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Foreword

Estonia's undeniable economic success has risen a number of questions. Is the present fast growth also sustainable? How great is the risk of economic overheating? Is our loan burden already too high for us? What is Estonia's economic situation like in comparison with other European Union Member States? And what to think about the developments in the real estate market in light of all that?

There are no simple and straightforward answers to these questions. Neither does the present issue of Kroon & Economy provide clear-cut answers. Nevertheless, it offers background information that might be of some help to the readers to draw their own conclusions.

First, Estonia's housing market is analysed and the structure of our housing stock is compared to that in other European Union Member States. Then the household loan growth is studied across European countries. Last but not least, different issues related to the deposit insurance framework will be discussed.

THE STRUCTURE AND DEVELOPMENT OF THE ESTONIAN HOUSING MARKET

Raoul Lättemäe, Krista Touart

According to the Statistical Office, the estimated number of dwellings in use in Estonia was 633,000 in early 2006. Majority of these (96%) belong to private persons. The number of population considered, Estonia enjoys a rather good position among the other European countries for the number of dwellings. However, significant differences in statistics and in the composition of the housing stock should be taken into account when drawing any conclusions. The present article provides an overview of recent developments of the Estonian housing market, and analyses the housing stock structure compared to other EU Member States.

THE SITUATION OF THE HOUSING STOCK IN ESTONIA

There is an average of 28 square metres of dwelling area per resident in Estonia. This is somewhat less than in the old EU Member States (about 35–45 square metres), but the indicator slightly exceeds the average of the new Member States. Regarding the average size of a housing and the number of rooms, we may observe a similar structural difference between the old and new EU Member States: in the old EU Member States the average area of a dwelling is about 90–100 square metres and the dwelling typically has 3 or 4 rooms, whereas in Estonia (and in the other new Member States) the respective indicators are 60 square metres and 2 or 3 rooms (see also Figure 1). While the membership of a household is rather similar in these countries, Estonian residents have somewhat tighter conditions than a Western European person. Given the rise in the standard of living and increasing opportunities, requirements to the quality of dwellings will presumably grow as well. This may be observed in the structure of new buildings in Estonia where the “average indicators” of a new dwelling are 89 square metres and four rooms, respectively.

The distribution of the housing stock by the type of dwelling shows that about three quarters of the Estonian dwellings are in apartment blocks, and a quarter in detached houses. The relatively high share of apartments in the Estonian housing stock stems from the structure of construction during the Soviet period, when the goal was to build large concrete apartment blocks. In comparison with Finland or Sweden, our northern neighbours, where detached houses account for 40–45% of the housing stock, there are considerably more apartment blocks in Estonia. Today, however, we may detect a shift in the housing stock structure of new buildings towards that characteristic of the Nordic countries.

The results of the Population and Housing Census in the year 2000 show that the ratio of new buildings in the age structure of the housing stock in Estonia is fairly low – dwellings of up to 15 years of age only account for 5.3% in the total Estonian housing stock according to estimates. The ratio of newer buildings in the existing housing stock in the Baltic States (in Latvia 3.7% and in Lithuania 6.3%, respectively) remains in the bottom group of the EU countries (see Figure 2). A third

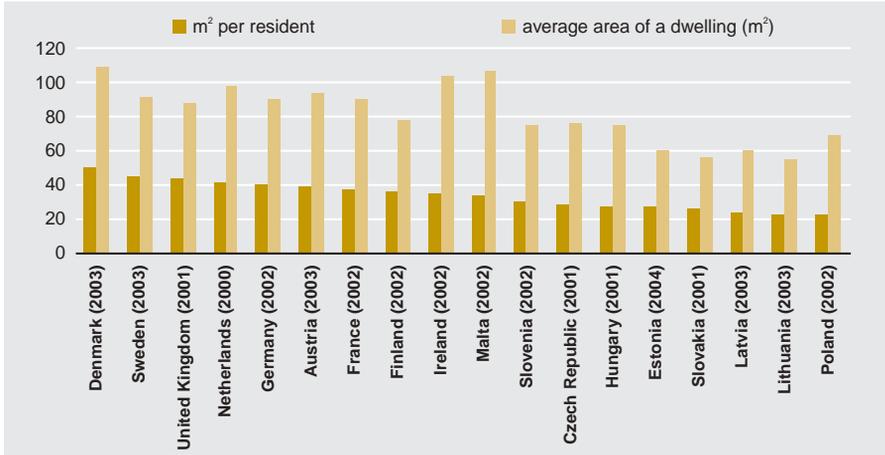


Figure 1. Average area of dwellings in the European Union

Source: Housing Statistics in the European Union (2004)

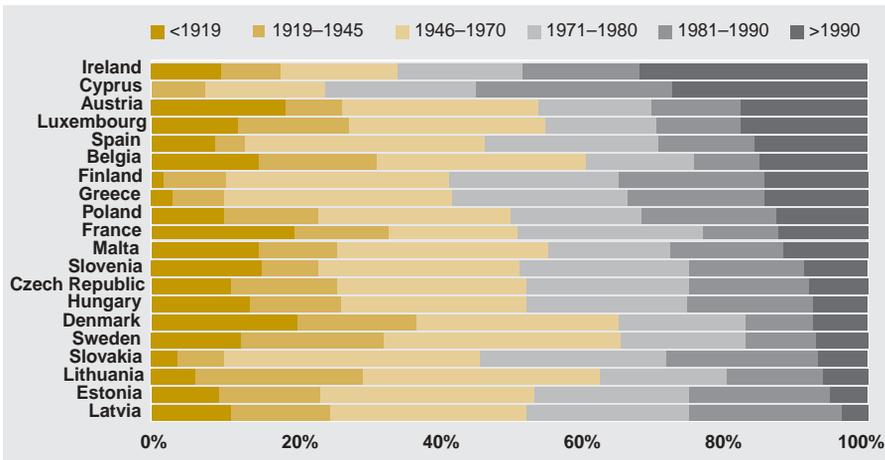


Figure 2. Age structure of housing by year of construction in the European Union

Sources: Housing Statistics in the European Union (2004)

of the Estonian dwellings are apartment blocks built during 1971–1989. The relatively large volume of construction over a short period also necessitates a surge in demand for renovation when these blocks get nearer to the end of their useful life.

