

Evaluation of the consequences of implementation of the Directive 94/19/EC on deposit insurance systems in the Republic of Lithuania

Introduction

This work has been performed with the goal to define the effects on Lithuanian banking sector and the country's economy, caused by implementation of the European Union Directive 94/19/EC on deposit insurance systems, and to define the measures to amortize the possible negative effects. Lithuania is asking for a transition period until December 31, 2007 to implement the Directive. This process is aiming at harmonization of the Lithuanian deposit insurance system to have it integrated into EU legal norms. At the same time, the Directive requires to insure not only the population deposits, but deposits of the legal persons as well as deposits in all types of credit institutions, to increase insurance amounts and compensations. This is directly influencing the competitive power of Lithuanian banks and branches of foreign banks operating in Lithuania, solvency of the Deposit insurance fund (DIF) in the case of bankruptcy of a credit institution, and implementation of rational insurance levels. This work seeks to evaluate the consequences of these integration factors and to present recommendations on feasibility of measures to amortize such consequences.

The goal of the Directive 94/19/EC is to equalize the conditions of credit institution deposit insurance in the single market of EU.

The following features of the deposit market will be influenced by implementing this Directive in Lithuania:

- the insurance sum is increased gradually over a specific period until the level set by the Directive;
- the relation of the insurance sum and per capita will change;
- the insurance conditions will be equalized for the Lithuanian banks and foreign banks operating in Lithuania;
- the insurance premium might be reduced.

Apart from the above, there would be a need to evaluate such factors as the internationalization of the Lithuanian banking sector and removal of limitation to freely provide services in the boundaries of European Union.

The following entities shall be influenced by the Directive:

- deposit market members – banks and credit unions;
- deposit insurance institution – the Deposit insurance fund;
- customers – depositors.

1. Principal requirements of the European Parliament and Council Directive 94/19/EC “On deposit insurance systems”

This part of work lists the principal requirements of the Directive.

2. Principal provisions of the Law of the Republic of Lithuania No.IX-192 on deposit insurance

Here the new Law on deposit insurance in Lithuania, which has been adopted on the February 27th, 2001 by the Seimas, is discussed. This law replaces the former law on population deposit insurance, which has been in power since 1996. The most important new issues set by the law are:

- introduction of deposit insurance for legal persons and enterprises who do not hold the status of a legal person;
- introduction of deposit insurance in credit unions;
- a schedule to reach the maximum compensation sum of EUR 20,000 as set by the Directive;
- the premium percent and its calculation are similar to EU countries;
- application of transition period.

3. A comparison of the Lithuanian law on deposit insurance and provisions of the EU Directive

The comparison shows the exact or near-exact matching between all the principal issues in deposit insurance, with the exception of one issue – compensation sum, to achieve which Lithuania is asking for a transition period until December 31, 2007.

4. Deposit levels in Lithuania and other countries

In 1998, Lithuania, as compared to other countries – EU candidates (11 countries: Lithuania, Slovenia, Czech Republic, Slovakia, Croatia, Hungary, Poland, Estonia, Romania, Bulgaria, Latvia), had the fourth lowest average of individual deposits, but fourth largest maximum level of insurance and largest relative level of coverage. The consequences for this had been high requirements for initial size of DIF capital, and high premium percentage (1.5%). After some time, and in particular regarding that these figures had been introduced after the banking crisis of 1995-1996, these measures have paid off (as evaluated in 2000): individual deposits had doubled (in EUR), and the premium percentage had dropped to less than 0.5%.

On the other hand, the growth of deposits in Lithuania, as compared to other candidate countries, has been slower. In 1998 Lithuania held 8th place by average deposit per head of population, and in 2000 – only 10th place. The conditions of deposit insurance in Lithuania have been the best among the Baltic countries; however, the growth of average deposit per head of population had been the slowest. This may point to a conclusion that conditions of deposit insurance are not the most important factor for deposit growth.

5. Trends and forecasts of deposits in Lithuanian credit institutions

There has been a stable growth of deposit market in Lithuania after the banking crisis in 1995-1996, albeit slower than in neighboring countries. This period has seen an advent of branches of foreign banks, which started operating in Lithuania. Although

the deposit volumes in the branches of foreign banks have been growing relatively faster than in Lithuanian banks, this can be mostly explained by aggressive marketing campaigns on entering Lithuanian market. Data on deposit growth in two of the foreign bank branches in Lithuania – Polish bank Kredyt Bank S.A. and German bank NordLB – are presented.

The presented forecasts of deposits in Lithuanian credit institutions show that rates of the deposit growth should increase, and, though growing slower than in the branches of foreign banks, by their absolute meanings deposit levels should considerably exceed deposits in the branches of foreign banks. In attracting customers to deposit services, their choices are influenced by various factors: bank image, branch network size, interest levels, reliability, pricing of services and others.

The average deposit in Lithuania at the end of the year 2000 has been at LTL 1751.75, and the forecasts show that until the year 2004 this figure should reach LTL 2723.22, at the end of the year 2007 – LTL 5141.69.

