RESEARCH PAPERS OF WROCŁAW UNIVERSITY OF ECONOMICS No. 138
Financial Sciences 5 2010

Agnieszka Ostalecka
Wrocław University of Economics

DEPOSIT INSURANCE SYSTEM IN POLAND AND ITS PLACE IN FINANCIAL SAFETY NET

Summary: The aim of the article is to present the organization of deposit insurance system in Poland. As a starting point there are presented theoretical aspects of deposit insurance system functioning and its place in financial safety net. Against this background there are discussed detailed issues and assumptions of Bank Guarantee Fund functioning, like its main tasks, its powers, participants, categories of deposits included and excluded, guarantee limits and co-operation with other elements of financial safety net.

Key words: financial stability, financial safety net, deposit insurance, Bank Guarantee Fund.

1. Introduction

In such turbulent times, which we are experiencing at present, one of the most important challenges for the authorities is to ensure financial stability. Financial stability constitutes an indispensable condition for the financial markets effective functioning. It creates a favourable environment for investors, enforces better efficiency of financial intermediaries' activity, contributes to better resources' allocation and creates a better condition for conducting macroeconomic policy. The occurrence of financial instability results in serious negative consequences disturbing effective functioning of financial markets as well as creating huge costs both for financial markets and real economy. The most serious risk for the financial system connected with the loss of financial stability is banking or financial crisis eruption.

Taking into account this enormous threat, nowadays one of the most important challenges for the authorities is to preserve financial stability. In order to ensure financial stability, in most countries there are created financial safety nets which include: deposit insurance system, regulation and supervision of the banking system and central bank in its role of the lender of last resort. The main aim of this article is to present, beyond theoretical deliberations, the organization of deposit insurance system in Poland, run by Bank Guarantee Fund and its place in financial safety net.

2. The role of financial stability and a need for its protecting

Despite the key role of financial stability for financial markets one widely accepted definition of this notion has not been worked out. In the simplest terms financial stability is understood as the lack of financial crisis occurrence. The definition created by G.G. Kaufman [Kaufmann 1998] presents financial stability (stability of financial system) as a stability of key institutions and markets making up a financial system. According to this definition financial stability takes place if:

– key financial institutions are stable – which means high level of confidence in their possibility to fulfill their contract obligations without disruptions and external help,
– key markets are stable – which means that participants can carry out transactions at stable prices which reflect its fundamental value.

Financial stability can be also understood as a situation, in which financial system functions correctly, which means that it ensures:

– efficient flow of financial resources among market participants – from these who have money surplus at their disposal to these who borrow money for investments and consumption,
– correct assets valuation, which manifests itself in the lack of sudden assets prices changes or their expected changes,
– safe and efficient course of payments.

Regardless of financial stability definitions variety, it is beyond any doubt that financial stability is a very desirable phenomenon, contributing to higher efficiency of financial market functioning and lower vulnerability to external shocks and crises. That is why every participant of economy is constantly interested in financial stability and it should be treated as a public good [*Podstawowe przesłanki*... 2004]. High price, which the economy and the whole society is paying for the crisis in financial system, induces to take actions directed to its protection from destabilization [Szczepańska 2005].

3. The idea of financial safety net

Protection and supporting of financial stability is a very complex task, which goes beyond the possibilities of single institution and requires cooperation of different institutions involved. That is why particular competences connected which performing this function are divided among special institutions, which all together create a financial safety net.

As it is presented in Figure 1 in most countries financial safety net is made up of:

– central bank – which performs the function of a lender of last resort,
– supervisory authority,
– deposit insurance system,

– government, which has public money at its disposal and if the needs arise provides support for financial system.

Sometimes clearly defined resolution mechanisms for banks in distress (including exit market mechanism) are also included in the scope of financial safety net.