The quality of housing in Estonia, as well as in other Baltic States, remains well below the EU average level. The infrastructure and communications do not meet modern requirements. Over a fifth of the Estonian dwellings do not have a flush toilet and hot running water or a shower/bathroom, while in the old Member States the share of such dwellings is just a few per cent.

Therefore, the existing housing stock in Estonia comes of lower quality, compared to the developed EU Member States: dwellings are smaller, older and may also have poorer technical communications, and the share of apartments is higher. The income growth is obviously accompanied by demand for better housing and the quality of the housing stock will also increase. The situation of the housing stock in Estonia is still more or less comparable to the rest of the new EU Member States. Thus, in the long term the development of the Estonian housing market should not differ considerably from the development of Central and Eastern European countries.

EARLIER DEVELOPMENTS IN NEW HOUSING

On the basis of the statistics of residential construction and the age structure of the housing stock it can be concluded that between 1919 and 1945 an average of 3,000–3,300 new dwellings (192,000 square metres) were built annually. Considering also the dwellings that became unfit for human habitation over the same period, the actual volume of construction may have well been 10–15% higher.

The volume of residential construction gradually picked up during the period of Soviet occupation: in 1946–1959 on average about 4,200 new dwellings (231,000 square metres) were built each year. Residential construction peaked between 1960 and 1990, when an average of 13,000 new dwellings (approximately 700,000–800,000 square metres) were built annually. This mainly reflected in the construction of new residential districts (mostly apartment blocks), but also features demographic factors related to massive immigration.

After regaining independence in the early 1990s, the volume of construction declined by over 15 times for a whole decade: the volume of construction reduced from earlier 12,000–14,000 new dwellings a year to 2,000 in the early 1990s, and in the late 1990s to 900 new dwellings a year (275,000 and 103,000 square meters a year, respectively). There are several reasons for the huge drop in the construction volume in the 1990s: from uncertainty and difficulties of financing construction in the transition period to slow privatisation and land registration processes, and ownership disputes. The low period continued in the early years of the new millennium: according to the official statistics in 2001 merely 619 new dwellings were put into operation, which is about 25 times less than in the peak years.

We should also mention demographic factors in regard to the developments of the new dwelling construction. In the early 1990s, the number of population stood at 1.57 million, which had decreased to 1.34 million by the beginning of 2006. The drop in residential construction is remarkable even

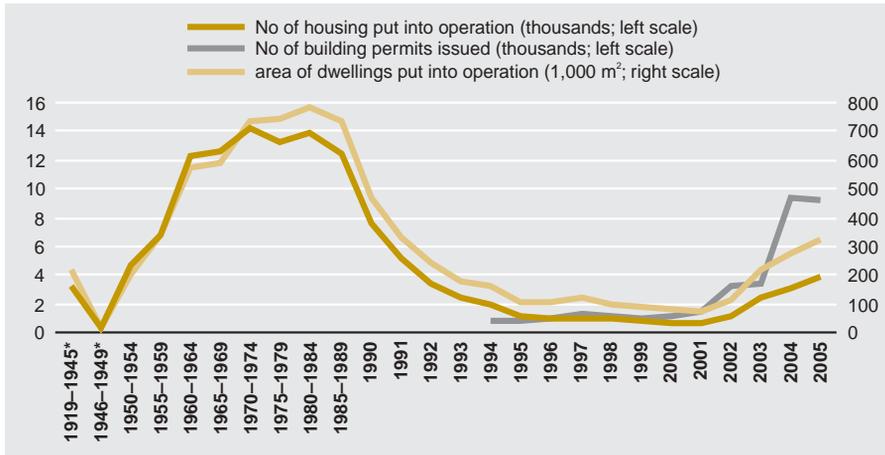


Figure 3. Average annual volume of construction of new housing during 1919–2005

Source: Statistical Office, authors' calculations

* According to estimates.

without the demographic factors: in the 1970s nearly 1,000 new dwellings per 100,000 residents were built a year, whereas in the early years of the new century the respective figure was only 50, and 230 in 2004. At the beginning of the previous century, the size of Estonia's population was about 1.1 million; today, residential construction per 100,000 residents remains below 270, the respective figure of that time (however, higher today on the basis of square metres).

RECENT TRENDS IN RESIDENTIAL CONSTRUCTION

The construction of new housing gained impetus in 2002. Regarding the present situation of our housing stock, an increase in the construction volume in the recent years was to be expected. The growth in the volume of new housing has been facilitated by cheaper credit and better loan conditions. Recent developments in residential construction have been affected by a hike in the prices of existing standard apartments in 2003 and in the first half of 2004, which has decreased the gap between the prices of older and new dwellings. Owing to income growth and the above factors, more and more households could afford to purchase a new dwelling and that brought along a considerable increase in the supply of new dwellings. By 2005, the number of dwellings put into operation reached 3,928. This figure slightly exceeds the volume of construction in the pre-occupation period, but remains significantly below the levels of construction from 1960s to 1990s.

Seemingly, the growth in construction has been very rapid in the recent years (since 2002) but actually, it accounts for merely 1.7% of the entire housing stock. Our indicators are rather modest compared to other countries. In Austria, for instance, the share of new buildings in the housing

stock was 5% in 2003 alone. At the same time, we should draw attention to the fact that most of the new structures have been built in Tallinn and Harju County. Comparing the data on new buildings and the stock of apartments in Tallinn, the construction volume in Tallinn formed 2.2–2.4% of the housing stock in 2005.

As for the volume of new housing, it should also be considered that part of that is necessary to maintain the housing stock at its current level, that is to compensate for the dwellings which have become unfit for human habitation. In order to attempt to evaluate such compensatory construction volume on the basis of our experience, we can conclude – when comparing earlier construction volumes with the statistics on the age structure of the housing stock in 2000 – that 6.8% of the dwellings built in 1961–1970 and 6.0% of the dwellings built in 1971–1980 had been removed from the housing stock by the year 2000. The statistics from the 1990s cannot be analysed in more detail here since more dwellings from that period are in operation than were built according to the official statistical data¹.