Based on the above findings, it can be concluded here that during the transition period for the full implementation of the Directive 94/19/EC from January 1, 2004 until December 31, 2007, the different conditions for deposit insurance between Lithuanian and foreign credit institutions should not significantly influence the Lithuanian deposit market and its competitive environment.

6. Relation of insurance premiums and insurance sums to EU countries and candidate countries

The insurance premiums set the costs of deposit insurance to the country's banking system. The insurance sums define the level of depositors' demands satisfaction in a given deposit insurance system. The relation between insurance premiums and insurance sums should be balanced, and should allow comparing different deposit insurance systems. Data on this relation are presented for EU countries and candidate countries. For all these countries, the insurance premium percentage is lower than in Lithuania.

An important issue is to include deposits of legal persons, and especially small and medium enterprises, into the new deposit insurance scheme, and this is provided by the new law on deposit insurance. The absence of enterprise deposits from the insurance scheme has been one of the reasons why the Lithuanian banking sector has been lagging behind those of other Central and Eastern European countries.

Forecasts on the volumes of insured deposits and insurance payments for the years 2001-2008 are presented, and a relation has been drawn between the level of insurance premium percentage and insurance cover as compared to bank profits. After introduction of free provision of services, Lithuanian banks should worsen their competitive position because of the high costs incurred by high insurance premium percentages. On the other hand, possible reduction of the insurance premium percentage should equalize the effect on costs between credit institutions. But, as shown in the chapter 8 of this work, even at the current premium level of 0.45% the capital adequacy of DIF will reach acceptable levels only after 2009. This is the

reason why it should be recommended to maintain the existing insurance premium levels.

7. Effects of the Directive on the market participants

Possible positive and negative effects of the implementation of the Directive are discussed separately for credit institutions, the DIF and depositors themselves. The driving forces for these effects to all the above entities are the same: higher insurance coverage, expanded base of eligible depositors and deposit types, possible reduction of the insurance premium percentage. The positive effects are the boost to insurance market by introducing better guarantees to depositors, and inclusion of additional depositors and deposit types into the insurance scheme, also the more level competitive conditions for Lithuanian and foreign credit institutions. The negative effects are the possible imbalance between insurance sum and the premium percent, which can directly influence the costs and prices of banking services. Among the indirect economic consequences, it is noted that changes in deposit insurance conditions, acting together with other growth factors, should attract additional money into the credit institutions and eventually into the country's economy. On the other hand, the growing economy should stimulate the emergence of assorted investment instruments, thus driving away some of the money from the deposit sector.

8. The necessity for the transition period

The expansion of the insured deposit base by the new law on deposit insurance is increasing the DIF capital adequacy requirements, which can be met only over a longer period of time. The International Monetary Fund has recommended that the relation of insurance cover to per capita should be in the region of 1.5 – 2. The presented calculations show that without the transition period this relation would jump to 5.14 in the beginning of the year 2004, thus jeopardizing the deposit insurance system. With the transition period, this relation should grow to 3.80 in 2009, and then should start gradually falling because the per capita should continue growing, and the payout level would be constant by then.

9. Evaluation of the duration of the transition period

The presented analysis shows that the required transition period until December 31, 2007, under forecasted conditions is not exactly optimal in terms of capital adequacy of the DIF. The fund is going to have adequate capital to remedy the bankruptcy of a medium-sized bank only in the years 2009-2010. At the same time, the DIF capital deficit of LTL 126 million in 2008 and LTL 50 million in 2009 is not that much critical, because it is likely that DIF will find financing sources and will be able to borrow about LTL 130 million in the Lithuanian financial market for the period of about three years. As well, the relation of insurance cover to per capita (which is recommended by the IMF to be considered rational in the region of 1.5 – 2) should be around 4.35 in the year 2008, or not exactly adequate. Considering the duration of the proposed transition period, this should press to maintain the current level of the insurance premium.

Conclusions

The conclusions of the work can be grouped into few main directions.

1. The requirements of the EU Directive 94/19/EC “On deposit guarantee schemes” are met in most of their aspects in the Lithuanian deposit guarantee scheme, whose activities are regulated by the Law on deposit insurance of the Republic of Lithuania.
2. The Lithuanian deposit market is lagging well behind those of the EU countries, and is among weakest in the candidate countries. However, the deposits are growing with increasing rate. The analysis has shown that deposit insurance is not the most important factor in stimulating the deposit growth. The presence of the foreign bank branches in Lithuania does not show any significant influence to the deposit market, and if the transition period is to take place, this presence and the different conditions of deposit insurance should not influence the competitive climate significantly.
3. The direct effects of the implementation of the Directive are the increase of the insurance cover to match the EU level of EUR 20,000; inclusion of deposits of legal persons, deposits in other financial institutions and various types of deposits into the insurance scheme, and the possible reduction of the insurance premium percent. The indirect effects will include the boost of the deposit market, but transition period is required to soften the effects on DIF solvency.
4. The DIF capital adequacy issues should be given priority when considering the role of the Directive to the deposit market. The current insurance premiums should be maintained at their present levels until the year 2009. This would strengthen the position of the Lithuanian deposit insurance scheme among the candidate countries.