THE ROLE OF DEPOSIT INSURANCE SCHEMES IN DEVELOPING RELATIONSHIPS OF TRUST

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ABSTRACT

The functioning of the banking system is based on trust. Winning trust takes decades of hard work but losing it may be a matter of minutes. Averting potential threats is one of the main tasks of the banking sector, and therefore, there is a genuine need and role for the institution of deposit insurance or deposit guarantee. This paper aims to present this complex system of relationships, including its evolution and previous experience with such schemes.

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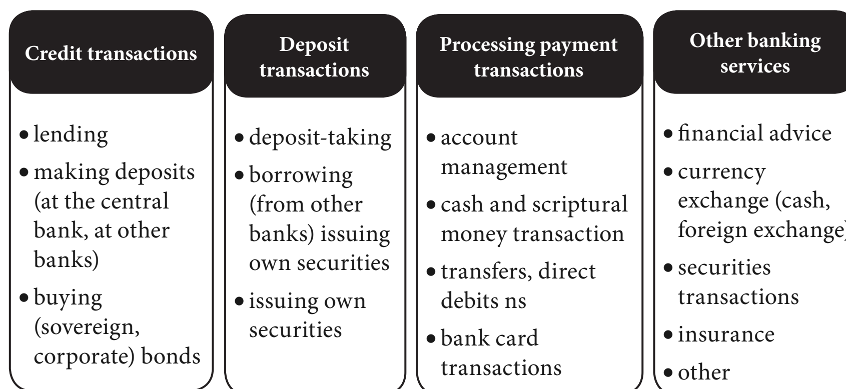
1. THE ROLE OF TRUST IN THE SECTOR OF FINANCIAL INSTITUTIONS

The types of relationships between banks and their clients are generally divided into the following four areas based on banks' categorisation of services: credit transactions, deposit transactions, payment services and other services. This classification is illustrated in the figure below:

Figure 1
The classification of commercial banking services



Source: Merényi–Vasné–Fritz (2016): *A Compass to Finance*, p. 163.

These banking services are typically and necessarily used and provided on the basis of mutual trust. One of the most simple and frequent type of contact is the transfer of money which is a two-way relationship. Either a bank receives a deposit from a client or a bank extends credit to a client. The relationship is based on trust in both directions, as both the client making a deposit and the bank extending credit expect to get back their money with interest on the date of maturity or the due date of monthly repayments, respectively. However, if clients, for an unforeseen reason, need the deposited money before the date of maturity, they still expect to have full and immediate access to it (or part of it). By early withdrawal, banks customarily provide depositors with an opportunity to receive interest on their long-term savings with a simultaneous possibility of access to their money, if needed. To this end, depositors are typically looking for a bank with a good reputation in the market, i.e. an institution which is secure, reliable and liquid in the long run according to public opinion. Furthermore, the institution should ensure continuous contact personally and/or electronically, in addition to offering appropriate investment options in terms of return and risk.

The repayment guarantee for depositors is made up of several components. The main source of coverage is the bank's capital, the amount of which is regulated in all countries by the applicable minimum requirements (typically several millions of EUR). Management competence is provided by the managers and employees of the bank. Bank managers are generally appointed based on professional experience and tertiary qualifications, and just as importantly integrity. Compliance with these requirements is ensured by banking supervisors. Keeping market risks at a low level – which is required for members of the banking sector to be able to retain their stability and liquidity position in all circumstances – is ensured by international, EU and local banking regulations. The Basel accords provide a prudential regulatory framework for the banking sector.[1]

On the other side, the management of banks makes the best use of the deposits received and the capital of the bank if it invests them in forms and to a clientele that promise a positive return. Credit institutions are better positioned to determine the creditworthiness of borrowers effectively and accurately as well as to monitor their payment behaviour than private individuals lending their own money at their own discretion. By doing so, banks considerably reduce losses due to asymmetric information and incentive problems between savers and borrowers. This is how they add value and foster economic growth (*Lautenschläger*, 2015).

1 The Bank for International Settlements (BIS) – the bank for international payments and settlements – is based in Basel. The international regulatory standard setter Basel Committee on Banking Supervision operates at the same location and in a close historical relationship with the prominent financial institution of BIS.

