2013 IADI Research Conference
"Evolution of the Deposit Insurance Framework: Design Features and Resolution Regimes"

IADI International Association of Deposit Insurers

Basel, Switzerland
9-10 April, 2013

Ex-ante Funding: Incentives to emerging markets with buoyant banking industry

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Assumptions

i. Deposit insurance is a monopolistic business: depositors do not have the choice of selecting the insurer on the market (it comes with the chosen bank)
ii. Deposit insurance provides an incentive for banks to engage in riskier activities: a bank can increase its expected return by investing in riskier assets or by increasing its leverage ratio. Banks have an incentive to take on risks until their benefit of risk-taking is equal to the marginal costs. Moreover, as efficient the process of asset transformation by banks might be for the overall economy, it also has its downside. As a result of liquidity transformation, banks' balance sheets are inherently unstable (P. McCoy, 2007) as the bank's assets have a lower liquidity than its liabilities.
iii. As deposit insurance schemes usually have uniform insurance premiums rather than risk-based premiums, the marginal costs are fixed at a uniform level that does not depend on the risk of a bank's portfolio. Hence*, marginal costs are, socially, low and therefore risk-taking is high.*

That technical thing

If a deposit insurance scheme fails when it is in the spotlight the damage is huge and credibility cannot be restored easily: i.e. the financial planning of adequate resources in the deposit insurance business is of great importance. It is a technical issue, more important from an operational perspective for the effectiveness of a DIS than from that of theory.

That technical thing, cont.

- Financial planning is particularly important in schemes where ex-ante funding exists and where the fund is created in advance and needs to be properly managed.
- Overviews of the characteristics of the two different funding schemes and an evaluation of the effectiveness and efficiency of each (D. Ognjenović, 2006 and J. Roy, 2000) indicate *that ex-ante schemes are more effective but less efficient than ex-post deposit insurance schemes*.
- Indeed, when financial resources for deposit insurance are collected continuously, a *DIS is more liquid* and ready for payouts when needed. Members pay premiums constantly at a time of prosperity as well as in times of recession.
- While the *ex-ante fund must be managed, which increases operating costs compared to an ex-post DIS*, those last ones do not impose an unnecessary burden on member institutions during periods without bankruptcies, because they do not have to make payments to the fund and money may be used more efficiently.

Financial planning

- According to an IMF Working Paper done by G. Garcia (1999) it is useful for a DIS to set targets in order to achieve and retain financial viability and avoid any financial deficiencies that may even lead to the insolvency of a DIS.
- Garcia says that appropriate target demands: … "a realistic assessment of the condition of the banking industry, the size and timing of the financial demands that are likely to be placed on the fund…" and the industry's ability to pay the necessary premiums without prejudicing its profitability, solvency and liquidity.
- Optimization of the fund's size is the most advanced usage of the financial planning in any deposit insurance scheme. This means that financial planning is a strategic tool for the definition of what the size of the fund should be and how the liquidity needs of a DIS can be determined and structured.
- Optimization of deposit insurance through financial planning means that a DIS tries to achieve optimal fund size (not too big, not too small) through optimal financing.