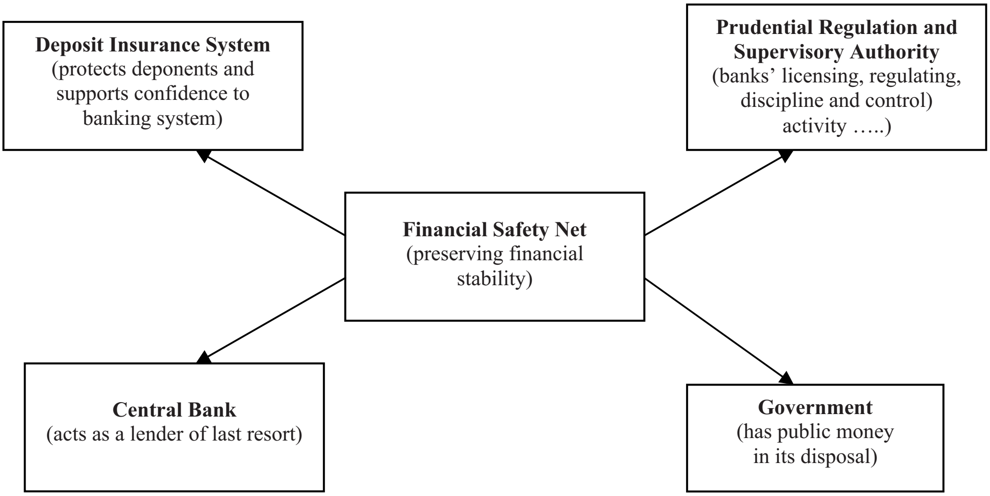

Fig. 1. Elements of financial safety net

Source: own study.

So the term financial safety net is understood as different institutions, rules and procedures, which aim at ensuring (at least increasing) the safety of financial system. According to this aim the components that constitute a financial safety net try to promote an efficient and stable banking system when there is no financial crisis and to manage the problems connected with a threat of its occurance.

In more details financial safety net goal can be understood in two ways:

– the first aim is a **preventive activity** which consists in decreasing the risk of potential distortions in financial system;
– the second aim is **crisis management**, concerning limiting the scale and consequences of financial crisis in case of its occurrence.

Having considered the tasks of financial safety net, it seems to constitute an indispensable element of every financial system. The most important reasons for creating financial safety nets are as follows [Ostalecka 2009]:

1. the necessity of financial stability protection,

2. particular tendency of banks' destabilization in case of the lack of regulation mechanisms,

3. threat of systemic risk leading to financial turbulences spreading among financial system and beyond it,

4. importance of confidence in bank's activity and the necessity of its ensuring,
5. the necessity of limiting the market failure (e.g. asymmetric information),
6. significance of banking system and its important role in economy (e.g. the necessity of ensuring effective settlement system, providing capital to company's development and to households).

There are many arguments in favour of creating financial safety net coming down largely to increasing the stability of financial system and resulting from that different disruptions of risk limitation, for example financial crisis. However, one has to remember that creating and maintaining effective financial safety net requires incurring many direct and indirect costs, which are as follows:

– direct financial cost connected with its functioning,
– indirect, not measurable, costs of creating the phenomenon of moral hazard and weakening of market discipline,
– costs connected with limiting the effectiveness of financial market functioning in case of its overregulation.

Considering the pros and cons for financial safety net establishment, we have to remember that, in spite of the fact that there are some costs connected with its existence, it is the price we pay for increasing financial stability and lowering the risk for financial crisis occurrence. Taking into account how severe and far-reaching financial crisis consequences are, it seems that this price is acceptable.

4. Deposit insurance system as an element of financial safety net

One of the elements of financial safety net, not always included in its scope, is government, which has public money at its disposal and if the need arises provides support for financial system.

Second element of financial safety net is central bank performing the function of a lender of last resort (LoLR), which consists in granting financial support to banks afflicted by a crisis. The need of LoLR existence is explained by the fact that banks as public trust institutions are exposed in case of confidence loss to massive deposit withdrawals (called bank run or bank panic), which can result in spreading this problem on other banks (contagion effect). In order to limit this risk, it was necessary to create the system of liquidity loans granting for banks which lose their liquidity. This kind of financial support is crucial for banks because of the fact that central bank by increasing banking sector liquidity prevents banks from the excessive sale of its assets. One of the most important rules of granting liquidity to banks experiencing financial problems is that the liquidity loans can be granted only to illiquid banks, but not insolvent (the latter should be closed). Sometimes exceptions to this rule happen, which consist in granting financial help to a bank which is insolvent but big or important to the banking system (according to the rule "too big too fail" or "too important too fail").