With certain allowances for the statistics from the 1960s to the 1980s, the average annual rate of removal from the housing stock (up to 35 years old) is about 0.2%. This figure seems somewhat underestimated, as in that case the useful age of the housing stock should be 500 years, that is nearly ten times more than considered normal for those dwellings back then. In the overall context, the 500-year replacement cycle need not be totally ruled out; moreover so that in international comparison there are lower as well as higher removal rates.

Therefore, given the fact that from the 1990s the volume of new buildings has been below 1% of the housing stock and even less than 0.2% during 1995–2002, we can claim that the situation of the Estonian housing stock has worsened over the last decade. In other words, the supply of new dwellings since the 1990s has probably not compensated for the removal of dwellings unfit for human habitation from the housing stock. Official statistics does not support this statement outright, since the growth in the volume of the housing stock precisely matches the volume of residential construction according to the statistics. As for statistics, probably the case is that the volume of the housing stock is assessed over a longer period, and statistics for the interim years is provided as estimates. Therefore, the growth in new buildings does not necessarily signify over-investment in the housing stock caused by an overheated real estate market, but also refers to an aging housing stock.

STRUCTURAL CHANGES IN THE ESTONIAN HOUSING STOCK DUE TO NEW BUILDINGS

There are a few differences when we compare the structure of new buildings and the existing housing stock. Before the Soviet occupation nearly 70% of new housing comprised (farm)houses

¹ According to the construction statistics about 17,700 dwellings were built in 1991–1999, but in 2000 the housing stock actually included a total of 23,100 dwellings built in the same period.

or multi-family houses, and from 1960 to 1990 nearly 90% were apartment blocks, but by mid-1990s the share of detached houses in total residential construction again rose to 85%. In 2004, multi-family houses accounted for about 35% of new dwellings. Thus, today about two thirds of new dwellings are provided in apartment blocks. There is a similar difference in the size of dwellings: before World War II the estimated area of a dwelling was 67 square metres, whereas during the occupation period the average new dwelling was 45–55 square metres. By now, the average area of new dwellings has grown to over 80 square metres. This indicates that since regaining independence the trend in Estonia's residential construction is towards larger dwellings, detached houses and smaller apartment blocks.

Regarding structural changes in the type and size of new dwellings and assuming that the supply of new buildings has met the demand in recent years, we may suppose that the **housing stock inherited from the Soviet times and based on small apartments in large blocks built from the 1960s to the 1990s, does not meet the structure of the housing demand today.**

HOUSEHOLD LOAN GROWTH IN EUROPEAN COUNTRIES: COMPARING THE INCOMPARABLE

Jana Kask

In recent years, the rate of loan growth has been very fast in several countries across the world. Inevitably, a question arises as to whether such growth is sustainable also over a longer period and how does it affect the macroeconomic stability of a country. Changing economic cycles have given ground to raise primarily the issue of corporate credit growth. The possible negative impact of increased household lending on the vulnerability of the economy, particularly in transition economies, has been somewhat overlooked. Meanwhile, understanding household credit growth trends along with accurate risk estimates also contribute to the assessment of corporate, and more generally, macroeconomic risks as well as anticipation of potential problems. Therefore, the following article analyses household loan growth in different European countries.

Whether loan growth in a country is overly fast or not is often defined on the basis of simple international comparisons. Comparison of reference data proceeds from the presumption that credit growth in rapidly developing countries has to be considerably faster as it contributes to the convergence of income levels between countries. But factors affecting loan growth vary across countries and therefore, simple international comparison might not provide sufficient support for substantiating one's standpoints and evaluations. This article compares the most widely used loan growth indicators between European countries with different income levels and indicates possible (intentional or unintentional) interpretation errors, which may easily occur when analysis is too one-sided or if relevant credit growth factors are not taken into consideration.

DIFFERENT POSSIBILITIES FOR COMPARING DEBT LEVEL AND LOAN GROWTH

Loan growth rate

The most frequently used indicator when analysing the financial behaviour of households is the rate of loan growth, which shows the percentage change in the loan stock of a country's households from the year before. If the loan stock serving as the reference basis is small, then the otherwise relatively modest nominal loan growth can show very fast annual growth. Consequently, it is not surprising that the loan growth in many transition countries with very short credit histories has been very fast.

Estonian households' credit growth that accelerated to nearly 60% was one of the fastest in Europe in 2005. Growth was faster only in other Baltic States, and Romania and Bulgaria (see Figure 1). Meanwhile, loan growth in several other Central and Eastern European (CEE) countries remained several times slower. For instance, the loan growth rates of Hungarian, Polish and Croatian households were practically similar in proportion to those of some older EU Member States and the Nordic countries – though these were namely the countries with the fastest growing loan markets in the EU-15. Among the countries with a longer history of market economy, the rate of household credit growth at the end of 2005 exceeded 20% in Ireland, Iceland and Spain (29%, 23% and 21%, respectively).¹

¹ Sources: national central banks, Eurostat, EcoWin.

