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## **DEPOSIT GUARANTEE SYSTEM IN UKRAINE: PROBLEMS AND PERSPECTIVES AFTER THE FINANCIAL CRISIS**

*The events that occurred during the global financial crisis of 2008-2009 indicate the critical importance of early development of effective deposit insurance mechanisms. The article gives main features of the Deposit Guarantee System in Ukraine, funding sources and National Deposit guarantee system restrictions. It is also described main problems of the Deposit Guarantee System in Ukraine and possible directions to resolve existing problems.*

*Key words: deposit insurance, Deposit Guarantee System in Ukraine, Deposit guarantee system restrictions*

### **Introduction**

The individuals' deposits is an important source of Bank resources and one of the key components of an effective financial system. Modern global financial system based on market principles of competition, provides the receipt of income by the same participants due to the receipt of losses by other. This causes the need of state protection against financial risks, first of all consists in introduction of effective deposits insurance mechanisms.

Deposit insurance system has an important place in the General system of state financial security. It is not intended to overcome the consequences of the large system banks bankruptcy, or the consequences of the financial crisis. In such situations, the stabilization should be achieved by the close cooperation of all participants of the financial safety of the country. But effective, efficient and adequate system of the deposits insurance is one of the main preconditions to prevent

panic among depositors during crisis situations, and is one of the mechanisms of overcoming the consequences of the financial crisis.

The events that occurred during the global financial crisis of 2008-2009 indicate the critical importance of early development of effective deposit insurance mechanisms. This causes the need of the development of proposals regarding the functioning of the Deposit guarantee system, which would be generally accepted at the global level.

In July 2008 the Basel Committee on Banking Supervision and the International Association of Deposit Insurers decided to collaborate to develop an internationally agreed set of Core Principles for Effective Deposit Insurance Systems [2]. In cooperation with these international organizations in June 2009 were published Core Principles for Effective Deposit Insurance Systems. This document includes 18 principles, which are united into 10 groups, and provides an explanation and guidance on their application.

### **Key Features of the Deposit Guarantee System in Ukraine**

In General, Deposit insurance system in Ukraine corresponds to international principles. The main features of the Deposit Guarantee System in Ukraine are below (Table 1).

Table 1 - Key Features of the Deposit Guarantee System in Ukraine

Features	Peculiarities in Ukraine
Explicit	The Law of Ukraine "On Households Deposit Guarantee System" establishes the legal, financial, and organizational grounds for the operation of the deposit guarantee system.
Centralized	The deposit insurer in Ukraine is Deposit Guarantee Fund (DGF)
Mandatory	Banks mandatory membership in DGF.
State	The DGF is an economically independent state institution
Limited	Minimum guarantee level of deposit, including principal and interest is 200 000 UAH
Selective	The DGF compensation spreads only for bank deposits (not applicable to non-Bank financial institutions)
A “paybox plus” mandate	The DGF is responsible for the reimbursement of insured deposits and provides resolution functions

Source: [3]

The mandates of deposit insurance systems are generally well defined and formalized, and may be broadly classified into four categories [1]:

1. A “paybox” mandate. Narrow mandate systems that are only responsible for the reimbursement of insured deposits (Australia, Germany, Hong Kong, India, Netherlands, Singapore, Switzerland);

2. A “paybox plus” mandate, where the deposit insurer has additional responsibilities such as resolution functions (Argentina, Brazil, United Kingdom);

3. A “loss minimiser” mandate, where the insurer actively engages in the selection from a full suite of appropriate least-cost resolution strategies (Canada, France, Indonesia, Italy, Japan, Mexico, Russia, Spain, Turkey);

4. A “risk minimiser” mandate, where the insurer has comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities (Korea, United States)

According to this classification, until 2012, national Deposit insurance system has responded to the first type, i.e. a “paybox” mandate. The reform of the national Deposit insurance system and the adoption of the Law of Ukraine "On Households Deposit Guarantee System" in 2012, has significantly expanded the functions of the DGF, which has led to the improvement of the institutional framework of the DGF and brought Ukrainian deposit guaranteeing system to the international standards of efficiency. According to the new legislation the DGF has additional responsibilities such as resolution functions and National deposit insurance system may be classified into second mandate category, i.e. a “paybox plus” mandate.

