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Iwona Dorota Czechowska
University of Lodz
Faculty of Economics and Sociology
Centre for Central Banking and Financial Intermediation
e-mail: dorota.czechowska@uni.lodz.pl

The essence of the Bank Guarantee Fund's activity and related dilemmas in the context of banking system stability*

Abstract

The deposit guarantee system in Poland was devised at the time of the economic transformation. Its creation resulted from a difficult situation in the banking sector, and so it was meant to be an antidote to clients' problems associated with the insolvency of collapsing banks and with adjusting to European community law. The aim of this work is to present the Bank Guarantee Fund—an institution that is part of the financial safety net, whose main task is to protect the interest of depositors and to ensure the banking system's stability. The paper looks at some aspects of the growing interest in bank deposit insurance schemes and lively discussions on the subject during a crisis in banking markets. In response to the crisis that started in the subprime lending market in the USA and spread to other segments of the financial markets as well as to other countries, the ECOFIN made a decision to increase the existing guarantee limits for individual persons and to speed up the payout of guaranteed funds. The above changes were aimed at strengthening the security of clients and increasing confidence in the banking sector.

Keywords: Bank Guarantee Fund, deposits, stability

JEL Classification: E52, E58

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1. Introduction

The deposit guarantee system in Poland was devised at the time of the economic transformation. Its creation resulted from a difficult situation in the banking sector, and therefore it was to be an antidote to customers' problems related to the insolvency of failing banks and the adjustments to Community law. The aim of this work is to present the Bank Guarantee Fund, an institution that belongs to the financial safety net, whose main task is to protect the interests of depositors and to ensure the banking system's stability. The stabilizing function of deposit guarantee schemes consists in preventing a general panic among depositors when a crisis in the financial markets arises. Yet, this existence of this scheme brings not only benefits, but also involves certain risks. Some studies demonstrate that the danger lies in the obligatory, non-market character of this scheme, leading to *moral hazard*, a stronger inclination to take greater risk in order to maximize profit (Pawlikowski, 2010). The thesis of this paper concerns the growing interest in bank deposit insurance systems and the revival of the discussion on their activity in a time of crisis in the financial markets.

2. The specificity of the functioning of deposit guarantee schemes

As an institution, a bank is of a dual nature. On the one hand, it functions as an enterprise and is focused on increasing the profits and market value of the company. On the other hand, it is an institution of public trust, and consequently, its good image and clients' confidence in the security of entrusted funds is of overriding importance to the stability of an individual bank and the entire banking system, as well as the related economy. In order to earn the trust of clients, drawing on the experience of other countries, the Bank Guarantee Fund (Polish: Bankowy Fundusz Gwarancyjny, hereafter: BFG) was created in Poland, which is—among other things—a deposit insurance system. The first deposit guarantee fund was established in the United States in 1934 in the aftermath of the Great Depression (Szczepańska, 2008, p. 61). Deposit guarantee schemes exist not only in the developed world, but are also present in African countries. Typically, one scheme is designed in each country; yet, sometimes there are more. In some regions of the world, a single scheme is drawn up for several countries, e.g. the Central African Republic, Chad, Congo, Equatorial Guinea and Gabon (Jurkowska-Zeidler, 2008, p. 196). The organization and competences of the funds vary. According to the scope of functions, two main models can be distinguished:

(1) narrow—*paybox*,
(2) wide—*risk minimizer.*

Under a narrow mandate (*paybox*), only the guarantee activity is undertaken, which consists in the payout of deposits in the event of the bank's failure. Under a broad mandate (risk minimizer), however, in addition to performing the guarantee function, financial assistance is provided to banks that are at risk of crashing. The decision about which model is chosen depends on the condition of the banking sector, its level of concentration and the nature of the ownership structure (Zdanowicz, 2007, p. 34).