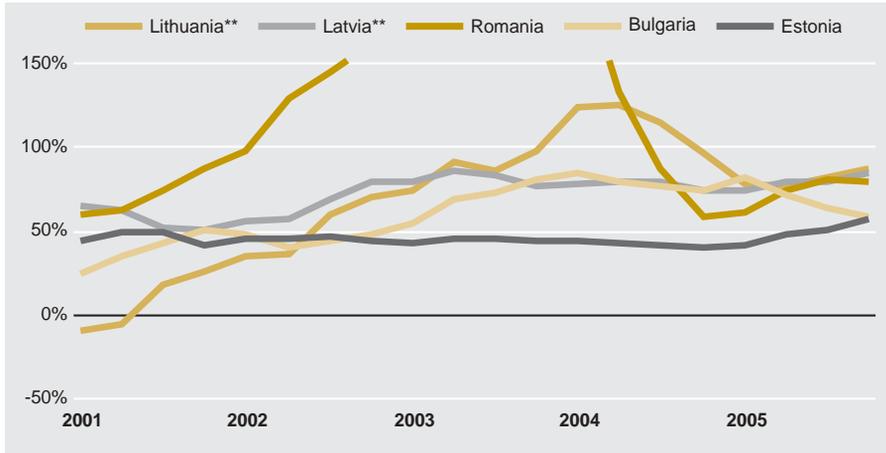


Figure 1a. Selected CEE countries with faster loan growth rate

Sources: national central banks, Eurostat, EcoWin

** leasing excluded

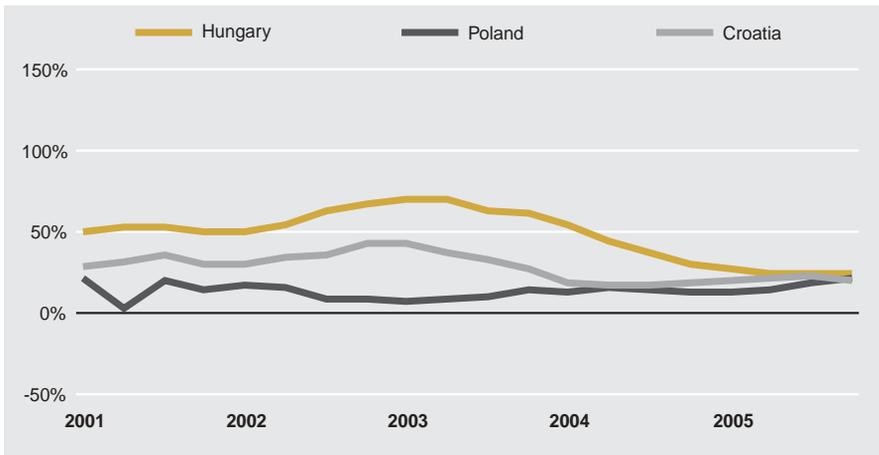


Figure 1b. Selected CEE countries with slower loan growth rate

Sources: national central banks, Eurostat, EcoWin

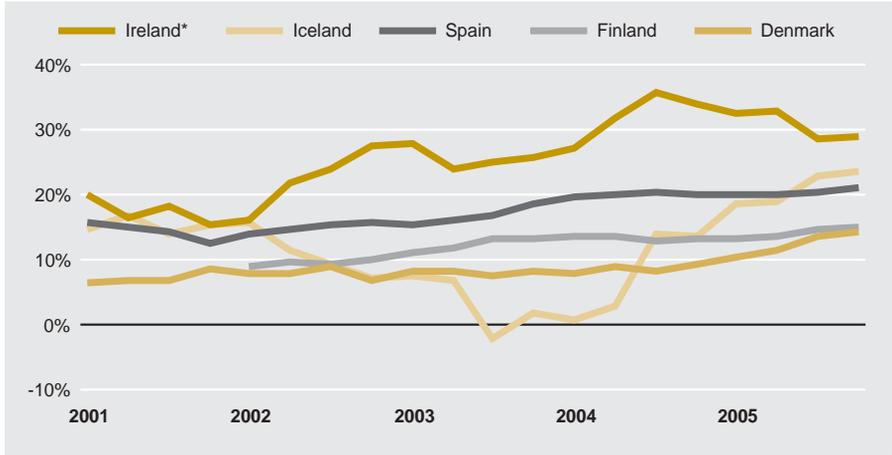


Figure 1c. Selected EU-15 and Nordic countries with faster loan growth rate

Sources: national central banks, Eurostat, EcoWin

* real estate loans

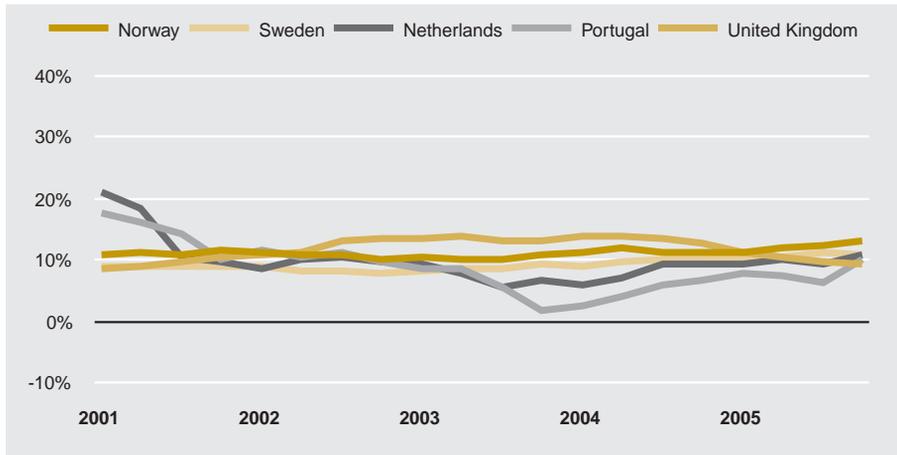


Figure 1d. Selected EU-15 and Nordic countries with slower loan growth rate

Sources: national central banks, Eurostat, EcoWin

Debt-to-GDP ratio²

Another important indicator for evaluating credit market developments is the debt-to-income (or debt-to-GDP) ratio. This is an indicator often used for measuring the level of financial deepening³ in a country, which shows how developed the country's financial markets are and how actively economic agents participate in the financial intermediation process.

The level of household indebtedness in the new EU Member States and candidate countries remains relatively low considering the level of income in these countries. While the average household debt-to-GDP ratio in the developing European markets remained below 20% at the end of 2005, the respective indicator for developed countries was over four times higher (see Table 1). Given the large disparities in levels, it is in every respect logical that along with the development of financial markets growth has been faster in countries with lower indebtedness. However, comparing countries with relatively similar development level (i.e. within the CEE or EU-15), the existing data do not provide a definitive (short-term) correlation between the level of debt and the rate of credit growth. Notably, there are exceptions that prove the rule where the rate of loan growth has remained fast regardless of the high level of indebtedness, e.g. in Estonia and Denmark. In order to explain such a development, loan growth factors (incl. the structure of the financial market and the housing market as well as loan conditions) and respective changes over time should be studied more closely.