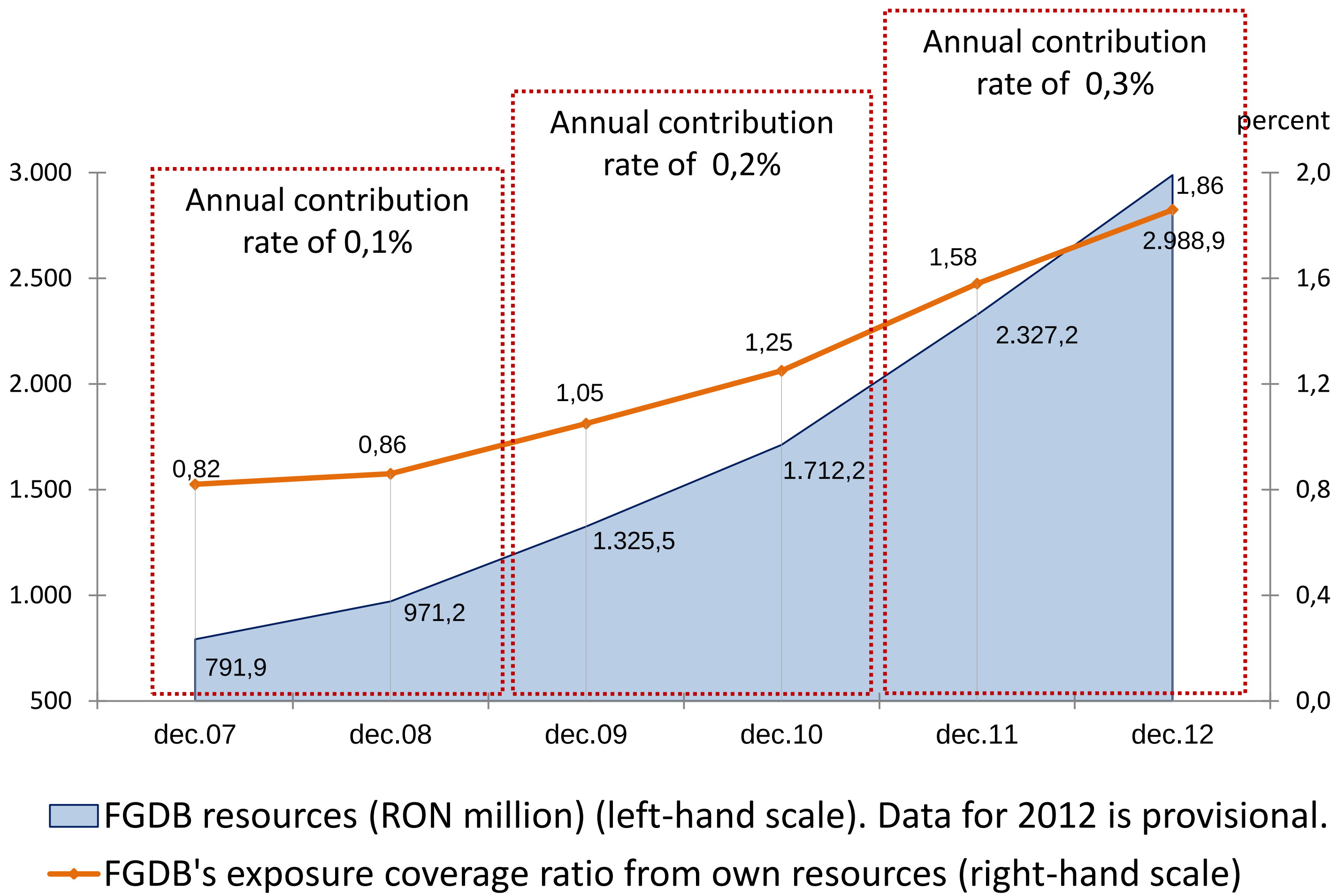
DIS & market discipline

- Deposit insurance is only effective if it is part of a sound regulatory environment.
- One of the most important tasks at the design of the regulatory framework is to replace the market discipline that is being lost also due to a deposit insurance system. Comprehensive financial stability bodies, to which DIS should be associated, effectively monitor the soundness of financial institutions and, if necessary, shut inefficient ones down before they cause a crisis or restructure them.
- Following Demirgüc-Kunt and Kane (2002), an ideal regulatory framework would be as close as possible to the ideal case of perfect transparency (i.e. information about the financial institutions), perfect deterrence (i.e. the ability of depositors and supervisors to immediately "protect themselves from any adverse consequences") and perfect accountability for actions taken.

FGDB in an emerging market

- FGDB is an ex-ante funded DGS.
- The *FGDB's exposure coverage ratio is determined by the dynamics of its resources* (where banks' contributions have a considerable influence) *and with the one of insured deposits*. Currently, the annual contribution rate is of 0.3 per cent, unchanged from 2011.
- *The target is to reinforce the funding mechanism along the growing banking turbulences in the nearby area and the markets from where many banks have spread their activity to the local market*. The FGDB must reach a target level for the *medium-term exposure coverage ratio for ex-ante funding of 2 percent of the value of insured deposits*. At the end of 2012 the exposure coverage ratio stood at 1.86 percent.

Getting ready for...