### **The DGF financial resources**

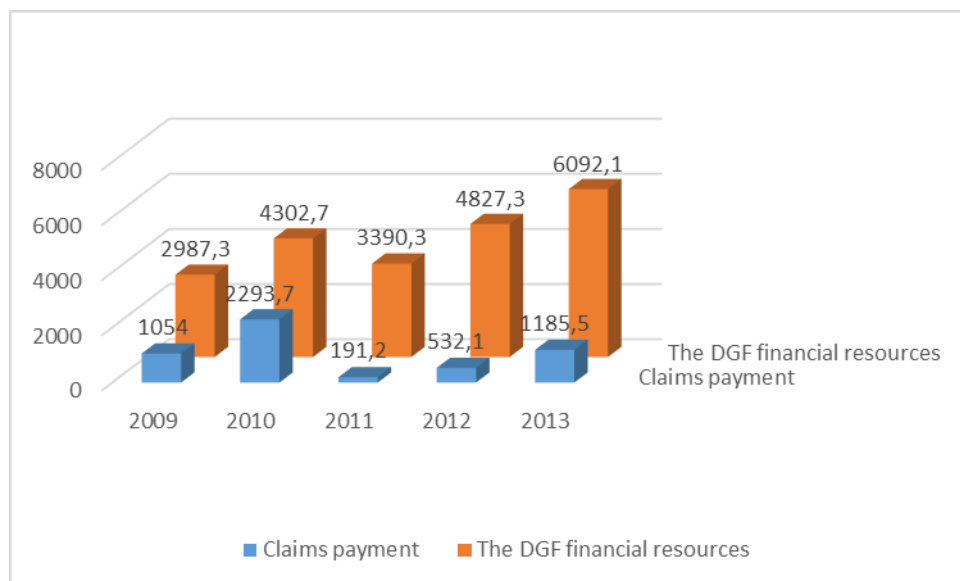
To perform the functions of the DGF provides funding sources [3]:

- initial, regular and special contributions of the DGF members;
- income received from investments of the DGF funds in Ukrainian government securities;
- funds (including the internal state bonds) obtained by Fund in course of placement of bonds or issuance of financial promissory notes;

- interest income on the outstanding balance of the DGF's account with the National Bank of Ukraine;
- loans taken from the National Bank of Ukraine;
- forfeit (fine, penalty) enforced under this Law;
- funds contributed by the National Bank of Ukraine at the amount of UAH 20,000,000 at the time of the DGF establishment;
- funds from the state budget of Ukraine;
- income from provision of financial support to an assuming bank;
- revenues obtained from granting a special-purpose loan to a bank for covering payment;
- charitable contributions, grants, technical assistance, including those provided by foreign entities;
- credits from non-banking financial institutions and foreign creditors;
- funds obtained from implementation of measures envisaged by the resolution plan, in particular, from sale of an insolvent bank or a bridge bank, or from liquidation of a bank.

Dynamics of financial resources of the DGF in recent years is shown below.

Graph 1 - The dynamics of the DGF financial resources and Claims payment (million UAH)



Source: [5]

By the beginning of 2013, the total volume of financial resources of the DGF is 6,1 billion UAH, which is more than twice more in comparison with 2009. General dynamics of financing development is positive.

### **National Deposit guarantee system restrictions**

A compulsory condition for the effective functioning of the Deposit guarantee system is the certain **restrictions**: the establishment of the compensation limit; the special conditions of deposits payout in foreign currency; franchise (non-payoutable minimum deposit amount); the reimbursement of certain types of deposits; determination of the contributors' circle who may receive compensation; and other.