Increase in indebtedness

In order to evaluate the pace of financial deepening the analyses of the loan growth rate and the debt level are often combined. The easiest way to make credit growth rate comparable across countries is to use different ratios based on flow indicators (e.g. loans taken during a period in ratio to the GDP of a period), which help level off the base effects arising from different development levels of credit markets. Also, when analysing the levels of indebtedness one must, upon interpreting the results, definitely take into consideration that the traditional (i.e. stock-based) debt indicator does not reflect substantive differences in the development of the indicator. In other words, when comparing indebtedness, the debt levels that have accumulated either gradually or extremely fast (e.g. during the past 50 or 10 years, respectively) are compared. Moreover, the traditional debt indicator overlooks periods of faster and slower or even negative credit growth and the life cycle of a loan.

Arpa, Reiniger and Walko (2005)⁴ showed that if the debt indicator is constructed so that both the numerator and the denominator contain flow-flow indicators, the differences in indebtedness

² When calculating indebtedness, it is essentially more correct to use the households' disposable income indicator in the denominator of the ratio, especially as the differences in the GDP structure may vary greatly across countries. However, since most countries do not publish the disposable income indicator sufficiently regularly, this analysis is an attempt to make the debt levels of different countries comparable to each other with the help of the nominal GDP indicator.

³ Financial deepening refers to financial sector development usually measured as a ratio of a certain indicator characterising the size of the financial sector (e.g. the volume of assets held by financial intermediaries, the volume of loans issued by financial intermediaries) to GDP.

⁴ M. Arpa, T. Reiniger, Z. Walko "Can Banking Intermediation in the Central and Eastern European Countries Ever Catch up with the Euro Area?" Oesterreichische Nationalbank, Focus 2/05.

Table 1. Volume and growth indicators of household debt at the end of 2005

	Debt burden (debt-to-GDP ratio)	Loan growth rate	Increase in debt burden (percentage points)
Estonia	32%	57%	8.3
Latvia**	28%	84%	9.6
Hungary	23%	25%	3.3
Bulgaria	17%	58%	5.1
Poland	15%	22%	2.0
Lithuania**	13%	87%	5.2
Romania	7%	80%	2.6
Average of the selected CEE countries	19%	59%	5.2
Iceland	109%	23%	13.0
Denmark	109%	14%	8.0
United Kingdom	96%	9%	4.9
Netherlands	83%	11%	6.1
Norway	75%	13%	1.5
Spain	72%	21%	7.8
Portugal	67%	10%	4.3
Sweden	67%	11%	4.3
Ireland*	59%	29%	9.6
Finland	44%	15%	4.4
Average of the selected EU-15 and Nordic countries	78%	16%	6,4

Sources: national central banks, Eurostat, EcoWin

* real estate loans

** leasing excluded

between the CEE and the euro area countries are significantly smaller than with the commonly used debt indicator combining stock-flow indicators. Nevertheless, in order to achieve the level of indebtedness comparable to the euro area countries, the indebtedness of the CEE households must grow consistently faster than the euro area average of the past ten years.

Hence, the intensity of loan growth can be assessed on the basis of the increase in indebtedness, i.e. by how many percentage points the debt-to-GDP ratio increased during a certain period⁵. According to that measure, Iceland stood out in 2005 for particularly fast financial deepening with household indebtedness growing 13 percentage points against the background of 23% credit growth (see Table 1). As regards the Baltic States, Latvia witnessed the fastest growth with indebtedness increasing by 9.6 percentage points year-on-year. Meanwhile, Lithuania's

⁵ Theoretically, the most appropriate indicator would be the ratio of the period's loan turnover to income. However, since the loan turnover may include refinancing of earlier loans, calculations based on that indicator are not adequate for assessing the convergence of debt levels.

indebtedness grew much more modestly (5.2 percentage points) despite fast credit growth. The situation was similar in Bulgaria and Romania (5.1 and 2.6 percentage points, respectively). An interesting trend was the acceleration of indebtedness in Denmark and the Netherlands, where the levels of indebtedness are already among the highest in Europe. In Denmark, for example, indebtedness went up as much as in Estonia (8 percentage points), while in the Netherlands the growth was the most robust seen in the past five years (6.1 percentage points). Indebtedness also increased very fast in Ireland (9.6 percentage points) and in Spain (7.8 percentage points).

While 2005 marked a period of fast financial deepening for most countries, the increase in the indebtedness of several European countries had been significant also in earlier years (e.g. 6–8 percentage points in Norway in 2002; 6–7 percentage points in the United Kingdom in 2003–2004; 5–7 percentage points in the Netherlands in 1997 and 7–8 percentage points in 2000).

An analysis of the increase in indebtedness over a longer period provides interesting insights. For example, during the past five years the countries with the fastest increase in household indebtedness have notably been older European Union Member States. In Ireland, the United Kingdom, Spain and Denmark indebtedness increased more than 20 percentage points in five years (see Figure 2). So far these countries have outpaced Latvia and Estonia, which have the most robustly growing credit markets among the new Member States. In the coming years the new Member States will probably be capable of breaking these records since the growth in household indebtedness in this region has significantly accelerated in recent years.

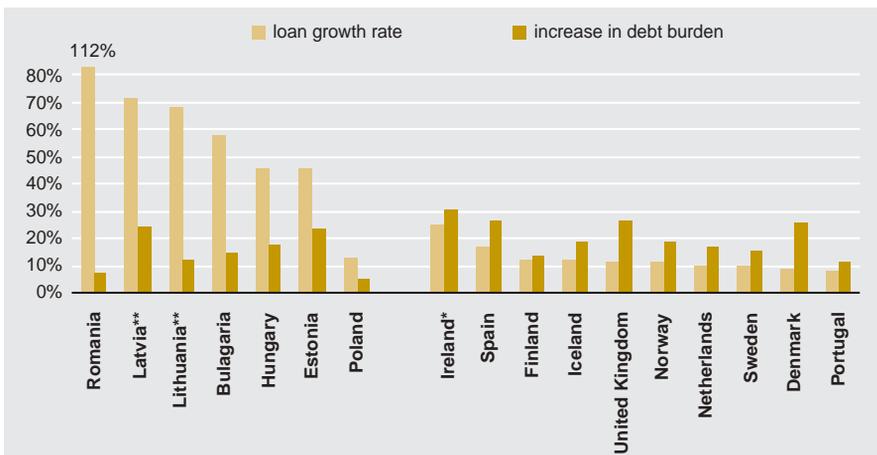


Figure 2. Average growth rate of household loans and debt burden during 2001–2005

Sources: national central banks, Eurostat, EcoWin

* real estate loans
 ** leasing excluded

Other indicators

Although the three indicators described above are very convenient for obtaining a quick overview of the size a country's household indebtedness and the respective growth rate, these indicators do not show in any way how vulnerable households are owing to their loan commitments. Therefore, besides the debt level also the size of loan servicing costs and respective changes need to be analysed. One indicator used for that purpose is the interest ratio or interest rate burden, which is expressed as the ratio of households' interest payments to disposable income. Since the share of families that have taken loans is much smaller in the CEE countries compared to the European countries that have higher income levels, presumably also the ratio of loan-servicing cost to disposable income is relatively smaller in the CEE countries.

