The Sky is not the Limit Anymore

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The New Regulation On Deposits and Participation Funds as a Solution to Systemic Risk in the Banking Sector

Commercial banks are institutions that typically have a large percentage of their assets in the form of illiquid bank loans and a large percentage of their liabilities in deposits that are capable of being claimed. As a result of this, a sufficiently large deposit withdrawal may put a bank in a very difficult position. The failure of one major bank or other important financial institution is likely to cause sufficient uncertainty and loss of confidence by depositors and other creditors in other similar institutions that the adverse effects will spread in a domino fashion throughout the industry.

When a crisis spreads beyond the banking sector, it starts a full-fledged financial crisis. Turkey is the most recent example of this situation where weaknesses in the banking system triggered a crisis of confidence in other domestic financial institutions and led to a large-scale flight of foreign capital and a severe currency crisis. Fortunately, new developments in the Turkish banking system such as new Banking Law No. 5411 and the Regulation on Insurance of Saving Deposits have made the sector safer.

In every country, policymakers set up a financial safety net to make systemic breakdowns less likely and to limit the disruption and fiscal costs generated when they occur. A country's safety net includes a collection of disruption-mitigating financial policies. These policies include implicit and explicit deposit insurance, lender of last resort facilities at the central bank, specified procedures for investigating and resolving bank insolvencies, strategies for regulating and supervising banks, and provisions for accessing emergency assistance from multinational institutions such as the IMF.[1]

Under Turkish law, Article 72 of the Banking Act identifies the measures to guard against systemic risk. Article 72 states that "in cases where a negative development that could spread over to the entire financial system occurs and such development is detected jointly by the Savings Deposit Insurance Fund (SDIF), the Undersecretariat of the Trasury and the Central Bank under the coordination of the Agency,

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[1] Demirguc-Kunt, A., Sobaci, T., "Deposit Insurance Around the World: A Data Base, World Bank.", available from: <http://www.worldbank.org/research/interest/confs/upcoming/deposit_insurance/data.pdf, n.2 p.3, retrieved 18/07/2002.

the Council of Ministers shall be authorized to determine the extraordinary measures to be taken and all relevant institutions and agencies are authorized and responsible for prompt implementation of such extraordinary measures.' Accordingly, the Turkish banking system has a two-step solution. First, the position of the market must be examined by the above institutions and second, the Council of Ministers must determine the extraordinary measures to be taken. The first responsibility is on the Agency because of its coordination duty and second is the responsibility of the Council of Ministers.

As Demirguc-Kunt and Kane mentioned, there are many different strategies to deal with systemic risk. One is to try to reduce the likelihood of potential precipitating shocks. Another is to decrease the likelihood that some initial disturbance is transferred widely and becomes destructive to significant numbers of financial institutions, markets, or the system as a whole.

A deposit guarantee scheme is one of the most important ways to solve systemic risk. The subject of depositor protection has caused substantial debate ever since it was first introduced on a limited basis in the United States in the nineteenth century.[2] By the end of 1999, 68 countries had established explicit deposit insurance scheme.[3] Last, the Turkish Saving Deposits Insurance Fund issued a regulation on deposits and participation funds subject to insurance and premiums collected by saving deposits insurance fund.[4] Although there are many ways to solve systemic risk, only deposit insurance schemes will be examined in this article.

DEPOSIT INSURANCE SCHEMES:

Definitions and types of scheme:

A deposit guarantee scheme is one which supplies a payout to a bank's customers when certain circumstances arise, such as the bank becomes solvent.[5] The subject of depositor protection has caused substantial debate ever since it was first introduced on a limited basis in the United States in the nineteenth century.[6] The United States was the first country to introduce a national deposit insurance system; its goal was to restore confidence in the liquidity of bank deposits rather than to protect small depositors.[7]

Governments in advanced economies and money-developing economies grant formal deposit insurance in the hope of reducing the risk of systemic failure of banks and hence stabilizing the payment and financial system. Accordingly, there are two main purposes to such schemes. The first purpose is to provide stability in the banking system. To this extent, deposit guarantee schemes are part of a range of measures which supervise and regulate banking activity.[8] The second aim is to have adequate consumer protection.[9] On occasions in the past, "bank runs" have destroyed the payments system, with a resultant depression. Credible deposit insurance is presumed to forestall such runs.[10]