In order to limit the phenomenon of moral hazard, there were formulated two conditions of granting liquidity loans [*Integracja rynków*… 2007]:

– loans granted by central bank should be secured by good quality securities,
– central bank loans should have quite high interest rate because they should be treated by banks as the last resort.

The second rule of granting last resort loans is constructive ambiguity according to which granting financial support from central banks should not be certain and should impose more cautious activity on banks that cannot count on central bank in case of financial trouble emergence.

Banking regulation and supervision is the third element of financial safety net. It performs a crucial role in preventing financial crisis. It is because of performing functions of licensing, regulating, discipline and control of banks activity [*Stabilność systemu*… 2008]. More detailed, prudential regulation and supervision include, *inter alia*, the chartering (e.g. licensing) function which imposes capital and disclosure requirements, restrictions on the types of assets that banks may hold and on the activities in which they may engage. Regulation is designed to reduce unwarranted or unmitigated risk taking and supervision to monitor banks to see that they are complying with the regulations in order to ensure the safety and soundness of the banking system [*General Guidance*… 2006].

Deposit insurance system constitutes the last element of financial safety net. Despite the differences in deposit insurance system construction and its details assumptions, the main idea of its existence is deponents' protection and at the same time maintaining confidence to the banking sector. This function of deposit protection is especially important in case of banking crisis emergence, because it helps to decrease or even prevent bank panic. The degree of bank panic prevention ability depends on guarantee limits as well as credibility of deposit insurance system.

The construction of effective deposit insurance system, which on one hand will enhance public confidence in banking sector and on the other will not disturb market discipline, is a very difficult and challenging task. It is so because the authorities have to consider many detailed issues connected with its shape.

Two crucial issues are the scope of coverage and powers of deposit insurance institution. When it comes to scope of coverage, the authorities have to decide about the size of guarantee limits. As presented in Figure 2, the scope of deposit insurance coverage and its limits depend on country's willingness and ability to balance the objective of achieving financial stability with the introduction of incentives for depositors to exercise market discipline.

Coverage that is set too narrowly and limits that are set too low will fail to prevent bank runs, while coverage that is set too broadly and limits that are set too high will eliminate any incentive depositors may have to monitor bank risk-taking [*Working Group*… 2001]. So the authorities have to decide if it is a blanket guarantee system or a system with the limitation of guarantee, set at certain level.

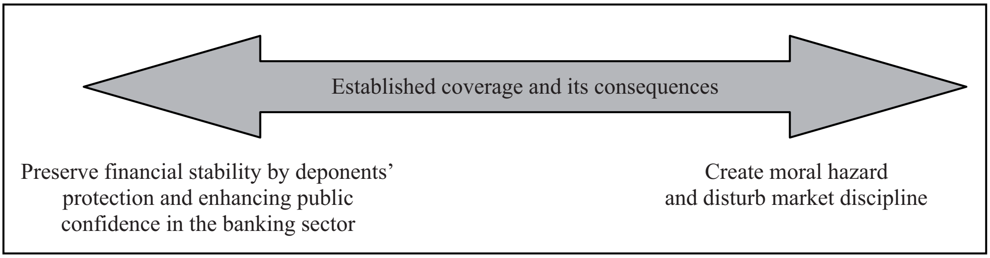

Fig. 2. Deposit Insurance Systems' construction dilemma

Source: own study.