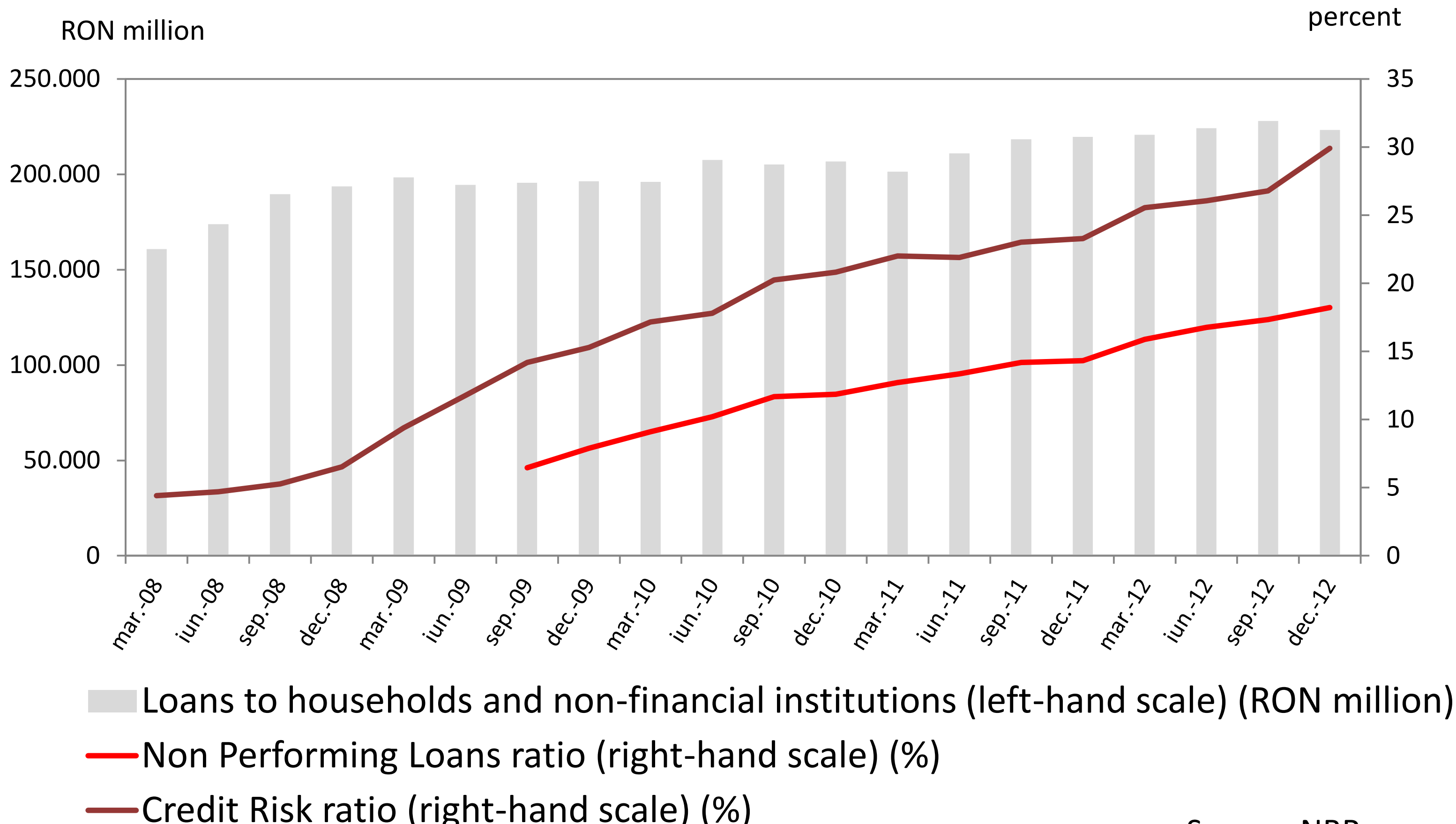


Source: FGDB

Why is that?

- The quality of the credit portfolios has decreased within the past three years witnessing a steady rise in the *Non Performing Loans ratio, which reached its highest level so far*, registered at the end of 2012, of 18.2 percent, exceeding by around 4 percentage points the end 2011 value.
- The total amount of loans granted had a fluctuating evolution over the same past period, however showing mostly positive 12-month readings, despite the surge in the Credit Risk ratio which stood at 29.9 percent at end December 2012, indicating that not only the loans granted classified as loss increased their weight, but also those classified as doubtful. <u>Remark:</u> the credit risk ratio as at 31 December 2007 was of 4 percent.