[2] Cartwright, P., International Banking Regulation, Module Guide 2001-2002, p. 43.
[3] Demirguc-Kunt, A., Kane, E. J., *op cit.,* p 1.
[4] Published in Official Gazette Nr. 22639, dated November 7, 2006.
[5] Cartwright, P., "Deposit Guarantees and the Individual Bank Customer" *Consumer Protection in Financial Services*, in P. Cartwright (ed), (1999), p.125.
[6] Cartwright, o*p cit*., n. 3, p. 43.
[7] Golembe, C. H., 1960 "The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and Its Purposes" *Political Science Quarterly*, 1975 (2, June), 181-200.
[8] Penn, G., Banking Supervision, (London: Butterworths, 1989). (deposit guarantees and the individual bank customer, Cartwright).
[9] Cartwright, P.,op cit., n. 44, p.125.
[10] Cull, R., Senbet, L. W., Sorge, M., "Deposit Insurance and Financial Development," World Bank Pol. Res. Paper, Reg. No: WPS2682, p. 5, available from: <http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2001/10/19//000094946_01100404003817/Rendered/PDF/multi0page.pdf>, retrieved 15/07/2002.

On the other hand, deposit insurance can be socially counterproductive (non-advantageous) when the system is not appropriately structured. Under many deposit insurance schemes, if a depository institution, such as a savings and loan firm, goes bankrupt, the government absorbs all or nearly all of the depositors` losses. This weakens market discipline and creates a moral hazard problem, since there is now an incentive for depository institutions to engage in excessively high risk activities, relative to socially-optimal outcomes.[11]

Accordingly, potential gains from a deposit insurance scheme come at a cost. Even in the 1930s, there were concerns that deposit insurance would encourage excessive risk-taking behavior.[12] Indeed, this argument helped defeat the 150 legislative attempts to institute formal deposit guarantees prior to establishment of one in 1933 in the United States. The moral-hazard problem, which is aggravated by deposit insurance, continues to be a concern today. Therefore, even those subscribing to the helping-hand view may argue that the adverse-incentive costs of deposit insurance outweigh the benefits. Yet, many authors believe that official regulation and supervision can control the moral-hazard problem, including an appropriately-designed insurance system that includes coverage limits, scope of coverage or the extent of uninsured liabilities, coinsurance, funding, premia structure, fund management, and membership requirements.[13]

The compromise (trade-off) between the aims of stability and minimizing moral hazard can also be understood by examining the interests of the four different groups of agents involved in deposit insurance schemes: depositors, banks, scheme managers and scheme owners. While depositors value the apparently higher safety of their deposits and might hence lessen their effort of monitoring banks, for bank owners and managers the existence and features of a deposit insurance scheme change their incentive structure by minimizing the down-side risk of the bank business. However, there might also be conflicts between strong and weak banks. If strong banks have to provide financial support to weak banks via flat premium rates, they will leave a voluntary deposit insurance scheme. The resulting adverse selection increases the problems of moral hazard even further. Scheme owners want to minimize the costs of the scheme, while the scheme managers might have personal interests, such as their professional career, or might represent the interests of other groups, such as politicians or banks. These agency problems might result in an inefficient safety net.[14]

Deposit guarantee schemes take a variety of forms. Some of them are provided by the government alone, some by banks, and others by a combination of banks and government.[15]

Types of Scheme

There are two kinds of depositor protection schemes. One is an explicit scheme and the other one is an implicit scheme. A scheme which has been formally established and which clearly sets out the level of protection offered and the situations when compensation will

[11] *Ibid,* p. 5.

[12] Barth, J., R., Caprio, Jr., G., Levine, R., "Bank regulation and supervision: what works best?" 1991, 30/11/2001, Reg. No: WPS2725, p. 10, available from: <http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2002/01/17//000094946_01120104231862/Rendered/PDF/multi0page.pdf>, retrieved 17/07/2002.

[13] *Ibid,* p. 11.