Most countries legally implement only the protection of small deposits. Support of social-political stability is of great importance to ensure a high specific weight of population's savings in banks.

Small investors, significant part of which refers to the socially unprotected layers of the population, unable to estimate correctly the state of affairs in the bank deposits market and financial stability of banks to make correct decisions. It is the large number of small savers creates particularly critical circumstances in banking crises and causes panic at mass by withdrawal of deposits. National Deposit guarantee system has the following restrictions set by the law (Table 2).

Table 2 - National Deposit guarantee system restrictions

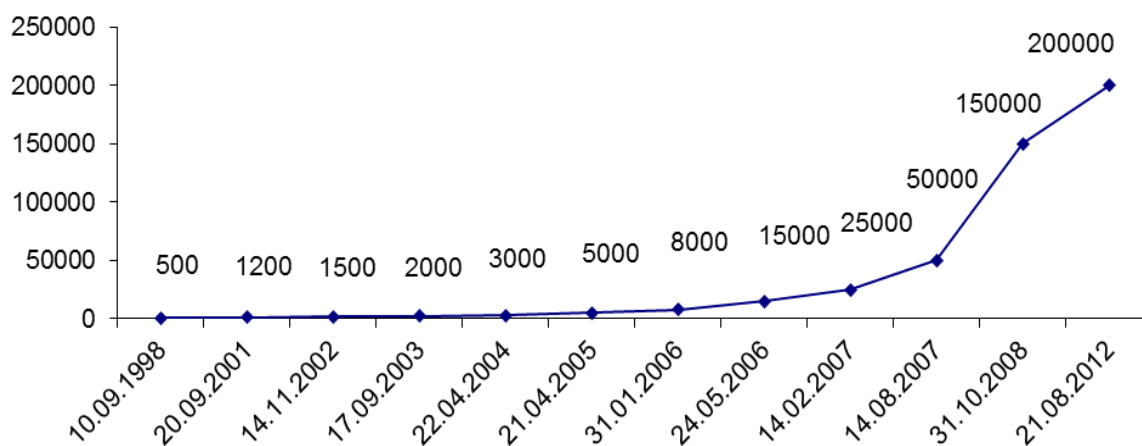
<b>Restrictions</b>	<b>Peculiarities in Ukraine</b>
Minimum guarantee level of deposit	200 000 UAH
Franchise	10 UAH
Non-payoutable categories of deposits	<ul style="list-style-type: none"> <li>- funds put into trust management of a bank;</li> <li>- funds certified by a saving (deposit) certificate payable on demand;</li> <li>- funds with more favorable contractual terms, or other financial preferences from the bank;</li> <li>- funds that serve as pledge;</li> <li>- funds from subsidiaries of a foreign banks.</li> </ul>
Non-payoutable categories of individuals	<ul style="list-style-type: none"> <li>- member of the supervisory board;</li> <li>- member of the management board (board of directors);</li> <li>- member of the audit committee of a bank;</li> <li>- individuals who provided professional services to the bank as an auditor,</li> </ul>

	legal advisor, estimator if their services had the direct effect on the bank insolvency.
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Source: [3]

Minimum guarantee level of deposit should cover most of the deposits. According to the data on the individuals deposits participants of the DGF during the 2013-2014 [5] the coverage percentage of the number of depositors at the beginning of 2014 was 99,4%. The dynamics of the minimum guarantee level of deposit size increase is shown below.

Graph 2 – The dynamics of the minimum guarantee level of deposit size increase (UAH)



Source: [4]

Despite the positive trend, there are problems of the Deposit Guarantee System in Ukraine:

- Imperfection of interrelations between participants of financial system safety net;
- lack of the available financial resources to perform the functions of the DGF in case of the systemically significant bank failures;
- imperfection of legal regulation and experience of obtaining financing from the state funds;

- lack of depositors protection of the financial institutions nonmembers of the DGF;
- unequal conditions for state and commercial banks;
- inefficient usage of financial resources of the DGF;
- lack of public awareness about the peculiarities of the national Deposit guarantee system.