Apart from the scope of the functions served, the difference between guarantee schemes relates to their administrative structure. In this case, schemes can be divided into the following categories:

(1) public—implemented by public authorities (mandatory participation, as authorized by the law),
(2) private—implemented by representatives of the banking sector (voluntary participation),
(3) mixed—implemented jointly by public and private entities.

Public funds prove to be an effective solution in countries where the banking system is stable, and there are no major threats to financial markets. In other cases, schemes of private and mixed funds are adopted (Zaleska, 2007, p. 218).

3. The essence of the BFG's activity

The Bank Guarantee Fund was established by the Act of 1994, in accordance with Directive 1994/19/EC of the European Parliament and of the Council of 1994 on deposit-guarantee schemes, and its mission is: "to contribute to the safety and stability of banks and to increase confidence in the banking system" (www.bfg.pl). The BFG was set up in order to carry out the operations of the mandatory and contractual deposit insurance schemes. The goal of the mandatory deposit insurance scheme is to provide depositors with a payout up to the amount of guaranteed funds in the event of their unavailability. The goal of the contractual guarantee scheme is to extend aid to entities covered by this scheme. The above goals are attained through specific tasks, among which can be listed (Act of 14 December 1994 on the Bank Guarantee Fund):

(1) protecting funds deposited in the accounts of natural persons and other entities, who entrust their money to banks (personal deposits in PLN and foreign currencies by natural and legal persons, including local government units, school savings associations and employee assistance-and-loan associations, units who cannot assess financial risk on their own). These deposits are kept at all domestic banks (i.e., those with registered head offices located within the territory of Poland);
(2) providing banks with financial assistance if a threat of insolvency arises;
(3) supporting the merger processes of threatened banks (the acquisition of stock or shares, or receivables of the bank facing a threat of insolvency);

(4) collecting and analysing information on entities covered by the guarantee system, preparing analyses and forecasts regarding the banking sector, as well as undertaking initiatives and taking preventive measures to maintain the stability of the banking system.

Two main areas of the Fund's activity are usually indicated—mandatory deposit insurance and discretionary financial assistance for banks with solvency problems.

While analysing the guarantee function, it can be observed that the guaranteed funds covered by the BFG protection constitute the basis for determining the amount of financial resources owed to an individual depositor. This benefit is calculated in the event of the bankruptcy of any bank in the amount specified in the amended BFG Act of 2010, according to which the deposit amount not exceeding the PLN equivalent of EUR 100,000 is guaranteed in its entirety (Act of 16 December 2010 amending the Bank Guarantee Fund Act and certain other acts). The calculation of the guaranteed amount is based on all funds accumulated in a bank (also electronically, online) by one person. Irrespective of the number of accounts (e.g. term deposits, current accounts, savings and settlement accounts), they are treated as one deposit. Joint accounts are also covered by the guarantee. Each joint account holder is entitled to a separate guaranteed amount. Each of the spouses is seen as a separate depositor regardless of their mutual property relationship (Act of 14 December 1994, on the Bank Guarantee Fund).

The basis for calculating the guaranteed amount is the sum of funds deposited in all accounts. Irrespective of the currency in which the deposit is denominated, the guaranteed funds are disbursed in PLN, after calculating the value of the foreign currency deposit according to the exchange rate from the day of the bank's failure. It is also possible to recover some of the deposits that are not guaranteed by the BFG. They constitute depositor's claims against the bankruptcy estate of a bank and can be recovered during the bankruptcy proceedings. Moreover, it should be noted that in the case of certain products available to clients, the bank acts solely as an intermediary in their sale (this applies to, for instance, units in investment funds or insurance products) and hence, they are not covered by the guarantee scheme. Only the deposit component of the product is insured (Act of 14 December 1994, on the Bank Guarantee Fund).

The following are excluded from the group of depositors protected by virtue of the Act of 14 December 1994, on the Bank Guarantee Fund: the State Treasury, domestic and foreign banks, credit institutions, entities trading in financial instruments, insurance companies, investment funds, pension funds, major shareholders of the bank holding at least 5% of the shares as well as bank management staff.

