INTERRELATIONSHIPS AMONG SAFETY-NET PARTICIPANTS

Abstract

Deposit insurance is one component of many countries' financial safety net, which also includes prudential regulation and supervision, and the lender-of-last-resort function. In many countries, a department of the government—generally, the ministry of finance or the treasury—also plays an important role in the financial safety net. The interrelationships among these players can vary significantly and are the outgrowth of the institutional, economic and financial situation of a country, as well as of its history.

In order to design an effective deposit insurance system and to contribute to an effective financial safety net, smooth cooperation and goodwill among a country's financial safety-net participants are essential. Information sharing and coordination are particularly relevant, and explicit arrangements should be designed to avoid or minimise potential conflicts among safety-net participants. The more complex the safety-net institutional set-up is, the more relevant the "interrelationships issue" becomes. The need for coordinated actions by safety-net participants is particularly important when the need to handle bank failures arises. There also needs to be a strong accountability regime in place.

INTERRELATIONSHIPS AMONG SAFETY-NET PARTICIPANTS

The following paper represents the work of the Subgroup on Interrelationships among Safety-Net Participants.[1] Every country has a safety net that underpins the financial system. This safety net usually includes the central bank, a department of the government such as the ministry of finance or the treasury, an entity responsible for prudential regulation and supervision, and, in many cases, a deposit insurer or a deposit insurance agency. The paper focuses on: 1) how the institutional set-up of a country's safety net influences the interrelationships among the various agencies involved; 2) information sharing between safety-net participants; and 3) the need for coordination among safety-net participants.

Interrelationships and the Institutional Set-Up of a Country's Safety Net

Deposit insurance is one component of many countries' financial safety net, which also includes prudential regulation and supervision, and the lender-of-last-resort function. In many countries, including those countries represented in the Subgroup, a department of the government—generally, the ministry of finance or the treasury—also plays an important role in the financial safety net. For example, officials from the ministry of finance or treasury are key players when a crisis-management situation may necessitate the use of government resources.

The interrelationships among the safety-net participants can vary significantly. These interrelationships are the outgrowth of the institutional, economic and financial situation of a country, and of its history. Irrespective of the specific structure of a country's financial safety net, however, smooth cooperation and goodwill among the various components are key to an effective deposit insurance system. A well-designed safety net is integral to a smooth-functioning financial system and contributes to economic stability.

A need for coordination exists in any institutional set-up, as three different instruments—deposit insurance, lender of last resort and supervision—are used, each with its own criteria, to achieve the common objective of banking-system stability. However, the nature and the extent of the problem vary with the specific institutional set-up a country has adopted.

When a single agent—generally the central bank—acts simultaneously as lender of last resort, banking supervisor and deposit insurer, the interrelationships issue is an internal matter and thus should be capable of being dealt with and resolved relatively simply. The smooth resolution of potential conflicts is dependent on an adequate accountability regime among the departments that are responsible for each mandate.

[1] The Subgroup is comprised of representatives from Italy (coordinator), Argentina, Chile, France, Jamaica and Japan.

When, however, the functions of lender of last resort, banking supervisor and deposit insurer are allocated to separate agencies, the interrelationships issue may be more complex, as each agency is held accountable for discharging its own mandate.[2] As a consequence, various issues related to information sharing, allocation of powers and responsibilities, and coordination among the different functions need to be clearly and explicitly addressed in order to promote and maintain the credibility of the safety net.

There are no specific rules or guidelines to address and, possibly, resolve the interrelationships issue described above. Possible solutions by their very nature must be country-specific. Moreover, even within the same country, the safety-net institutional set-up and, therefore, the characteristics of the relationships among the various agencies evolve in response to changes in the country's financial system.

When a country decides to implement an independent deposit insurance system, or to reform an existing deposit insurance system, it is important that any "interrelationships issues" that may arise should be addressed.[3] This task is made easier if policymakers consider and are guided by what would be in the best interest of the general public.

Information Sharing: Interrelationships and the Deposit Insurer's Information Needs

Information sharing among safety-net participants is essential to an effective deposit insurance system. Indeed, in order to discharge their mandates effectively, deposit insurers and other safety-net participants should have access to an adequate flow of information.

The need for information on the part of the deposit insurer varies significantly according to its institutional mandate and its powers. In a simple paybox system, for example, the deposit insurer should have the necessary information to be able to reimburse depositors whenever necessary, including information on the amount of insured deposits held by individual depositors.