The second important issue to be dealt with, are the powers of a deposit insurance institution. There are two basic kinds of deposit insurance system taking into account its power (Figure 3). The authorities can create a deposit insurance system functioning as a *paybox*, which only purpose is to pay depositors the value of their deposits held in bank, which went into bankruptcy. However, in order to ensure more comprehensive influence on banking system stability, they can establish deposit insurance system acting as *risk-minimizer*. This kind of a deposit insurance system has additional power, besides deposit guarantee, namely it can e.g. decide about including and excluding banks from a deposit insurance system or it can grant a financial support to banks which have financial problems following the rule of minimizing deposit insurance institution losses.

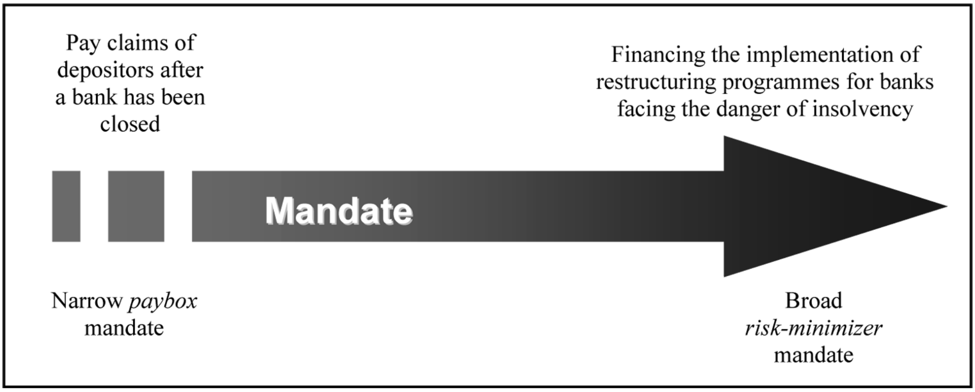

Fig. 3. The powers of deposit insurance institution

Source: own study.

In designing deposit insurance systems, policymakers should address the deposit insurer's relationships and co-ordination to other safety net participants.

A need for close co-ordination exists in any institutional setting and information sharing. However, when more than one organization is responsible for the smooth functioning of the financial safety net, it could be said that *Good Fences Make Good Neighbors* as the functions assigned to different organizations raise issues related to the allocation of powers and responsibilities, information sharing, and the co-ordination of actions. In this regard, there is a need to set out guidance to promote effective interrelationships [*General Guidance…* 2006].

5. The organization of deposit insurance system in Poland

In Poland the institution responsible for deposit guarantee is Bank Guarantee Fund with its office in Warsaw. It was established by the Act on the Bank Guarantee Fund of 14 December 1994, which took effect on 17 February 1995. Having established this institution the legislator defined the rules of bank deposits guarantee and incorporated it in the system of institutions responsible for the safety of banking sector.

The legal regulations of the Act on the Bank Guarantee Fund are in full conformance with the directive of the European Parliament and Council (94/19/EC of 30 May 1994) on the deposit guarantee schemes.

The mission of Bank Guarantee Fund is to work in favour of the safety and stability of banks and to increase confidence in the banking system, while its basic tasks are formulated as:

- to reimburse, up to the amount specified by the Act on the BGF, the funds accumulated on bank accounts, in the event of the bankruptcy of a bank which is a participant in the deposit guarantee scheme,
- to provide financial assistance to banks which have found themselves faced with a loss of solvency and are engaging in independent reforms,
- to support processes involving the merger of endangered banks with strong bank entities,
- to collect and analyse information about entities covered by the guarantee system, including the preparation of analyses and forecasts concerning the banking sector.

In reference to the powers of deposit insurance institution, Polish Bank Guarantee Fund acts as *risk-minimizer*, which means that apart from guaranteeing the deposits of banks that went bankrupt it performs the function of assistance activity.

When it comes to guarantee limits in Poland, there recently were some changes introduced in order to mitigate the financial crisis. The financial crisis, which started on the subprime mortgage credit market in 2007/2008 in the United States and after short time spread on other countries, becoming the global financial crisis, resulted in the unprecedented loss of confidence in financial markets. The scope of this crisis and pace of its spreading forced the authorities worldwide to cooperate and introduce special remedies oriented towards mitigating the crisis. Among the set of activities taken up to overcome it, there were introduced changes in European deposit guarantee systems. The European Union member countries signed 2009/14/WE directive [*Dyrektywa 2009/14/WE*... 2009], establishing new minimum guarantee limit. In former 94/19/WE directive the guarantee limit in the European Union member countries could have amounted to minimum 20.000 euros. According to the new directive this limit was increased to the level of 50.000 euros. What is more the co-insurance was abolished, which means that deponents were repaid in 100% up to the guarantee limit.