[14] Beck, T., "Deposit Insurance as Private Club- Is Germany a Model?" 28/02/2001, Reg. No: WPS 2559, Policy Research Paper Work p. 3, available from: <http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2001/03/30//000094946_01032007445638/Rendered/PDF/multi0page.pdf>, retrieved 18/07/2002.

[15] Cartwright, *op cit.*, n. 44, p.126.

be payable is an explicit one.[16] There has been a rise in explicit deposit insurance schemes around the world in the last two decades. While in 1980, just 16 countries had explicit deposit insurance schemes; by the end of 1999, 68 countries had established explicit schemes.[17] While most of the institutions have normally supported the establishment of explicit insurance schemes, Demirguc-Kunt and Detragiache show that countries which have an explicit deposit insurance scheme are more likely to have a systemic crisis and are more unprotected to systemic risk factors than countries without such a scheme.[18]

There are some features to make an explicit deposit insurance incentive compatible and therefore decrease moral hazard, adverse selection and agency problems. According to Beck, on the one hand, one can assign a margin of loss to private parties to force them to monitor banks and, therefore increase market discipline.[19] The aim is to identify a group which is best able and most likely to examine market discipline when forced to do so. Especially large depositors are forced to monitor banks when a limit to the coverage makes the insurance incomplete. All depositors are forced to bear a certain share of losses by coinsurance, since they are often reimbursed for less than 100 percent of their deposits. Excluding interbank deposits and foreign currency are another way to decrease the moral hazard. In addition to these, excluding insider accounts reduces moral hazard by making owners and managers participate personally in the down-side risk of the bank business.[20]

An implicit depositor protection scheme is one which does not have certainty as to the protection offered, the situations in which compensation payments will be made, or the amount of protection which will be provided.[21] Therefore, implicit schemes do not provide enforceable legal rights to depositors. According to this, implicit schemes are less desirable from the view of the lawyer.[22] Implicit schemes, by their very nature, have built in flexibility but this flexibility is overridden by the disadvantages presented by the lack of advance funding and the problem of where the money required to either mount a rescue or to pay compensation to depositors will come from.

Another problem of a legal nature, in relation to implicit schemes, is to know exactly what sort of situation will amount to a triggering event for compensation to be paid to depositors. Since there will be no written rules it will not be clear in what circumstances a depositor will be entitled to compensation.[23]

Reint Gropp and Jukka Vesala argue that, in Europe, implicit insurance has meant an even higher potential for moral hazard than explicit schemes.[24] This is because, although it introduces some uncertainty of the terms of a "bailout," the coverage of implicit insurance may extend to a larger set of bank stakeholders in contrast to the case of explicit laws protecting depositors alone. In less developed countries, this might not hold – lacking the institutional development to make limits binding – explicit deposit insurance might offer no benefits over implicit.[25]

[16] Cartwright, *op cit*., n. 3, p. 46.
[17] Demirguc-Kunt, A., Sobaci, T., *op cit.,* n. 4, p. 1.
[18] Demirguc-Kunt, A., Detragiache, E., "Does Deposit Insurance Increase Banking System Stability?", WPS2247, available from: <http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2000/01/06/000094946_99122006330270/Rendered/PDF/multi_page.pdf>, retrieved 17/07/2002.
[19] Beck, T., *op cit*., n. 53, p. 3.
[20] *İbid,* p. 6.
[21] Cartwright, *op cit*., n. 3, p.46.
[22] *Ibid*, p. 46.
[23] *İbid*. p. 47.
[24] Gropp et al., op cit., n. 49, p. 4.
[25] *İbid*. p.4-5.

Recent bank crises shown that in times of crisis, whether deposit insurance is explicit or implicit, depositors tend to be bailed out anyway when systemic problems arise.