The business ethics of the banking sector is substantially different from that of any other sector, as the assessment of each of its members is heavily influenced by the standing of the sector as a whole, including its weakest link. In the eye of society, credit institutions are not considered individually but as a homogeneous sector, and are judged / recognised accordingly. When clients run on a bank (as was the case with Postabank in 1997) depositors at other banks begin to stir, too. In the first half of the 2010s, a series of credit institutions of a cooperative type/background failed in Hungary, which gave rise to a growing tendency of keeping the sums paid as compensation under the mattress. This shows that even the smallest members of the sector may measurably undermine trust. It is easy to see why the sector joined hands to bail out Postabank in the aftermath of the above-mentioned panic. Normally, it would not work like that in other sectors. For example, when two confectioneries operate in the same street, they typically want each other to close up shop and work against each other.

The above-mentioned considerations also demonstrate that the functioning of the banking system is first and foremost based on mutual trust. Among the bases on which trust rests positive performance in the past, references, stability, efficiency, an appropriate ownership structure, owner's capital, predictable operation, the quality of service and customer relations in general as well as market recognition are frequently mentioned. Building up trust typically takes years or even decades, but it may be degraded in only a few days (*Narayan*, 1999). In the banking sector, loss of trust is generally equivalent with loss of brand value and therefore absolute failure and the winding up of the institution, which may have reverberations in the entire sector.

Within this complex set of relationships, it is typically private individuals with smaller savings – and usually limited financial knowledge – who are the most exposed and therefore the most worthy of protection.

2. LOSS OF TRUST

The most severe and long-term effect of the economic crisis of 1929–1933, caused by overproduction, was the loss of trust. For that reason, according to certain economic historians, its effects lingered up until the beginning of World War II (www.wikipedia.org).

The economic crisis of 2008–2011 is regarded as a financial crisis which undoubtedly caused the most severe deficit of trust of all times in the banking sector. A key moment of the crisis was the 2008 failure of Lehman Brothers, one of the biggest and most prestigious banks of the world. Financial turbulence stemming from excessive risk-taking was instrumental to losing public confidence, a prob-

lem which did not pass with the most intense period of the crisis. Although it has been a couple of years since anti-bank protesters marched along the streets of Europe, trust in the banking sector remains low. 'But mistrust is not only confined to banks themselves. Investors and clients also have less confidence in the correct functioning of the banking sector and in the ability of supervisors and regulators to prevent excessive risk-taking' (Lautenschläger, 2015). Finding a way out of this situation requires sustained joint work by all involved and responsible parties.

The dangers of low public confidence from the point of view depositors may be summarised as follows:

- Combined with low interest rates, it keeps depositors away, and as a consequence, limits the ability of banks to raise funds. This, in turn, curbs lending capacity and ultimately economic growth.
- Technical advice by bankers has limited impact as lack of trust leads clients to prefer to act based on their own assumptions / opinions. In case of an emergency, statements by government and political leaders tend to increase panic instead of calming the financial markets (see the case of Greece in 2015).
- It sustains the threat of a landslide effect in the financial markets, which may culminate in systemic crisis, since unfavourable news – even fake news – may immediately trigger massive and excessive withdrawal of funds by panicking depositors and investors.

In the end, trust may be restored only by the state assuming a blanket guarantee for the full amount of deposits in the banking system or acquiring majority ownership in one or more banks at taxpayers' expense. Such dysfunctional operation of the banking system gives rise to distortions such as disproportional social costs – since in the latter case, every taxpayer has to contribute temporarily, which does not apply to deposit insurance – or increasing moral hazard on the part of depositors and credit institutions.

A decade after the outbreak of the crisis, trust and reputation remain major issues for the banking sector (www.ebf-fbe.eu, 2016).

3. REGAINING TRUST AND DEPOSIT INSURANCE SCHEMES

'However, even though banks assess and monitor borrowers' creditworthiness, savers may still be concerned about whether banks – and their managements – have the necessary skills and will make the required effort to protect their savings. Asymmetric information and incentive problems are still present, but arise at new, different levels: no longer between savers and borrowers, but between savers, bankers and supervisors. [...]

Asymmetric information and incentive problems can be addressed through contracts, institutions and appropriate regulatory and supervisory frameworks. But this is a rather abstract and idealised view. In reality, more is needed: trust is needed.' (Lautenschläger, 2015)

Financial institutions are a privileged sector, as they are more capable than any other sector to foster economic growth substantially and effectively. In fact, this is their basic task. Therefore, building, maintaining and continuously strengthening trust in the banking sector is not only the interest and the responsibility of bank leaders and employees but also of government and political leaders, and considering indirect effects, also of clients.

