

## **Deposit insurance, as the basis for ensuring financial sustainability of the banking system**

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### **Abstract**

The main issue of economic development and implementation of market principles is the basis of ensuring financial sustainability of the banking system-establishment of deposit insurance system. The banking system does not have model of financial sustainability of deposit insurance and accordingly no experience, as for implementation of insurance models of operating deposits of developed market economy in Georgia, their practical implementation without preparing preliminary conditions and without taking into account the state interests will be detrimental for safety of financial-economic condition of country. Different models of deposit insurance have one goal-to take into account bank interests and rights of their clients. The means of achieving the goal are quite different from each other, In some countries, insuranceofdeposits are compulsory, in some cases voluntarily. Deposit insurance is also made by state organizations, in some non-governmental sectors, as well as tariffs.The main objective of discussions in deposit insurance is the incentives that should be included in the contribution system. These incentives refer to all interested individuals with small and large depositors.Every stakeholder in the deposit protection system must see its benefits,it is also important that in the first years of operation of the Deposit Insurance System, the bank's membership process in this system.

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## **1 Introduction**

Defining the effectiveness of deposit insurance system in the banking sector, the aim of the introduction of the deposit insurance system in Georgia is gaining the trust of depositors and to avoid banks bankruptcy. Deposit insurance will increase in Banks the number of deposits, which, in turn, will solve a long-term unresolved problem of private savings in the country.

Obviously, the introduction of a similar system will burden the bank's payment and every bank will not be able to solve the problem quickly. That is why it is necessary to introduce a subsidy system to enter in the bank's insurance system. Establishment of the Deposit Insurance Agency will help to increase cash flow in the banking system along with reduction of interest rates on the savings. Depending on the above, the formation of the deposit insurance system is a more complicated process when there is not defined financial stability current problems. We mean receiving information by all deposit insurers in the case of development of cash resources and financing schemes.

In order to establish the structure of the deposit insurance system in Georgia first of all, it is necessary to define the legislative base. The World Banking Practice has two systems known for this issue. The first covers the deposit claims after the closure of banks, consequently, it has no obligation to supervise and and the right to interfere. However, this system requires access to deposit information and adequate funding and effective compensation of depositors after bank bankruptcy. In the second system deposits insurance has a relatively broader authority. This may include: The ability to control and release the Deposit Insurance System, its risk management and assessment, the right to conduct the bank's expertise. Establishment and implementation of deposit insurance system is a strategic measure. It has particular importance for commercial banks and the entire banking system, but for the economy of the country.

Deposits insurance by commercial banks will significantly facilitate optimal banking risks, which will eventually protect banks from bankruptcy and banking from crisis. Special attention should be paid protection of the bank depositors from the losses, which should be have as a result of the bank high risky credit policy. Expected negative consequences reduce the adequate assessment of credit operations carried out by the bank, protection of established economic standards and creation reserves of possible losses. Among the most problematic activities of Georgian commercial banks are development and implementation of reliable protection of bank deposits. The reality of this assertion proved by practical activities of international financial organizationsto get out the world banking system from the crisisover the last half century, which once again demonstrates the necessity of speeding up of introduction of the bank deposit insurance system.

Providing protection of savings of population of Georgia in modern conditions and in order to increase confidence in the banking system, by the National Bank of Georgia for commercial banks are established economic standards and limits. Their protection facilitates the financial stability of the banking system entirely on the

basis of the Bank's depositors and lender's rights and interests. We mean such economic regulations and limits, such as: Statutory Capital, Sum of assets, Liquidity Standards, Capital sufficiency normative, Maximum Risk Rate of activity, Operating Capacity, capacity of trust and guarantees, volume of non-cash part of statutory capital and etc. Effective system of bank deposits insurance should minimize Bankruptcy Opportunity of bank and at the same time solve problems related to it. Creation of such a system implies implementation of the following measures: 1. Creation of legislative basis for bank deposit insurance system; 2. Analysis of Banking activities and structure. 3. Administrative regulation organization of insurance system. 4. Create an independent state governing body and 5. Financial and credit assurance of the insurance system. {6}.