DEPOSIT GUARANTEE SCHEME IN TURKEY

The protection of savings deposits in Turkey was first provided in 1933 by the Deposits Protection Act.[26] According to this Act, 40% of the deposit was guaranteed and in case of bankruptcy, the guaranteed part must be paid without waiting for the result of the liquidation.[27] With the amendment of the Banks Act in 1958, the guaranteed part was increased to 50% of deposits.[28]

In order to insure savings deposits and participation funds in credit institutions, the Savings Deposit Insurance Fund was founded with Decree of Law on Banks Nr. 70 dated July 22, 1983, which annulled 1958 Act. The task of administrating and representing the Fund was given to the Central Bank of Republic of Turkey (CBRT) with the regulation prepared by the Ministry. Arrangements of the said Decree of Law regarding the SDIF were legalized with Banks Act Nr. 3182, dated April 25, 1985. With Decree of Law Nr. 538 dated June 16, 1994, the Fund was charged with strengthening and the restructuring the financial structure of the banks, when necessary, besides insuring savings deposits.[29] The Regulation about the Insurance of Saving Deposits aims to set the rules and procedures for the insurance of savings, to include accounts opened in the form of New Turkish Lira (YTL), foreign exchange currency, or other accounts linked to gold or other precious metal indexes in a domestic branch of a credit institution. This credit institution must operate in Turkey, where commercial transactions are excluded with the exception of checking activities. Saving deposit accounts are insured up to an amount of 50,000 YTL per person.

Article 4(2) stipulates the exemptions to insurance of saving deposit accounts. Accordingly, if the accrued interest on the day the bank's license is revoked exceeds the average interest rate of the five largest deposit banks and the interest calculated by applying the interest rate announced to the public and declared to the Central Bank by the defaulted bank, then the parts of the amount that exceeds the limit are not insured. Second, the difference between the profit shares calculated on the day the bank's license is revoked and the profit share calculated by taking the average profit share of the three largest participation fund banks are not paid under the insurance coverage as well.

However, one of the problems that consumers face is in relation to obtaining and using information about products, and a major element of consumer protection policy has been trying to remedy these information deficits.[30] First of all, it is really very difficult for a consumer of financial services to classify the characteristics of a product prior to purchase. Second, financial products tend to be technically complex, such as the calculation of interest rates of credit cards, and so even, if the consumer received accurate and detailed information prior to purchase, it would be very difficult for that consumer to understand the information.

[26] Law No. 2243 dated May 30, 1933.
[27] Banks Act No. 2999, dated June 01, 1936, amending Act No. 2243.
[28] Banks Act Nr. 7129, dated June 23, 1958.
[29] http://www.tmsf.org.tr.
[30] Weatherill, S., "The Role of the Informed Consumer in European Community Law and Policy" (1994) 2 Consumer Law Journal p. 49.

DEPOSIT GUARANTEE SCHEMES AROUND THE WORLD

An optimal worldwide blueprint is not likely to be found. For instance, account coverage varies from unlimited guarantees to tight coverage limits. Japan and Mexico promise 100 percent depositor coverage; Turkey promised unlimited guarantee from 1994 to 2004 as well.[31] On the other hand, some countries such as Chile, Switzerland, and U.K. cover only an amount of deposits that is actually less than their per capita GDP.[32] Besides setting a maximum level of coverage, some countries insist that accountholders "coinsure" a proportion of their deposit balances. Coinsurance provisions are still relatively rare, but are more frequent in recently adopted schemes.[33]

Depositor protection schemes are typically advance-funded. All the explicit schemes have been established by government intervention at present. It can be argued that private insurance schemes should provide deposit protection. The banking crises of the 1980s and 1990s in United States support this idea because of the cost to the United States taxpayers. The problems are considerable and as yet no country offers its protection in this manner.[34]

Insurance schemes are typically managed in a government agency or in a public-private partnership. However, a few countries – such as Switzerland, Germany and Argentina – manage their schemes privately. In 55 out of 68 countries which have explicit deposit insurance schemes, membership is compulsory for chartered banks.[35]

A number of countries adopted or expanded their deposit insurance scheme during a financial crisis. Thailand, Malaysia, and Korea moved to blanket coverage in response to their recent crisis. The 1990s saw a rapid spread in transitional countries – perhaps partly motivated by their long-term interest in joining the EU – and in some African countries.

There has been a Deposit Protection Scheme in the UK since 1982. The Banking Act of 1979 introduced this. Credit Institutions (Protection of Depositors) Regulations 1995,[36] came into effect on 1 July 1995 and implemented Directive 94/19/EC on Deposit Guarantee Schemes, making important changes to the scheme. The Credit Institutions Regulations 1995 increased the level of protection from 75 percent of the first 20,000 pounds to 90 percent of the first 20,000 pounds. This means that the maximum amount which can be awarded to any individual customer will be 18,000 pounds.