Up to this date, this common interest has been the most effectively served by the emergence of deposit insurance schemes under which credit institutions contribute to an insurance fund in proportion to their deposits, which is then used to compensate depositors in the event of future bank failures. Cooperation between banking supervisors and governments was required for these schemes to function effectively, in compliance with the principles of consumer protection and also reliably, in order to ensure that the new institutions fulfil their purpose within a properly regulated framework and securely in the long term.

It shows the success of deposit insurance schemes both globally and at European level that – except for Greece and Cyprus – flight to liquidity has not become a general phenomenon despite more frequent bank failures. This is due to a large extent to the ability of deposit insurers to provide an adequate response at the right place and at the right time, reassuring depositors that they can fulfil their task efficiently, if needed. The level of awareness and social acceptance of deposit insurance were sufficient to eliminate panic. All this suggests considerable capital in confidence, considering that the purpose of deposit insurance is not to resolve systemic crises but to address specific situations what are called idiosyncratic crises in the international literature, by paying compensation or by other means.

In Hungary, the relevant legislation establishing the National Deposit Insurance Fund (NDIF) was Act XXIV of 1993 (*Jánossy* et al., 2003), which was based from the outset on international best practice. As a next step, the Fund will improve its procedures and services in the light of domestic experience with compensation events.

The NDIF was a founding member of the two most significant deposit insurance bodies, the IADI (International Association of Deposit Insurers) established in 2002 and the EFDI (European Forum of Deposit Insurers) founded in 2003, and its representatives were elected members of the top management of these organisations.

After Hungary's accession to the EU in 2004 continuous legal harmonisation began. Now, as the 25th anniversary of the foundation of the NDIF approaches, we have in place a system in which – similarly to other EU Member States – compensation is paid up to EUR 100,000, without any own funds required and within 5 to 20 working days after bank failure.

The reasons behind depositors' choice of bank vary from country to country. In Hungary, the proximity of bank branches has traditionally been a decisive factor. Conditions, personal contacts, recognition of the institution etc. were frequent reasons of secondary importance. These are valid considerations for small depositors, since national deposit insurance schemes guarantee the repayment of their money – as mentioned above – up to a limit of EUR 100,000. However, those with larger savings should look at and keep track of the current reliability of the bank. Large depositors and more experienced clients are less likely to entrust all of their savings to an institution which is considered risky or unreliable.

This also works the other way round: banks extend credit to clients with either a long track record of reliable repayment and a favourable assessment by the bank's risk managers based on their business activity and profit/loss, or for whom the likelihood of repayment is highly predictable based on their financial data and statistical methods (in the case of smaller/mass credit, using automated IT-based data analyses and/or personality profiles etc.). (*Németh* et al., 2016) 'Today, banks are more complex to manage harder to monitor and their activities are more difficult to understand than was previously the case, and the asymmetric information and incentive problems [...] are more prominent than ever.

In short, trust is and has always been essential for banks to carry out their activities, foster economic growth and add value to society. Banking is and always has been trusting' (Lautenschläger, 2015).

4. SUMMARY: TRUST IS INEVITABLE

The banking sector and the economy are in a relationship of interdependence, and share in both success and failure. For a long time, they continued on a path of monotonous growth, a state which had come to be taken for granted. The economic crisis of 2008 put an end to this trend and – among its other repercussions – severely undermined trust.

But lack of trust heavily impedes the functioning of the banking sector and prevents banks from fostering economic growth by its adverse impact on their core activity, the acceptance of deposits, and thereby also lending which is based

upon it. Banks have a common interest in regaining and maintaining a high level of trust in and also within the banking sector.

Trust is a prerequisite for the functioning of the banking sector, and therefore, it is a shared interest and responsibility for each and every prudent supervisor, regulator, political decision-maker / advocate (whether in the government or in the opposition), bank manager and employee. The importance of trust has not diminished by the increasing globalisation of the banking sector, the widespread use of information technology and ongoing digitalisation. Trust is absolutely essential for the taking of deposits which is the most basic service provided by banks. The global presence of deposit insurance schemes, their regulation by law and guaranteed functioning, public awareness of these institutions and the size of the accumulated compensation funds are all important components contributing to trust.

The actors mentioned above have a shared responsibility for re-establishing trust. The need for setting the economy on a path of growth makes it imperative for bank managers, governments and other economic and social operators to contribute actively and positively to this work.

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