## 2 Preliminary Notes

### **Definition 2.1-** Legislation of Deposit Insurance

Deposit insurance bill in Georgia will enter into force from 2018. Initially, insurance only concerns individuals and will not apply to legal entities. As well as the deposits will be insured within 5000 GEL, as in Gel as well as in dollars. The margin may be revised in late 2020. An independent foundation will be created, which may be transferred to another organization in management, including the National Bank. The capacity of fund at first will be determined by 20 million gel, which is fully provided by commercial banks. If the fund does not have enough money, in this case the state undertakes the obligation to satisfy the depositors from the state budget:

"This will be fund created by commercial banks and they will be able to make cash deposits. Fund will exist independently; the system will be mandatory for all banks. There was discussion that the dollar deposits were not insured and to encourage gel deposits, but The EU directive prohibits any discrimination against currencies. {4}

For commercial banks it was hard decision to pay these amounts but we are waiting that, this will encourage the population to save money in deposits. We use more than we can and it will be useful in macroeconomic terms. It is possible the rising loans as well as the drop in prices, but it is shown by international practice that after insurance interest rates go down. Deposit insurance system will further strengthen stability in the financial sector. Deposit insurance is the world Proven system. Deposit insurance system as financial security component has been introduced and operates in 125 countries around the world, including the European, Central Asian and in neighboring countries of Georgia.

### **Definition 2.2 –** Deposit Insurance Agency

In Georgia the aim of deposit insurance system against commercial banks is promoting sustainability of the country's financial system, encouraging savings, promoting economic growth and alleviate internal and external shocks. The Legal

Entity of the Public Law is established - Deposit Insurance Agency. The commercial bank will be obliged to fund a one-time deposit in amount of 100 000 GEL. As for the regular insurance contribution, the commercial bank will be obliged to pay insurance contribution, the amount of which will not exceed: in the relevant bank in national currency insured amount 0.067%; in the relevant bank in foreign currency insured paid amount 0.1%. In the event of an insurance case, liquidator of the corresponding commercial bank will be obliged to inform the agency about insured depositors and about their deposits. The agency will be obliged within 20 days after insurance case calculating and reimbursement of compensation funds.

The Agency has many privileges to implement the deposit insurance functions. The Agency is entitled to receive information from the commercial banks timely of its competence and to get detailed information provided by the Instruction. On the basis of the relevant agreement with the National Bank of Georgia on time and regularly exchange information about commercial banks; to get exact and timely information against commercial bank during Bankruptcy, insolvency and liquidation process from entitled person provided by the legislation. In accordance with the instructions, request from commercial banks information about deposit insurance for current and potential clients, to check received information directly on the place, remotely or/and through person defined by National bank of Georgia or through external bank auditors, etc.

The fund of deposit insurance is financed by the following sources: initial contributions, regular insurance contributions, special insurance contributions, income received from the agency investment activities; Amounts received from the assets of commercial banks with insurance accident; Other revenues allowed under the Georgian legislation.

If the funds were not collected enough money to pay deposits, the agency is obliged to attract funds, between them, on the basis of state guarantee, by the following sources and the following form: to borrow money by local and international financial institutions, to borrow money from National Bank of Georgia, from government of Georgia, to deploy securities, to find other alternative sources. The agency, in order to provide information, sends a yearly report to the Government of Georgia, parliament of Georgia and National bank of Georgia.

The Agency is obliged to publish information electronically: about commercial banks which is the participant in Deposit Insurance System, about accumulated funds in the fund, quarterly and annual reports, regulations and instructions of agency, information about placement of funds, annual budget of agency and report of auditor. Commercial banks are obliged to provide the current and potential depositor with the information established by the legislation about insured and uninsured deposits, about insured deposit limit according to law and instruction. Also, commercial banks are obliged, to publish electronically information about deposit insurance.

After the implementation of the law about deposits mandatory insurance, the expense of banking sector will increase approximately by 15-20 million GEL. This

can directly or indirectly reflect interest rates on deposits and loans. Today mandatory insurance of deposits is not an actual topic for banking sector. The program of deposit insurance is additional expense for bank. Each commercial bank will be obliged to pay one-time membership fees. Besides, they will have to pay monthly payment, in amount of certain percentage of insured amount (Deposits placed in Gel as well as in foreign currency. Deposit insured in gel paid percent will be lower, then in dollar). {5}

The new project will not be greeted by all players of the market. Likely, major banks will be less enthusiastic with this scheme. The reason for their dissatisfaction is obvious: They receive the largest share of deposits, so they have to pay great amount of money in the insurance program. Moreover, basically, these banks will have to pay for the kind of goodness that they have been receiving for free of charge all this time. In other words, public institutions, in case of financial crisis on behalf of plastic stability will release and save system banks. This approach was shared by the National Bank of Georgia, which has been very strongly maintained the supervision reins of banks and tried to protect them from irreparable risks.