When assessing the loan-servicing cost and the debt level it is important to take into consideration local credit market conditions. For example, if longer than average (housing loan) maturities feature in a country, this means that households can increase loan volumes without increasing their loan-servicing cost. In other words, a 10 percentage point rise in indebtedness might not necessarily bring along increased vulnerability of the household sector in case credit conditions for new and current borrowers have improved respectively. However, while such an interpretation allows to somewhat ease the financial stability risk assessment, risks to external balance and macroeconomic balance arising from fast credit growth still persist.

Besides the debt indicators used for analyses covering the economy as a whole, it is also important to assess micro risks at the single household level since the aggregated sector level data do not sufficiently reflect households' ability to repay loans on time and without problems. This means that a macro analysis does not provide for a sufficiently detailed evaluation of the prospects as to whether a borrower's income and the value of his/her financial and real assets (incl. real estate) are maintained and grow. Loan-servicing risks manifest differently across population groups. Those borrowers who along with current consumption do not forget saving are certainly better protected against negative economic cycles or personal setbacks.

CONCLUSION

Several new EU Member States have been blamed for overly fast loan growth. However, one should not forget that household borrowing entails several beneficial aspects in terms of macro economy, e.g. the smoothness of consumption, diversification of assets and broader investment opportunities. The important thing is that loan growth should be consistent with macroeconomic development. In recent years, loan growth in several countries across the world has been underpinned by very good global liquidity and favourable economic conditions that have also contributed to the sound financial situation of households and have spread optimism. If during such a boom households have made their loan decisions with deliberation and consideration for potential risks, then in the longer term fast loan growth need not lead to major backlashes against the economic growth potential in the future. There may still be short-term difficulties: for example a rise in interest rates may exert

pressure on the loan-servicing ability, bring down real estate prices or slow down consumption. Possible changes in investors' expectations of the sustainability of loan growth should not be underestimated either.

Estimates that are based solely on simple comparative analysis of credit indicators by countries do not offer any explanation as to what should be the appropriate loan market convergence rate for the new EU Member States as well as for the acceding countries. Even though loan growth indicators seem to be "unbearably" high in several CEE countries, alternative indicators evaluating changes in debt may lead to altogether unexpected conclusions and raise questions whether financial deepening has proceeded too slowly while inhibiting economic growth potential at the same time.

In order to fill in the knowledge gap in this exciting and fast-developing field of analysis, economists have started to tackle also the aspects of loan market convergence⁶. Looking for a so-called equilibrium indebtedness level and comparing national market developments against their respective equilibrium levels might be a solution that would enable to make "the incomparable comparable".

⁶ E.g. Kiss, Nagy, Vonnak (2006), Égert, Backé, Zumer (2006), Brzoza-Brzezina (2005), Boissay, Calvo-Gonzales, Kozluk (2005).

PROBLEMS RELATED TO THE EU FRAMEWORK FOR DEPOSIT GUARANTEE SCHEMES

Jaak Tõrs

According to the European Union Directive on deposit guarantee schemes, every Member State must have a deposit guarantee scheme in place. However, it has not been harmonised whether all deposits must be guaranteed or just those of small depositors. Besides, also the limit of coverage differs significantly across countries. In order to offset that, the topping-up instrument has been applied but the use of this option is complicated. The following article tackles these and other issues related to deposit insurance.

Banking has a special role to play in the functioning of the economy. It secures stable economic development with the help of different tools that can be generally called the safety net of the financial sector. This means that the banking sector has been licensed – banking institutions operate under licences issued to them – and is under the supervision of the Financial Supervision Authority. In addition, there is a crisis prevention and management framework in place, and deposit insurance constitutes a part of that. Besides securing financial stability, deposit insurance plays the role of consumer protection, as most deposit guarantee schemes compensate only the deposits of small depositors should a bank go bankrupt. Small depositors include private individuals and small companies that lack sufficient time and opportunity to assess credit institutions' solvency and risks.

With the aim of establishing common rules in the European Union, the **Deposit Guarantee Directive**¹ was adopted in 1994, which foresees that every Member State must have a deposit guarantee scheme in place. In Estonia, the Guarantee Fund performs this role, compensating deposits in case of a bank bankruptcy pursuant to the procedure prescribed by law. Similarly to banking supervision, deposit insurance has been built on the principle of the liability of the home Member State. This means that the Member State, which has given an operating licence to the bankrupt bank and which has been exercising supervision over that bank and its foreign branches, must through its deposit guarantee scheme secure compensation to depositors of a foreign bank branch.

The principles of cross-border division of tasks in deposit insurance as well as in other areas of the financial sector safety net have been agreed on the assumption that branches of foreign banks hold a comparatively small market share. In other words, these branches are not systemically important² from the point of view of securing the financial stability of the host country. The integration of the European Union banking market has the trend to transform bank subsidiaries established as separate legal persons into branches. Such a structural change **reduces the liability to compensate deposits for the deposit guarantee scheme of a host country and increases**

¹ Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit guarantee schemes.

² A bank is systemically important if its potential bankruptcy endangers the functioning of the entire financial system.

it for the home country. Such a development in the banking sector creates problems with the functioning of deposit insurance schemes and banking activities with regard to fair competition, consumer protection and cross-border co-operation.