There are two main types of institutions that must contribute to the Deposit Protection Scheme: banks which are incorporated in the UK and are authorized under the Banking Act 1987 to accept deposits are the first type institution and second type of institutions are banks which are incorporated outside the European Economic Area but authorized under the Banking Act to take deposits through UK offices. Other banks which satisfy the Deposit Protection Board that their home country has a scheme which provides those making deposits with UK offices with at least the same protection as the UK scheme

[31] With the decision of Council of Ministers, unlimited guarantee offered to saving accounts. Official Gazette dated May 5, 1994.
[32] Garcia, G., "Deposit Insurance: A Survey of Actual and Best Practices", IMF Working Paper No. 99/54, 1999.
[33] Demirguc-Kunt, A., Kane, E. J., *op cit*., n. 2, p. 5.
[34] Cartwright, op cit., n. 3, p. 47.
[35] Demirguc-Kunt, A., Sobaci, T., *op cit*., n. 4, p. 7.
[36] S.I. 1995 No. 1442.

will not be required to participate in the UK Deposit Protection Scheme.[37] Section 58 of the Banking Act 1987 provides that, if an authorized institution becomes insolvent, the Board shall "as soon as practicable" make payments to depositors who have protected deposits with the insolvent institution. The Depositor Protection Board is to be in a condition to make payments within three months of the insolvency.[38] In addition to this, Section 59 of the Act provides the circumstances relating to the declaration of bank insolvency.

CONCLUSION

To determine the definition of systemic risk is very important to find the solutions for systemic risk. Despite of the lack of an exact definition, it seems that most authors have in mind the problem of concurrent failure of many institutions.[39] The main idea in the definitions is that any failure of one bank, even if assignable to management inability, can bring about a domino effect on others. It shows that banks have different structure than other commercial firms.

Informational asymmetry which makes otherwise solvent banks unprotected to deposit withdrawals or stopping interbank lending in times of crisis can cause insolvency for other banks. In addition to this, there is a potential risk to the stability of the financial system as a whole following the failure of an insolvent bank. Such problems may be caused by the failure of a large financial institution, or group of smaller ones. Risks to the stability of the financial system as a whole also arise with the failure of a large insolvent bank.

A well-designed deposit protection scheme can strengthen incentives for good management for banks through internal management from owners and managers, discipline from the markets, and oversight from bank regulation and supervision, but a poorly designed deposit protection scheme can cause numerous problems. Agency problems, moral hazard, and adverse selection can be particularly serious if the scheme is not incentive compatible.[40]

The Turkish Regulation about the Insurance of Saving Deposits was issued in 2006 and set the rules and procedures for this protection. Credit institutions must operate in Turkey, where commercial transactions are excluded, with exception of checking activities. Saving deposit accounts are insured up to amount of 50,000 YTL per person. However, it is not very well known by customers. In order to use the benefit of the Deposit Guarantee Scheme, it must known by the public. In addition to this, customers must be informed by the SDIF about the situation of the Credit Institutions.

Consequently, the explicit deposit guarantee scheme can be a good option as a measure to guard against systemic risk whereas limited guarantee of savings is a burden for customers. Therefore, customers must monitor the institutions themselves, which is not an easy option for them. However, this insurance system forces the credit institutions to control each other to make the system safer. From the view of customers, the safer structure of the institution will be more important than the high interest which is given to saving deposits.

[37] Campbell, A., Cartwright, P., "Banks and consumer protection: the Deposit Protection Scheme in the United Kingdom", [1998] *L.M.C.L.Q.*, p.131.

[38] Banking Act 1987, s. 58(1).

[39] Mishkin, *op cit.*, n. 1, p. 36.

[40] Garcia, G. G., "Deposit Insurance", *Preventing Bank Crises: Lessons from Recent Global Bank Failures*, Ed. by Gerard Caprio, Jr., Hunter, W. C., Kaufmann, G. G., Leipziger D. M., EDI Development Studies. Worldbank.