NPL triggers credit risk

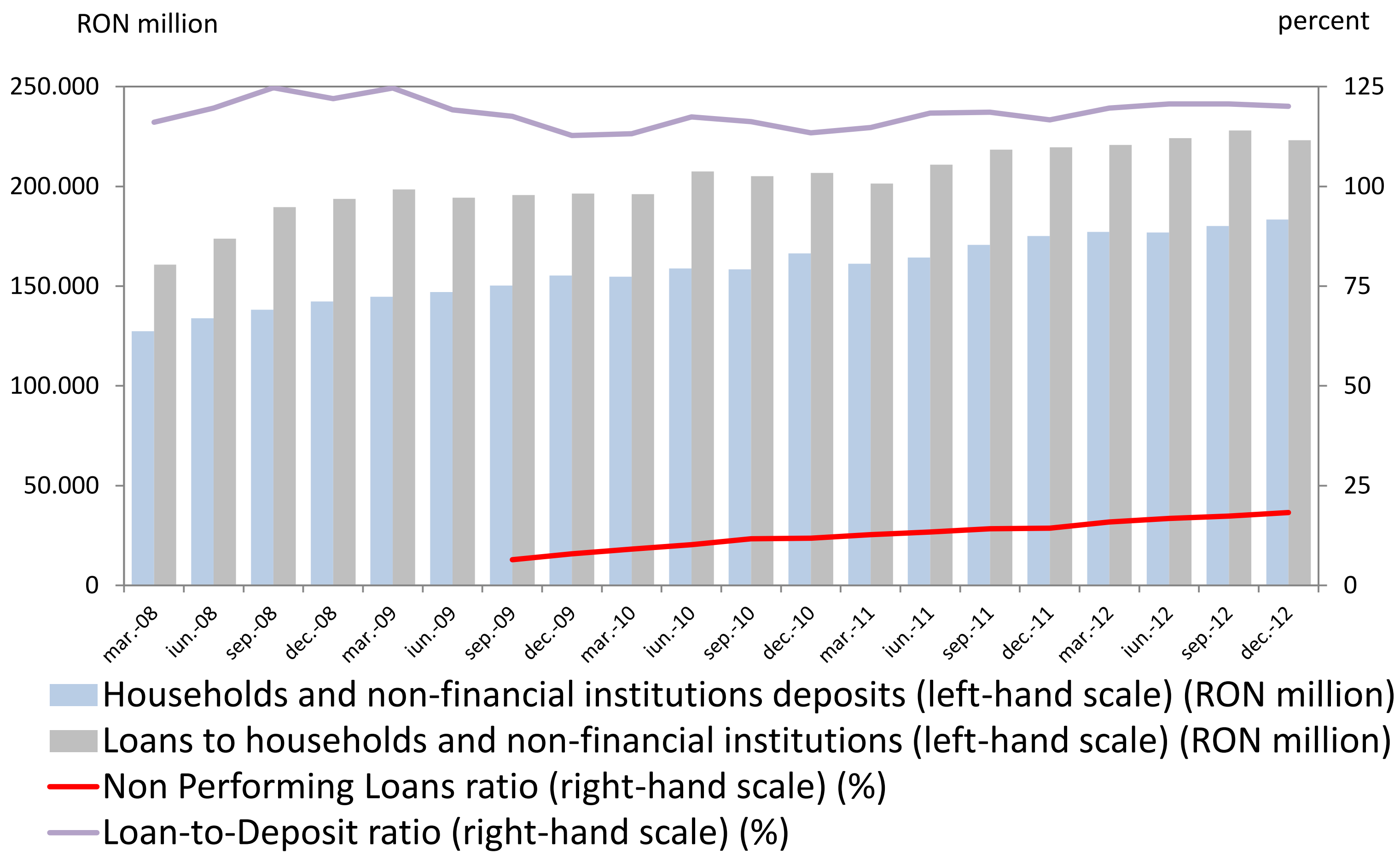


Source: NBR

Deteriorated environment

- As at 31 December 2012, almost a quarter of the loans value (20.1 percent) was financed from other resources than deposits.
- The average deposit interest rates, both for RON and foreign currency, continued to decline throughout the past five years.
- Over the past year, the prudential value adjustments of credit institutions - Romanian legal persons - headed higher by almost 30 percent in absolute values.
- Due to the decline in the banks' quality of assets and the important share that provisions hold in the structure of expenses, the profitability indicators decreased to the minimum of the past years (-0.58 percent for ROA and -5.36 percent for ROE).