In the event of bank bankruptcy, the BFG collects funds from all banks to pay out the amounts guaranteed to the clients of the failed bank, as at the day of the suspension of the bank's operations, plus interest due accrued up to the day of the fulfilment of the guarantee condition. The Fund assumes liabilities towards the depositor on the day that the operations of the bank are suspended by the Polish Financial Supervision Authority (Polish: *Komisja Nadzoru Finansowego*) and a petition to declare its liquidation is filed. Once the bank is declared insolvent, the manager or trustee in bankruptcy reimburses the guaranteed funds in places and on dates that are publicly announced. Depositors may apply to the BFG for the disbursement of due funds within a period of 5 years from the day the bank was declared insolvent (Act of 14 December 1994, on the Bank Guarantee Fund).

The Bank Guarantee Fund provides banks with returnable financial assistance in the form of loans, guarantees and suretyships, as well as the acquisition of receivables, which are intended for eliminating the risk of insolvency or acquiring stock and shares of the bank by new stockholders or shareholders. The financial assistance provided by the BFG is more beneficial compared to that offered by banks, as demonstrated in loans, guarantees and sureties with lower interest rates, from which lower commissions are deducted and more convenient time frames for the repayment are set. Since June 2002, the interest rate on loans granted by the Fund is, on an annual basis, between 0.1 and 0.4 of the rediscount rate. The amount of the commission was set at:

(1) 0.3% of the loan amount for joint-stock banks and state-owned banks,

(2) 0.1% of the loan amount for cooperative banks.

The BFG assesses the risk of insolvency occurrence resting on an analysis of the bank's economic and financial standing, taking into account both the scale and the reasons for its financial difficulties. It is understood that the insolvency risk occurs in a situation when the solvency ratio falls below the required target set out in separate regulations and when a balance sheet loss was incurred by the bank. What is more, the analysis of the insolvency risk occurrence involves an assessment of the trends of the basic economic and financial ratios of the bank compared to averages in particular sectors, namely (Act of 14 December 1994, on the Bank Guarantee Fund):

(1) gross return on assets,

(2) the ratio of gross non-performing assets to total gross assets,

(3) the encumbrance of the bank activity results with operating expenses,

(4) the encumbrance of assets with operating expenses,

(5) the encumbrance of bank activity results with the balance of provisions.

The Fund performs an analysis of the economic and financial standing based on documents and information submitted by the applying bank. The evaluation of the bank's situation is made in terms of the capacity to produce such an aid effect that would allow the threat of insolvency to be eliminated. At the same time, what is also assessed is whether the applying bank will be able to repay loans along with the accrued interest within a fixed period. The Fund's Management Board analyses applications of the banks that meet the statutory and economic conditions to receive assistance (Act of 14 December 1994, on the Bank Guarantee Fund).[1] As for the nature of the BFG's assistance activities, it is founded on the following assumptions:

[1] The detailed terms and conditions of financial assistance provided by the Bank Guarantee Fund, along with a list of documents and information that should be submitted in conjunction with the application were stipulated by the BFG Council in Resolution No. 35/97 of 20 November 1997, as amended (resolution 11/2002 of 26 June 2002).

(1) adhering to the principle of the equal treatment of banks in their access to assistance funds and the transparency of the criteria and procedures for granting aid,
(2) making the aid available to banks as quickly as possible in order to minimize losses,
(3) supporting the consolidation and restructuring processes by granting aid for the takeover of banks threatened with insolvency by strong banks,
(4) motivating applicants to seek additional sources of financial support, outside the BFG, in order to implement rehabilitation programmes,
(5) ensuring the economically high effectiveness of assistance, for instance, by setting out such conditions of the loan agreements, would allow banks to recover their solvency permanently.

