, the coverage has been updated to 100% of all deposits up to 10000 BGN in 2001 and to 100% of all deposits up to 15000 BGN in 2002.

As measure to reduce the moral hazard, existing deposit insurance system excludes deposits, held by individuals or organization, which are deemed capable of ascertaining the financial condition of a bank and exerting market discipline, or are conducting to banks' troubles or failure. In this category are included: persons, who uses privilege interest rates; shareholders with more than 5% of all vote; members of governing and supervision bodies; auditors' bank; financial institutions; insurers;

³ Law for guarantee citizens' deposits, held in banks, State Gazette, No. 49, Sofia, 1998

⁴ 1 EUR = 1.95583 BGN

pension, insurer and investments funds; the state and state authorities;
municipals and the Deposit Insurance Fund.

Conclusion

Although Bulgarian deposit insurance system is introduced relatively late (1996-1998), it achieves its main aims – to increase the public confidence in the bank system after 1996-97 crisis. Together with the other macro economic stabilization measures, and the Currency Board introduction in particular, the deposit insurance system contributes to rapid rehabilitation and normal functioning of the banking system after 1997.

After the crisis is overcome and macro economic stabilization occurs, the Bulgarian deposit insurance system has been changed in 1998. The usage of coverage limit and coinsurance, as well as enforcement of affiliation fees (1% of bank capital, but not less than 100,000 BGN) and yearly premiums (0.5% of deposit base of the past year), contribute to the building of a deposit insurance fund, which is able to cope with the aims of deposit insurance.

In conclusion, we may generalize that the existing deposit insurance system in Bulgaria is designed and developed according to the best practices, and does not have need or reasons to change its fundamental principles and used practices.

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