So now in the event of the bankruptcy of a bank in Poland, the Bank Guarantee Fund will pay the guaranteed funds up to the equivalent of EUR 50,000 without any co-insurance (which means the repayment of 100% of deposit amount hold in a bank). The Polish legal regulations on the deposit guarantee comply with the directive of the European Union.

The participation in Polish guarantee scheme is compulsory for all domestic banks as well as foreign bank branches with their offices outside the EU (if they do not belong to any deposit guarantee scheme or guarantee limits are lower then in Poland).

Bank Guarantee Fund covers deposits in zlotys and foreign currencies held by:

- natural persons,
- legal persons, including local government units,
- organisational units not having separate legal personality, in which they have legal capacity,
- school savings associations and employee savings-and-loan associations.

There are some categories of deposits excluded from the deposit guarantee system, such as:

- the State Treasury,
- financial institutions such as: banks, brokerage houses, pension funds, investment funds, entities providing insurance services,
- entities that are not permitted to draw up an abridged balance sheet or profit and loss account,
- managers of the bank and its main shareholders (holding at least 5% of the shares in the bank).

The guaranteed amount is calculated from the total funds located in all the accounts (e.g. term deposits, current accounts, saving accounts) of a single person in a given bank, while in case of a joint account, each joint account holder is entitled to a separate guaranteed amount up to the guarantee level.

6. Cooperation of Bank Guarantee Fund with other components of financial safety net

Maintaining financial stability and therefore lowering the risk of banking crises emergence and in case of its occurrence – lowering its scope and consequences constitute a very complex goal. Achieving this aim requires specific tasks division and establishing the rules of cooperation among financial safety net components. The necessity for close co-ordination and co-operation among safety net participants stems from the possibility of conflicting mandates which could undermine the effectiveness of the financial safety net.

As presented in Table 1, the deposit insurance system plays a significant role in preserving financial stability on all three stages: the identification and monitoring of threats, crises prevention and crises management.

Table 1. Tasks performed by individual elements of financial safety net

Activity \ Institution	Government (Ministry of Finance)	Banking Supervision	Central Bank	Deposit Guarantee System
Identification and monitoring of threats		×	×	×
Crises prevention	×	×		×
Crises management	×	×	×	×

Source: [Pyła 2007].

Activities undertaken in the field of the first stage include: an early warning system and the analysis of endangered banks, while activities connected with crises prevention are as follows: financial support for restructuring programmes and the control of its realization, financial support for the acquisition of banks which solvency is endangered. With reference to the crises management the deposit insurance system pays the guaranteed funds, cooperates with an official receiver in case of bank bankruptcy and finance the projects of bank acquisitions [Pyła 2007].

In order to ensure better efficiency of achieving the aim of financial stability the deposit insurance system has to cooperate with other components of financial safety net, especially central bank and banking supervisory. According to agreement signed on 31 January 2005 by Bank Guarantee Fund and National Bank of Poland, NBP was obliged to pass over the reporting data of banks in order to conduct independent assessment of banking sector situation and the identification of threats as a part of early warning system. Bank Guarantee Fund also signed the cooperation agreement with Commission of Financial Supervision [Pyła 2007]. The exchange of information connected with the results of banking sector assessment and trends analyses conducted by these two institutions constitute an important factor of objectivism of this sector situation.