The financial aid granted by the assistance fund comes from obligatory annual fees paid by all banks that are covered by the mandatory guarantee system. The Fund's Council established the rate of the obligatory annual fee in 2010 at 0.045% of 12.5 sums of the capital requirements for specific types of risk and of the capital requirements for exceeding limits and violating other norms specified in the Banking Law.

4. Dilemmas related to the functioning of deposit guarantee schemes

Evaluating how the Bank Guarantee Fund, as well as other funds of this type, operate, one may ask whether it is justified to guarantee bank deposits in a free market economy. The arguments are offered for and against institutionalizing the insurance of funds deposited in banks. Proponents point to the fact that the introduction of a deposit guarantee scheme brings many positive outcomes from the perspective of depositors, the banking system and society as a whole because:
(1) it makes depositors more resistant to bank runs;
(2) it prevents economically weak social groups from becoming impoverished, which means that it has a social aspect, as those who put their savings in banks are usually small depositors who cannot assess the financial standing of a depositary bank;
(3) prevents the reduction of the savings rate.

On the other hand, the "against" arguments most often emphasize that the institutionalized deposit protection:
(1) encourages banks to take excessive risks so as to maximize profits;
(2) reduces depositors' interest and engagement in seeking access to information on the financial standing of banks;
(3) favours the occurrence of an unfavourable phenomenon referred to as *moral hazard*, following from the fact that the system protects the parties to the contract against losses, which weakens market discipline among banks and depositors;

(4) brings about the situation in which clients do not attach enough importance to the bank's risk assessment and opt for those service providers who, in accordance with the principles of moral hazard, tempt clients with the highest interest on deposits and the lowest interest rate on loans;
(5) impairs the normal functioning of the market as a mechanism for the effective allocation of economic resources and calls into question the principles of financial security, leading to a situation in which the whole of society or other banks bear the costs of moral hazard.

Therefore, in the light of practice and theoretical analyses, the view has been formulated that the risk of its occurrence should be reduced by following adequate procedures and adopting specific system solutions – for example, making the amount of the insurance premium dependent on the risk a bank takes, forbidding banks from engaging in activities that involve excessive risk, and constantly monitoring the risks that banks are involved in (Golędzinowski, 2009, pp. 31–32). Thus, the emphasis is placed on shaping the deposit guarantee scheme in such a way that its benefits will outweigh the costs and inconveniences associated with its functioning.

Gradually, the rules for guaranteeing deposits by the BFG have been modified and modelled on the solutions adopted in the EU, such as (*Act of 16 December 2010 amending the Bank Guarantee Fund Act and certain other acts*):
(1) correlating the amount of guaranteed funds with the balance of funds accumulated by a depositor on the day on which a bank's operations are suspended (on the day the funds become unavailable);
(2) determining that guaranteed funds are reimbursed by the trustees in the bankruptcy within 20 days of receiving the deposits from the BFG.

Interest in bank deposit insurance schemes and the discussions on how they function are revived in times of crisis in financial markets. Hence, in response to the crisis that started in the *subprime* lending market in the USA and spread to other segments of financial markets and to other countries, a decision was made to raise the existing guarantee limits. The EU Economic and Financial Affairs Council (ECOFIN) announced that in order to protect the interests of depositors, all member states would raise the guarantee limits for natural persons to EUR 50,000 (Directive 2009/14/EC of the European Parliament and of the Council of March 11, 2009, amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay; for more, cf. Dunaszewska & Ślązak, 2008). Bearing in mind the crisis and the threat to the stability of the financial markets, it was decided that the main direction of changes in how guarantee funds function was a gradual increase of the guarantee limit and a faster payout of guaranteed funds. By the end of 2010, the guarantee limit was raised from the PLN equivalent of EUR 50,000 to the PLN equivalent of EUR 100,000. The purpose of the above changes was to offer clients greater security and to increase their confidence in the banking sector (see: Table 1).