For its part, a risk-minimising deposit insurer has greater needs for information because of its broader mandate. It must be able to assess the financial condition both of the industry and of individual insured institutions, as well as to anticipate the financial troubles of individual institutions and to deal with them effectively when they arise. Thus, depending on its mandate, a risk-minimising deposit insurer may need both macro-level—industry information—and micro-level information—information on individual institutions.

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[2] The different functions of the safety net are not necessarily allocated to three or more separate agencies. For instance, in Italy and in Jamaica the financial institutions' supervisory authority is a separate department of the central bank; in Chile the central bank is also the authority responsible for paying-off depositors when a bank fails. Argentina's institutional set-up evolved from a single-agent framework to the current framework of three separate agencies.

[3] For example, the paper on powers discusses that the roles and responsibilities of the deposit insurer *vis-a-vis* other safety-net participants could be spelled out in legislation before the establishment or the reform of the deposit insurance system. The objectives of such legislation include ensuring that adequate information sharing among safety-net participants occurs and all parties are held accountable for their actions.

Industry information encompasses macroeconomic conditions, main financial trends, as well as information about important policy consultations that may have a significant effect on insured institutions. In turn, information on individual institutions is crucial in order for the deposit insurer to evaluate the soundness of each member institution.

In the case of failing institutions, a deposit insurer should have access as soon as possible to specific information, including the amount of insured deposits and their size distribution at the institution so that the deposit insurer can estimate its liquidity requirements, resource needs and possible risk exposure. The deposit insurer also needs information regarding the estimated total value of the institution's assets and the time frame for the liquidation process, given that the value of the institution's assets depends on the time necessary to liquidate them. This kind of information, however, often is difficult to collect and evaluate even by the supervisor, especially when a strong disclosure regime is not in place or institutions' records and accounting rules are not transparent.

The supervisory authority is usually the primary source of information for the deposit insurer for several reasons. First, and most important, the supervisory authority in most countries has the authority to examine depository institutions. Second, laws in many countries normally require depository institutions to submit periodic, accurate prudential reports to the supervisory authority. Moreover, supervisors often are allowed to obtain any additional information necessary to carry out their institutional mandate. Because of its specific powers and responsibilities, the supervisory authority often is the only safety-net agency able to assess accurately and ensure the quality of the information provided by financial institutions. A high-quality information set is fundamental for the deposit insurer if it is to carry out its institutional mandate effectively.

Depending on the breadth of their individual mandates, deposit insurers may need to supplement information provided by supervisors with information directly collected from insured institutions. For example, if a deposit insurance system has an *ex-ante* fund, information must be received on the level of insured deposits on which premiums are based. In order to ensure that the deposit insurer obtains the information it needs to fulfil its mandate while minimising reporting requirements on its membership, it is important to coordinate effectively the collection and sharing of information between the deposit insurer and the other safety-net participants. One approach is to have the supervisory authority act as the primary collector of information required for supervisory and deposit-insurance purposes. However, the deposit insurer should still be able to access supplemental information from its members as the deposit insurer will need, from time to time, information directly pertaining to its operations and not related to safety-and-soundness issues.[4]

Obviously, deposit insurers should be able to access easily all the information publicly disclosed by member institutions. The effectiveness of a deposit insurance system is

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[4] This information could include, for purposes of verification, the level of deposits held for premium assessments and information on specific products and their insurability.

clearly enhanced if laws and regulation provide for a strong information-disclosure regime, which is characterised by a high degree of transparency of banks' financial statements and accounting rules.

It is important that information be accessed by deposit insurers on a timely basis, in order to ensure that an effective system of ongoing evaluation both of the industry and of individual institutions is in place. It is essential to have early warning of problem banks, so that in case of a failure the resolution can be implemented in a very short time. The experience of various deposit insurance systems around the world shows that strong coordination, information-sharing and exchange arrangements are essential. In some cases, however, the effectiveness of the arrangements actually can be enhanced when high-level officials from the different safety-net participants establish formal arrangements for sharing information as well as analyses and views on the state of the financial system.[5] All confidential information should remain so.