7. Conclusion

It is beyond any doubt that the deposit insurance system contributes to maintaining the stability of financial system in many ways. In good times it attracts savings into banking system, builds confidence in its overall safety, facilitates bank intermediation process, builds awareness and promotes financial literacy through deposit insurer's awareness programmes. Its existence is also crucial in the time of bank failures because the deposit insurance system provides incentive to depositors to retain savings in banking system as well as maintains confidence among bank clients in the safety of their deposits. However, in order to achieve their stabilizing role the deposit insurance systems have to be well–thought-out, especially when it comes to an element which decides about its shape, such as: the scope of coverage and the powers of deposit insurance institution.

In Poland an institution which is responsible for the deposit protection is Bank Guarantee Fund, which was established in 1995. Apart from Commission of Financial Supervision and National Bank of Poland in its role of lender of last resort, Bank Guarantee Fund constitutes Polish financial safety net. The main aim of the deposit insurance system in Poland is to work in favour of the safety and stability of banks and to increase confidence in the banking system. In order to perform its function in the best possible way it was created as *risk-minimizer*. It means that it was equipped with quite wide competences, besides deponent protection also with assistance activity. Such construction gives wider opportunities in stabilizing banking system, because it allows to support banks by protecting them from bankruptcy instead of repaying deponents according to the rule of minimizing costs of Bank Guarantee Fund.

Literature

Dyrektywa 2009/14/WE Parlamentu Europejskiego i Rady z dnia 11 marca 2009 r. zmieniająca dyrektywę 94/19/WE w sprawie systemów gwarancji depozytów w odniesieniu do poziomu gwarancji oraz terminu wypłaty, Dziennik Urzędowy Unii Europejskiej L 68/3.

Financial Stability Forum, *Working group on deposit insurance working group. progress report*, "Background Paper" 2001.

International Association of Deposit Insurers, *General Guidance to Promote Effective Interrelationships among Financial Safety Net Participants*, Basel 2006.

Kaufman G.G., *Central banks, asset bubbles, and financial stability*, "Working Paper" November 1998, No. 98/12, Federal Reserve Bank of Chicago.

Nowakowski J., Famulska T., *Stabilność i bezpieczeństwo systemu bankowego*, Difin, Warszawa 2008.

Ostalecka A., *Zaburzenia na rynkach finansowych a potrzeba istnienia sieci bezpieczeństwa finansowego*, [In:] Nauki o finansach 1, ed. G. Borys, Prace Naukowe UE Nr 61, Wydawnictwo UE we Wrocławiu, Wrocław 2009.

Pawłowicz L., Wierzba R., *Integracja rynków finansowych w Unii Europejskiej od A do Z*, "Bank i Kredyt" 2007, Nr 8-9.

Pyła M., *Współpraca systemu gwarantowania depozytów z innymi ogniwami sieci bezpieczeństwa finansowego*, "Bezpieczny Bank" 2007, Nr 2-3(35).

Szczepańska O., *Podstawowe przesłanki, założenia i struktura sieci bezpieczeństwa finansowego w świetle teorii i doświadczeń międzynarodowych*, "Bezpieczny Bank" 2005, Nr 1(26).

Szczepańska O., Sotomska-Krzysztofik P., Pawliszyn M., Pawlikowski A., *Instytucjonalne uwarunkowania stabilności finansowej na przykładzie wybranych krajów*, "Materiały i Studia NBP" Nr 173, Warszawa 2004.

SYSTEM GWARANTOWANIA DEPOZYTÓW W POLSCE I JEGO ROLA W SIECI BEZPIECZEŃSTWA FINANSOWEGO

Streszczenie: Artykuł ma na celu przedstawienie konstrukcji systemu gwarantowania depozytów w Polsce. Punktem wyjścia jest zaprezentowanie teoretycznych aspektów związanych z funkcjonowaniem systemu gwarantowania depozytów i jego miejsca w sieci bezpieczeństwa finansowego. Na tym tle omówione są konkretne rozwiązania i założenia Bankowego Funduszu Gwarancyjnego, takie jak podstawowe cele jego działalności, kompetencje, profil uczestników, zakres depozytów objętych i wyłączonych z systemu gwarancji, limity gwarancyjne i ,współpraca z innymi elementami sieci bezpieczeństwa finansowego.