Table 1. The maximum guaranteed amounts

Period	Guaranteed amount in EUR
Until Jun 30, 1997	3,000
Until Dec 31, 1997	4,000
Until Dec 31, 1998	5,000
Until Dec 31, 1999	8,000
Until Dec 31, 2000	11,000
Until Dec 31, 2001	15,000
Until Dec 31, 2002	18,000
Until Dec 27, 2008	22,500
Until Dec 29, 2010	50,000
Until Dec 30, 2010	100,000

Note. Adapted from „Sieć bezpieczeństwa finansowego," by M. Capiga, W. Gradoń, and G. Szustak, 2010, Warszawa, CeDeWu, p. 84.

In the period until November 27, 2008, guaranteed amounts of over EUR 1,000 were paid out in 90% of the amount to each person, and after November 28, 2008—100%. In addition, until December 30, 2010, the funds owed to a depositor of a given bank on account of the BFG guarantee were reduced by the depositor's liabilities to the bank, e.g., liabilities resulting from the loan agreement. Under the Act of 16 December 2010 on the BFG, the compensation principle was abolished.[2] The purpose of the above changes was to provide greater security to clients and boost their confidence in the banking sector. If we consider development trends in deposit guarantee schemes, what may draw our attention is the discussion on their character, which can be local or transnational, and the need to create a European deposit guarantee scheme for banks of systematic importance. Yet, there is a problem with defining them, since a bank that is systematically unimportant in its home country can have a considerable impact through a daughter company in a host country. In the age of globalization, an institution for global guarantees should be established, but its creation would require changes in the functioning of the financial safety net (Iwanicz-Drozdowska, 2005, pp. 449–450).

Another problem relating to guarantee funds—which is associated with the rationality in action understood as savings on administration and management expenses as well as economies of scale—is how to implement the concept of integrating organizationally national guarantee schemes in respect of the deposit guarantee schemes with the compensation system for stock investors and the participants of joint investment, or even a guarantee scheme for insurance policies. A solution to this issue could be a temporary transfer of assets between particular funds, which would make it possible to optimize costs (Szambelańczyk, 2005, pp. 464–465). Therefore, the institutional protection of depositors' interest and the stability of the banking system—in the form of the BFG in Poland and other funds in other countries—face numerous structural and organizational questions. Their resolution should lead to the optimization of actions in the conditions of universal integration and globalization in financial service markets as well as to the increase

[2] Changes in the deposit guarantee schemes that are favourable to customers of the banks, Jan 3, 2011.

in client confidence in the financial system, which has an impact on the financial stability, seen as a public good, a prerequisite for economic growth and an improvement in people's living conditions.

5. Conclusions

In conclusion, a guarantee fund is meant to protect depositors and preserve public confidence in the banking system, as well as to counteract the occurrence of panic breakouts and massive runs on the banks in the event of instability on financial markets. In the Act on the BFG passed on December 14, 1994, which entered into force on February 17, 1995, the legal basis for the deposit guarantee scheme was established, being universal and obligatory in character. Participation in this scheme became mandatory for all banks operating in Poland, regardless of the type of ownership or legal status. The scheme provides coverage to deposits of both natural and legal persons and is grounded in the principle of distributional solidarity. Taking into account the scale of bankruptcy risk in the banking sector and the financial capacity of banks, the Act obliged the scheme participants to jointly collect the resources for guarantees in the form of treasury securities and NBP (National Bank of Poland) money bills deposited in accounts with the NBP. Assets secured in this way constituted the so-called guaranteed amount protection fund, being a reserve of assets controlled by the banks, which, in the event of bankruptcy of one of them, could be used towards the reimbursement of guaranteed amounts to clients.

The objective of the study set out in the introduction has been accomplished, which is reflected in the presentation on the essence of the BFG, with special attention given to the question of the threats resulting from the non-market character of the fund. Additionally, the author discussed changes in the principles of how deposit guarantee funds operate, which are related to the crisis on financial markets, and are aimed at increasing depositors' confidence in the banking system.

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