Coordination among Safety-Net Participants

The need for coordination and goodwill among the various safety-net participants is directly related to the possibility of conflicting mandates. When dealing with bank crises, for example, it is particularly important to establish precisely which safety-net participant(s) has the power to formally declare an institution to be insolvent (or formally initiate the liquidation procedure of a failed institution).[6]

Tensions may arise between the deposit insurer and the lender of last resort with respect to financial assistance to troubled institutions. Indeed, the granting of funds to a troubled institution may create problems if the use of those funds by the troubled insured institution is not properly monitored or even conditioned by the central bank. Indeed, troubled institutions could use the financial assistance provided by the lender of last resort to engage in risky activities ("gambling for resurrection"), significantly increasing the deposit insurer's risk exposure and potential losses.[7]

Potential tensions between the supervisory authority and the deposit insurer may arise if the supervisor, who is generally in charge of closing a bank, is viewed to be delaying or even avoiding such an action altogether (forbearance). As long as failures of insured institutions are thought to somehow represent supervisory failures, there could be a tendency to give troubled institutions "the last chance" in order to avoid a potential crisis and its attendant

[5] In some countries, information-sharing arrangements are mainly informal, and the bank supervisory authorities provide the deposit insurers with the necessary information on a regular basis. In other countries, a formal memorandum of understanding is used to manage relationships.

[6] As stated above, the distribution of powers among safety-net participants is discussed in the paper on powers.

[7] At least in principle, there could be cases in which the resources provided by the central bank, whose repayment is usually guaranteed by the troubled institution's best assets, are actually used to repay uninsured, rather than insured, liabilities or to invest in riskier assets. In this case, the deposit insurer could find that its losses are higher than they otherwise would be.

effect on the supervisor's reputation; this, in turn, could create an incentive for troubled institutions to engage in riskier activities.

This is obviously not the case when failures of individual institutions are viewed to be a "natural" result of competition among financial institutions. Indeed, the primary objective of bank supervision is to avoid systemic banking crises; the pursuit of this objective generally is compatible with accepting failures of some insured institutions.

An important and effective way to promote smooth coordination on the part of safety-net participants is a clear division of powers and responsibilities. Although this clear division can be considered as a minimum requirement when addressing coordination issues, provision for prompt-corrective-action rules could be an additional requirement in order to promote smooth coordination among safety-net participants.

In the case of deposit insurers with broader mandates, it is important that the insurer has sufficient control of the risks it actually faces. This objective also can be achieved by coordinating the powers of the different safety-net participants so that they do not operate at cross-purposes. Although the precise mechanisms of the coordination obviously will depend on each country's institutional set-up, efforts should be made, for example, to ensure that the powers to revoke deposit insurance are coordinated with licensing requirements.

Finally, a clear division of powers and responsibilities is particularly important with respect to the closure and liquidation of insured institutions. This division should be spelled out beforehand, for example, in legislation. Indeed, when failures occur, it could be very hard for the participants in the safety net to fulfil their responsibilities without a clear *ex-ante* mandate. In such cases, events may unfold quickly and time becomes of the essence. Reconciliation of potential conflicting mandates requires prior discussion and a high degree of transparency when setting the "rules of the game."

Formal Mechanisms to Ensure Coordination and Information Sharing

Although informal arrangements for information sharing and coordination can work well in certain circumstances, given the sensitivity of institution-specific information and the challenge of maintaining open communication channels, it may be useful to formalise these agreements either through legislation, memoranda of understanding, formal agreements or a combination of these techniques.

If formal information-sharing arrangements are relied on, they should clearly acknowledge the roles and responsibilities of the respective parties, set out what is to be shared and by whom, as well as the type, level of detail and frequency of information to be exchanged. Confidentiality of information exchanged between parties also should be respected at all times.

Apart from these specifics, formal agreements also may be useful in providing a general framework for safety-net participants to coordinate their related operational and policy-making activities by promoting regular meetings and opportunities for consultation.

Conclusions

The main conclusions of this paper are as follows:

- When considering the creation of a deposit insurance system, a country should address effectively the issues related to the deposit insurer's relationships with the other safety-net participants. Depending on the institutional, economic and financial situation of a country, and its history, the characteristics of the relationships among the central bank, the ministry of finance or the treasury, the supervisory agency, and the deposit insurer can vary substantially. Irrespective of the specific structure of a country's financial safety net, however, smooth cooperation and goodwill between the components are key to an effective deposit insurance system.

- Information sharing among safety-net participants is essential for an effective deposit insurance system. Indeed, in order to discharge their mandates, deposit insurers should have access to an adequate flow of relevant information. Ideally, information should be timely, accurate and relevant; a strong disclosure regime is based on these elements. The effectiveness of a deposit insurance system is clearly enhanced if laws and regulations provide for a strong information disclosure regime, which is characterised by a high degree of transparency of institutions' balance sheets and accounting rules.

- The need for coordination and goodwill among the various safety-net participants is directly related to the emergence of potential conflicts between them. The most important and effective way to promote smooth coordination on the part of safety-net participants is to provide for a clear division of powers and responsibilities among them and appropriate mechanisms to ensure coordination and information sharing.