Smaller banks will like deposits insurance. Risk reduction scheme in regards of deposit insurance will give the chance them successfully compete with private deposit funds, even in terms of insured funds.

So it will be useful, once again, we will learn the world experience of deposit insurance and expected results of this scheme in Georgia.

### **Definition 2.3** – Deposit Insurance system in Different Country

Deposit insurance system is functioning practically in every country in some form, the first country where has been established deposits insurance was Czechoslovakia, but in bank regulation system more serious stage was to establish this system in USA, where after great depression distrust of the population towards the banking sector increased, which has significantly complicated problems solving in regards of economic stabilization. As we know, in 1933 in USA was established Federal Corporation of deposit insurance, the members of them became federal banks. The analysis of deposits insurance system showed us, that the costs incurred by his activities exceed the costs of its maintenance. In particular, in the 1900-1933 period, the United States of America has 14 crises of banking system (11 out of which there had been a massive failure of banks' obligations), in 1933 after establishment of federal corporation of deposit insurance. The USA Banks collapse caused by "domino effect" didn't take place.

As we mentioned, the deposits insurance can avoid or reduce banks bankruptcy in such countries which have strong financial institutions. However, the experience has shown us, that in case of incorrect use of this system, the private banks have stimulus to render unwanted risks and accelerate the financial crisis (This event is known in economics as "moral threat"). It is interesting that in USA and Canada, the system of deposits insurance was established after great depression, while many European countries introduced it since the early 1990s. Instead banks were relying on unconditional understanding of guarantees (for example, central bank strictly

controls liquidity and risks). In 2008, at early stage of the world financial crisis, many European countries increased limits of deposits insurance from 20,000 to 100,000 Euro. For a certain period of time government issued unlimited guarantees and promised that none of the banks will be given chance of failure. (United States Federal Deposit Insurance Corporation – FDIC) increased the limit of deposits insurance from 100,000 to 250,000 USD)

Empirical evidence testifies (Karapella and Di Giorgio, 2003) that the system of deposits insurance will increase interest rate of loans and deposits in banking system all over the country. Interest rate of deposits is falling, as soon as deposits are safe, and banks are able to reduce deposit interest rate. It's even more interesting that interest rate on loans increases.

Karapella and Di Giorgio loans rates growth are called "moral danger". Deposits insurance increase stimulus of private banks, to invest in risky assets, which will increase interest rate of loans. In order to prove this hypothesis, Karapella and Di Giorgio found that countries with good institutional quality have relatively low interest rates.

The new work of Deniz, Asli and Mini (2013) examined the deposit insurance and the risks of banks during the global financial crisis. According to the study, in the countries that use deposit insurance system, banking and systemic risks were lower at the time of the crisis. The results suggest that the insurance system is accompanied by significant stability effect. Moreover, they found that a well-functioning surveillance system could weaken side effects of deposit insurance banking risks.

### 3 Main result

The goal of introducing the deposit insurance system in Georgia is to obtain depositors' trust and avoid banking system from bankruptcy. In addition, the legislators hope that the insurance will increase the number of savings in banks, in addition, the legislators hope that the insurance will increase the number of savings in banks, which, in turn, will solve a long-term unresolved problem of private savings in the country.

#### Section 1

1.1 According to data of the National Bank, 11,9 billion GEL from foreign deposits attracted by commercial banks are in foreign currency. Naturally, the dominant currency is dollar. National currency is 4,3 billion GEL. A joint study conducted by TBC Bank and ISET Research Institute in 2016 about "financial Consciousness" the attitude of the Georgian population towards their savings.

1.2 According to the survey, 35% of respondents managed to save money last year. Most of them (47%) saved money in cash, approximately 32% placed amount on deposit. This number is very interesting for the following reason: the research about assessment of dependence on savings in 2011 we gave almost identical results about the behavior of people, which saved the money. 38% of depositors

saved money on deposits, when 47% of them saved money elsewhere. After many people saved money (if in 2011, 16% managed to save money, in 2016, 35% managed to save money)! Moreover, the query in 2011 determined, that 60% of respondents assented, to place their money in bank, if the bank will have deposit insurance system. At the same time, in 2016, 79% of the respondents are ready to keep money in bank. {3}

### **3.1 Cost**

Deposit insurance may be a positive development and, in case of its proper management, maybe will increase the number of savings and investments in the country. The main issue is to manage system correctly.