According to the Core Principles in order to be credible, and to avoid distortions that may result in moral hazard, a deposit insurance system needs to be part of a well-constructed financial system safety net, properly designed and well implemented. A financial safety net usually includes prudential regulation and supervision, a lender of last resort and deposit insurance. The distribution of powers and responsibilities between the financial safety-net participants is a matter of public policy choice and individual country circumstances [2]. However, the legislation of the interaction mechanisms between financial system safety net participants settled not enough. Thus, the Law only establishes the procedure of interaction between the DGF and the National Bank of Ukraine and some issues between the DGF and the Cabinet of Ministers.

A deposit insurance system is not intended to deal, by itself, with systemically significant bank failures or a “systemic crisis”. In such cases all financial system safety-net participants must work together effectively. In addition, the costs of dealing with systemic failures should not be borne solely by the deposit insurance system but dealt with through other means such as by the state [2]. Thus, in 2013, the percentage of the DGF capital accumulation in relation to the amount of insured deposits is only 1.7%, while in the transition economies this indicator is 3%.

To solve this problem in 2014 is adopted changes to the Law of Ukraine "On Households Deposit Guarantee System", according to which is formalized minimum percentage of the DGF capital accumulation.

The minimum volume of the DGF’s funds at any time shall not be less than 2.5 per cent of household deposits guaranteed by the DGF within the limits of the

marginal amount of payout including the contributions to be received in the in the current quarter from the DGF members [3].

The law provides that in case of insufficiency of funds the DGF has the right to attract loans from the Cabinet of Ministers of Ukraine or receive a state contribution on non-repayable basis. But in fact, the order and conditions of a loan from the Ministry of Finance of Ukraine and the state contribution not settled by the law. That, as a consequence, may lead to the impossibility of obtaining these loans.

Another problem of the national deposit guarantee system, in our opinion, is lack of depositors protection of the financial institutions nonmembers of the DGF. In Ukraine the right to attract deposits have banks and credit unions. However, the mandatory membership in DGF is only provided for the banks. Thus, investors who are owners of deposits in credit unions are not under the state protection.

Also, the law provides a special procedure for the protection of the state Bank “Oshadbank”, which is not a member of the DGF. In our opinion, this leads to unfair competition and growth of risk of loss of confidence in the banking system.

The following question is the efficiency of the financial resources of the DGF investment. Current legislation provides the possibility to invest funds only in government securities. The lack of investment diversification increases the currency risk. If the payment of deposits is accompanied by a devaluation of the national currency, this leads to increase of payments in the national currency and, consequently, to the increase of expenses of the DGF.

Another problem is lack of public awareness about the peculiarities of the national Deposit guarantee system, which leads to panic in a crisis, as well as reduction the confidence of depositors in the banking system.

### **Conclusion**

This paper has shown the main features of the Deposit Guarantee System in Ukraine, funding sources, restrictions and main problems of the Deposit Guarantee System in Ukraine. There are following directions to resolve the existing problems:

- development and approval mechanism of interaction between the participants of financial system safety net at the state level, which would take into account not



only the deposits compensation order and withdrawal of insolvent banks from the market, but also minimize moral hazard, include management of market discipline and prudential regulation and supervision;

- development of the corresponding resolution of the Cabinet of Ministers of Ukraine, which would regulate the financing from the Cabinet of Ministers of Ukraine and provide irrevocable contribution from the state budget;

- mandatory membership in the DGF of the state Bank “Oshadbank” and credit unions;

- diversification of the DGF investments by placing funds in the highest rating foreign assets (for example, foreign banks or foreign countries government securities);

- additional measures to raise awareness on the Deposit guarantee system to prevent panic in a crisis, as well as increasing the confidence of depositors in the banking system.

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