Loans to deposit ratio almost steady



Source: NBR

The Resolution fund

- Starting 2010, FGDB was appointed administrator of the funds set up to secure financial stability. Started as a Special Compensation Fund, established in view of ensuring the necessary financial resources for reimbursing persons affected by the measures ordered and implemented during the special administration, it has turned into a Resolution Fund in 2012.
- The Resolution Fund is separated from the deposit guarantee fund and is also ex-ante funded. According to the NBR's decision, the accumulation of funds for the new entity was set up during a five year span, as follows:

2011/2012	- 50 million RON /year
2013	- 100 million RON
2014/2015	- 150 million RON /year

- The funds may be replenished through: annual and additional fees from credit institutions, revenues from investing the amount built up, and borrowings from credit institutions, financial companies and other institutions, as well as debenture loans through FGDB securities issue.

The Resolution fund, cont.

- The determination of **the annual fee is done by applying a percentage to the value of the uncovered liability of each credit institution**, Romanian legal person.
- The percentage used for determining the annual fee is established taking into consideration the optimum necessary amount of financial resources of the Resolution Fund, as well as the appropriate level to be reached for every year and **cannot exceed the level of 0.1 percent**.

$$\textit{The annual fee} = \frac{\textit{The target for the current year}}{\textit{The uncovered liabilities reported by the credit institutions for the previous year}} \times 100$$

- The percentage for determining the annual fee was:

  0.027 percent in 2011 and

  0.0322 percent in 2012

Benefits of Ex-ante

- It is more rule-based
- It offers greater certainty than other systems (funds are in place before they are needed)
- It provides assurance to depositors that their insured deposits are safe and can be recovered in case of failure of the deposit-taker institution (provided they know that funds have been raised in advance and they are well-managed)
- It reduces the risk of sudden withdrawals and bank runs
- Is perceived as being more fair than an ex-post system (mainly because all member institutions, including those that fail, will have helped to support the system through payments into the fund)
- It helps avoid situations when prudently managed financial institutions subsidise the poor managed through the deposit insurance system.
- It spreads the cost of insurance losses over time, as insurance premiums are collected over time taking into account expected losses
- It contains an anti-cyclical feature and buffer for the industry
  - The fund accumulates premiums during stronger economic conditions, when losses may be low, as a safety cushion against future needs when economic circumstances may be unfavourable and losses higher.
  - It avoids further weakening of the overall banking industry at the time of a failure.

Backup funding

- The deposit insurance system may find itself without adequate funds to meet its commitments, even in a non-systemic crisis.
- A gap between resources and financial obligations can be covered by the insurer's access to:
  - additional or backup financing from the government or
  - market resources
  - DIS solidarity (ex-ante opens the way as ex-post raises more doubts)
- The backup funding would allow the prompt reimbursement of insured deposits and could be repaid through special assessments of the surviving institutions and/or proceeds from the liquidation.
- If a backup funding mechanism is in place, it is important that clearly defined rules are in place, so that the public funds are not excessively relied on or used inappropriately.

Advantages of a pre-arranged backup funding mechanism:

- The terms and conditions of the financing can be more carefully considered
- Access to funds is quicker
- The existence of a financial recourse mechanism may increase confidence in the system
- It may facilitate the timely closure and resolution of failed banks
- It helps contain the costs associated with the failure

Set the target reserve

- The most common approach is to consider the country's historical experience with bank failures and associated losses
  - The advantages of this approach are relatively straightforward and easily understandable and it relies on existing information.
  - A shortcoming is that the past may not be a good guide to the future (it does not take into account the current risk profile of member institutions and other information which may be useful in assessing potential losses to the deposit insurer)
- The credit portfolio approach is a more analytical method to determine a suitable reserve ratio
  - The deposit reserve is viewed as being subject to a portfolio of credit risks similar to a bank loan portfolio
  - The portfolio consists of individual exposures to insured banks, each of which has the potential (some greater than others) of causing a loss to the fund.
- In most cases there will be a relatively high probability of small losses and a much lower probability of very large losses.
- The probable large losses would tend to be associated with the presence of large banks.

Further reading

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Thank you,

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