The objective of the above-mentioned European Union directive is to secure harmonisation at the minimum required level. For that purpose, a harmonised minimum covered level of 20,000 euros has been agreed upon. Moreover, the directive stipulates which type of deposits are protected with some exclusion. In other words, the directive provides Member States with an option not to compensate deposits held by the government, large companies and financial institutions. Only fifteen Member States (incl. Estonia) have made maximum use of this option, i.e. they have decided to compensate only deposits held by small depositors.

One of the problems related to the development of cross-border banking and competition is the difference in the levels of deposit coverage. Three large and one small Member State differ greatly from the others in that respect. Namely, they apply a level of coverage two to five times higher than the minimum level provided for in the directive. At the same time, the topping-up instrument can be used to alleviate the problem. For example, if the limit of coverage in a branch is lower than that in other banks, several schemes offer the possibility to additionally cover the difference arising from the coverage levels of the two schemes. However, it is difficult to make use of this option, as reflected by the fact that only some 20 branches have applied the topping-up instrument, whereas the number of branches operating in other countries is relatively large. In order to promote the free movement of services and the development of cross-border banking, it would be reasonable to **agree upon a single coverage limit and eliminate the complicated topping-up instrument.**

Even though the directive provides requirements for cross-border co-operation regarding deposit guarantee schemes, particularly in the field of information exchange, from the consumer's point of view it is difficult to receive compensation from several different places. Such co-operation is further complicated by the fact that five Member States have more than one deposit guarantee scheme in operation.

The plan of the Nordic banking group Nordea to transform subsidiary type group into branch type group raised an issue concerning the different ways of funding the deposit guarantee schemes. Member States use schemes based on ex-ante or ex-post financing as well as a mix of these two. **Ex-ante financing** means that banks make regular payments into the scheme prior fixed for a certain period, i.e. funds are collected in advance over a longer period. In case of **ex-post financing**, the amount of payment into the deposit guarantee scheme is calculated on the basis of the sum needed for paying compensations after the bankruptcy of a bank. **Mixed funding** is a combination of these two options. Most Member States use ex-ante funding that provides better security for the functioning of the scheme as well as for banks. With ex-ante funding banks need not bear large expenses at a time in the form of payments into the scheme.

Nevertheless, the ex-ante scheme might cause problems if a banking group wants to transform a subsidiary into a branch and if that subsidiary is relatively big compared to the banking sector in the country of the parent bank. As a consequence, the ex-ante funding scheme might be under-financed for some time since the inclusion of the deposits held by the subsidiary in guaranteed deposits leads to a hike in the volume of guaranteed deposits. On the other hand, upon changing the scheme banks might have a justified expectation to take along the funds already paid into the scheme yet not used for paying compensations. As it has not been harmonised whether payments are transferable or not when changing the scheme, different practices in Member States might lead to a situation where banks that have joined some deposit guarantee scheme must increase payments due to the under-funding of the scheme. Thus, the diversity of funding methods raises the question how to assure a level playing field for cross-border competition between banks upon changing such schemes.

Finding solutions to the above problems poses a major challenge to the financial policy makers in the European Union. From the point of view of reorganising banking groups, it would be better if the method of funding were as uniform as possible. If ex-ante or mixed financing is preferred upon harmonisation, clear principles should be laid down for the transferability of funds.

Similarly to economic development, there are cycles also in banking: there are periods when bank bankruptcies are frequent and those when none occur. If in one country bank deposits are protected under a scheme based on ex-ante funding while in another country deposits are protected through ex-post financing, in one year the costs borne by competing banks related to payments into deposit guarantee schemes might differ several times. Meanwhile, payments into schemes might form a considerable share of banks' costs. For example, in several Member States payments made into ex-ante schemes within a year account for nearly 0.3% of the guaranteed deposits, i.e. for approximately 10% of banks' net interest income. Therefore, the differences in the cost of financing deposit guarantee schemes upon the simultaneous use of ex-ante and ex-post financing might distort competition depending on the amount of payments made in different years.

Given the above examples, we can conclude that the shortcomings related to cross-border banking exist also in the field of deposit insurance. Although these problems currently affect only some Member States, the EU framework for deposit guarantee schemes calls for substantial changes since the integration of cross-border banking is deepening. Amendments to the directive should proceed from the objective of creating a single European Union banking market through harmonising the conditions of competition.

FINANCIAL SYSTEM SAFETY NET: SYSTEM OF SECURITY MEASURES FOR MINIMISING SYSTEMIC RISK

The system of security measures developed to protect the financial system should ensure smooth functioning of the financial system as a whole if a single financial intermediary is exposed to risks. In other words, the system of security measures should minimise the possible materialisation of systemic risk.

Eesti Pank's activities for sustaining financial stability are targeted at **creating a system of security measures capable of minimising systemic risk and, should such a risk materialise, reducing the respective adverse effect on the functioning of the whole financial sector.** In the long run, it is the least costly solution for the society to secure safe and smooth operation of the financial system.

Today, the safety net of the Estonian financial system meets basically all the necessary requirements. However, this does not mean that further development is not necessary. Along with the development of the financial sector also the safety net needs consistent improvement.

The financial market safety net consists of different components and it can be viewed in both broader and narrower sense. From a broader perspective, the safety net comprises regulation, supervision as well as possible solutions to problems. From a narrower perspective, the safety net means above all an **opportunity to provide emergency liquidity to solve banks' problems, deposit guarantee schemes for small depositors and small investors, measures for preventing systemic crises, and co-ordinated action for the quick and competent solution of problems through the joint efforts of the central bank and the government, should such a crisis emerge.**

The following factors guarantee safe and stable functioning of the financial system:

- **Clear and sufficiently strict rules established for financial institutions.** In the Estonian banking sector, these rules are in line with the best practice in the EU. For example, the requirements for our banks regarding capital buffers against unexpected problems are considerably stricter than in the European Union. While some other EU Member States will have to tighten legislation and prudential ratios, Estonia could rather anticipate an opposite process in the more distant future.
- **Supervision of compliance with rules and requirements.** Even the best laws and rules are of little use if these are not followed – therefore trust but verify! This should be carried out by supervision authorities set up for that purpose.