If the country fails to provide a safe deposit insurance system against strong banking regulations or risks, together with a strong central bank, the introduction of deposit insurance system will only lead to catastrophe. Instead of solving the bankruptcy problem, it will cause "moral hazards".

#### **3.1.1 Advantages**

Deposit insurance system can solve important problems, in particular, provide financial sustainability of whole banking system and its members, create for depositors with small amount guarantees in case of bank bankruptcy and improve the degree of confidence of the population and entrepreneurial subjects to the banking system.

## **4 Labels of figures and tables**

As concerning our research To the question, do you think that the deposit insurance system will increase the interest rate on the loan? 36% of respondents answer, that will increase significantly, 43% think that will not increase, and 21% answer that do not have the answer.

**Table 1: Deposits Insurance System and Interest Rate**

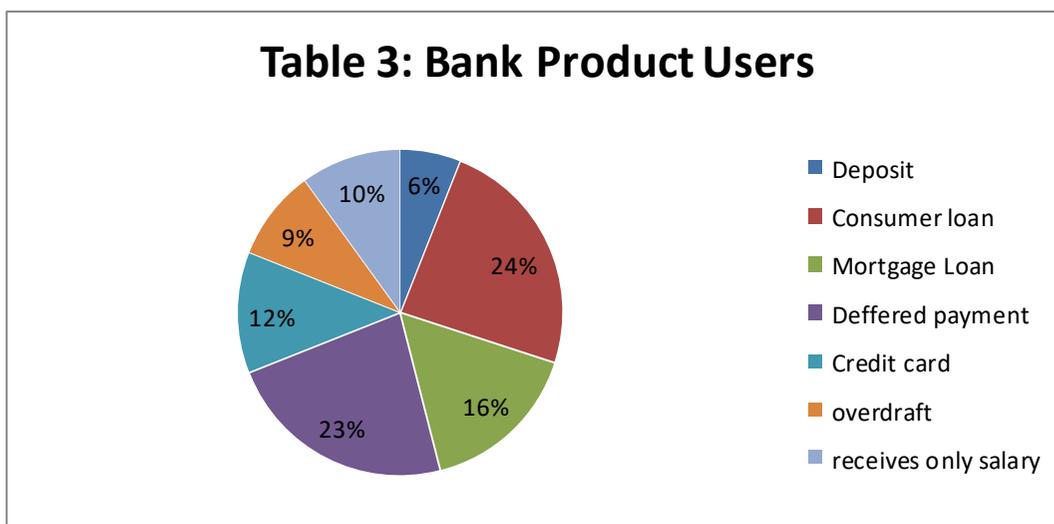


The answer to the question: Will the insurance deposit system save the bank deposits of the population? 36% answer that Yes it will, 43% think it will not and 21% do not have answer

**Table 2 : Bank Contributions and Deposits Insurance**



Which bank Product user are you? 6% of population answers that deposit, 24% have consumer loan, 16% mortgage loan, 23% have instalment, 12% credit card, 9% overdraft, and 10% receives only salary.



## 5 Conclusion

Based on the results of the survey, it will be difficult to assess how will change the dependence on savings after the reform, but we have the basis to optimize the effect of the new law.

It will be interesting to see what are the results we receive in Georgia?

Deposit insurance may be a positive development and, in case of its proper management, maybe will increase the number of savings and investments in the country. The main issue is to manage system correctly.

If the country fails to provide a safe deposit insurance system against strong banking regulations or risks, together with a strong central bank, the introduction of deposit insurance system will only lead to catastrophe. Instead of solving the bankruptcy problem, it will cause "moral hazards".

As a result, creating a trusted deposit insurance program for the National Bank of Georgia and the Government, which is strong guarantee and solid financial guarantee, is only the first step.

**Acknowledgements:** Finally, we may conclude that the efficiently functioning deposit insurance system can solve important problems, in particular, provide financial sustainability of whole banking system and its members, create for depositors with small amount guarantees in case of bank bankruptcy and improve the degree of confidence of the population and entrepreneurial subjects to the banking system.

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