Market self-regulation

Besides supervision, information about banks and other financial institutions is also necessary for market agents, namely depositors and investors, who according to modern principles must assess banks and risks related to financial institutions. Transparency is often mentioned in that

respect. International experts have evaluated Eesti Pank highly as regards public notification and availability of banking supervision information. The system of public reports of our banks and their consolidation groups offers sufficient material for anyone with a little knowledge of financial data. (Additional information about public reports is available on the web site of Eesti Pank.)

Liability of market participants

Global experience has shown that market participants (major corporations and large investors) are more interested in monitoring and analysing the activities of banks and other financial intermediaries if they have been given **sufficient liability for the consequences of their investment decisions**. For example, deposit insurance funds do not usually cover the investments of large investors. Similarly, the investments of managers and majority shareholders of financial institutions facing problems are not compensated either.

APPENDIX

MAIN QUARTELY INDICATORS OF THE ESTONIAN ECONOMY as at 31 August 2006

	Unit	Period	Indicator	Change compared to the previous period (%)	Change compared to the same period last year (%)	Source
Gross domestic product						
Current prices	EEK m	Q1 06	42,902.5			ESA
Constant prices	EEK m	Q1 06	33,403.1	-6.4	11.7	ESA
Production						
Volume index of industrial production (at constant prices, 2000 = 100)	%	Q2 06			7.7	ESA
Agriculture						
Meat (live weight)	thousand tons	Q2 06	24.6	3.8	-6.8	ESA
Milk	thousand tons	Q2 06	186.0	17.4	1.6	ESA
Eggs	m pieces	Q2 06	48.1	-4.2	-9.8	ESA
Investments in fixed assets (at current prices)	EEK m	Q1 06	7,700.8	13.2	40.7	ESA
Construction						
Construction activities of construction enterprises (at current prices)	EEK m	Q2 06	11,664.0	56.5	37.0	ESA
Usable floor area of completed dwellings	thousand m ²	Q2 06	81.4	-4.0	-4.8	ESA
Usable floor area of non-residential buildings	thousand m ²	Q2 06	235.7	43.3	45.1	ESA
Consumption						
Retail sales volume index (at constant prices, 2000 = 100)	%	Q2 06		19	19	ESA
New registration of passenger cars	pieces	Q2 06	21,182	46.3	21	ARK
Prices						
Consumer price index	%	Q2 06		1.5	4.4	ESA
Producer price index	%	Q2 06		0.9	4.2	ESA
Export price index	%	Q2 06		0.9	3.8	ESA
Import price index	%	Q2 06		1.5	4.4	ESA
Construction price index	%	Q2 06		2.5	8.4	ESA
Real effective exchange rate (REER) of the Estonian kroon	%	Q2 06		0.4	0.5	EP
Labour market and wages						
Employment rate (based on the Labour Force Survey)*	%	Q2 06	62.0	60.5	58.1	ESA
Unemployment rate (based on the Labour Force Survey)*	%	Q2 06	6.2	6.4	8.1	ESA
Registered unemployed	persons per month	Q2 06	15,915	-22.8	-42.4	TTA
% of population between 16 years old and pension age*	%	Q2 06	1.9	2.5	3.4	TTA
Average monthly gross wages and salaries (health insurance benefits excluded)	EEK	Q2 06	9,531	10.9	15	ESA

* Indicators of the period, not changes.

	Unit	Period	Indicator	Change compared to the previous period (%)	Change compared to the same period last year (%)	Source
General government budget (net borrowing not included here)						
Revenue	EEK m	Q2 06	21,314.7	37.4	28.2	RM
Expenditure	EEK m	Q2 06	17,128.3	11.0	12.2	RM
Balance (+/-)*	EEK m	Q2 06	4,186.5	87.0	1,360.0	RM
Period's revenue to the planned annual revenue*	%	Q2 06	29.7	21.6	26.8	RM
Transport						
Carriage of passengers	thousand	Q1 06	53,767	-3.1	2.4	ESA
Carriage of goods	thousand tons	Q1 06	22,044.0	-12.7	1.5	ESA
Tourism and accommodation						
Visitors from foreign countries received by Estonian travel agencies	thousand	Q1 06	294.7	-32.9	2.9	ESA
Visitors sent to foreign tours by Estonian travel agencies	thousand	Q1 06	117.4	10.8	10.9	ESA
Accommodated visitors	thousand	Q2 06	604.4	65.8	7.0	ESA
o/w foreign visitors	thousand	Q2 06	413.7	111.4	-1.2	ESA
Confidence indicators*						
of industrial enterprises	%	Q2 06	23	22	14	EKI
of construction enterprises	%	Q2 06	54	42	40	EKI
of trade enterprises	%	Q2 06	41	27	29	EKI
of consumers	%	Q2 06	10	8	-5	EKI
Foreign trade (special trade system)						
Exports	EEK m	Q2 06	30,120.5	6.7	28.7	EP
Imports	EEK m	Q2 06	40,592.7	12.3	29.3	EP
Balance*	EEK m	Q2 06	-10,472.2	-7,905.0	-7,991.8	EP
Foreign trade balance/exports*	%	Q2 06	-34.8	-28.0	-34.2	EP
Balance of payments*						
Current account balance	EEK m	Q1 06	-6,937.6	-4,426.2	-4,474.9	EP
Current account balance to GDP	%	Q1 06	-16.2	-11	-12.3	EP
Foreign direct investment inflow	EEK m	Q1 06	7,752.7	-216.9	14,678.6	EP
Foreign direct investment outflow	EEK m	Q1 06	-1,667.5	-2,663.2	-892.2	EP
International investment position						
Net international investment position	EEK m	31/03/06	-171,370.9	2.4	12.1	EP
Direct investment in Estonia	EEK m	31/03/06	175,615.9	4.4	23.3	EP
Net external debt	EEK m	31/03/06	163,432.5	9.9	22.1	EP
o/w government	EEK m	31/03/06	3,896.1	-0.8	2.5	EP
EEK/USD average quarterly exchange rate	EEK	Q2 06	12,436	-4.4	0.2	EP

Statistical Office of Estonia (ESA)
Motor Vehicle Registration Centre (ARK)
Eesti Pank (EP)

Labour Market Board (TTA)
Ministry of Finance (RM)
Estonian Institute of Economic Research (EKI)