SITUATIONAL ANALYSIS:
CONDITIONS AND IMPLEMENTATION CONSIDERATIONS

Abstract

It is important to conduct a comprehensive situational analysis when considering the introduction of a deposit insurance system or when planning to alter an existing deposit protection arrangement. In conducting such an analysis, the economic and institutional conditions and their effect on the alternatives available for a deposit insurance system must be considered. Among the conditions that should be taken into consideration are the state of the economy including, current monetary and fiscal policy; the state and structure of the financial system; the legal framework; the state of the regulatory and supervisory systems; and accounting and disclosure regimes. Although it is understood that in many cases conditions are not perfect, it is important to have a process to evaluate the alternative deposit insurance systems available and how these alternatives are affected by the economic and institutional structure of the country. Through a situational analysis, gaps between existing conditions and more-desirable situations can be identified.

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This paper emphasises the importance of conducting a comprehensive situational analysis when considering the introduction of a deposit insurance system or planning to alter an existing deposit protection arrangement.[1] In conducting such an analysis, the economic and institutional conditions and their effect on the alternatives available for a deposit insurance system must be considered. Among these conditions are the following: the state of the macroeconomy, current monetary and fiscal policy, the state and structure of the financial system, the legal framework, the strength of prudential regulation and supervision, and accounting and disclosure regimes. Although in many cases conditions may not be perfect, it is important to have a process to evaluate the alternative deposit insurance systems available and how these alternatives are affected by the economic and institutional structure of the country. Through a situational analysis, gaps between existing conditions and more-desirable situations can be identified.

To better understand the process, the experience of countries that have considered adopting, or significantly altering, deposit insurance systems were analysed. In addition, consideration was given to understanding the relative importance of these conditions and whether there are some basic criteria that should be satisfied before adopting a deposit insurance system.

Alternatives for Deposit Insurance Systems

The first step in establishing or significantly modifying a deposit insurance system is for policymakers to determine their public-policy objectives.[2] Policymakers then face a wide range of possible alternatives for the design of a deposit insurance system.[3] These include: the structure of the organisation—public, private, or jointly-administered systems; and the basic powers—paybox systems, which reimburse depositors on the instruction of another authority, or risk-minimising systems with greater capabilities to assess and manage risks. Policymakers should seek to ensure that an effective deposit insurance system is instituted, consistent with both the country's economic and institutional settings and aligned with the public-policy objectives they are attempting to achieve.

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[1] The Subgroup members are the International Monetary Fund (coordinator), Argentina, France, Mexico, and The World Bank.
[2] As described in the paper on public-policy objectives, there is a wide range of more specific formulations that fall into these categories.
[3] See papers on: membership, coverage, funding, reimbursing depositors, depositor priority and rights of set-off, structure and organisation, interrelationships, and powers.

Methodology to Analyse the State of Country Conditions

The methodology to assess the state of country conditions flows from the Strategic Analysis Model, which begins with the determination of the public-policy objectives, including the key attributes of the system desired.[4] After the public-policy objectives have been identified, policymakers should conduct a situational analysis of the conditions in their country. These conditions include: the macroeconomic environment, including current monetary and fiscal policy; the soundness of the financial system; the state of the legal, regulatory and supervisory systems; the quality of accounting; and the state of the disclosure and auditing regimes. The analysis should expose the strengths, weaknesses, opportunities and threats related to the conditions, and identify any changes necessary for the construction of an effective deposit insurance system.

If existing conditions are incompatible with the public-policy objectives, then either the objectives will have to be modified or different options for the design or structure of the deposit insurance system should be explored. Following the development of public-policy objectives that are aligned with the country's economic conditions and institutional framework, the next step is to develop a strategic plan for implementation.

Analysis of Conditions

Macroeconomic conditions

An important consideration in a situational analysis is the macroeconomic condition of the country, including its current monetary and fiscal policy. This is important since the macroeconomy can affect the financial system and influence the effectiveness of the deposit insurance system. Although macroeconomic stability is important for the successful implementation of a deposit insurance system, the boundaries between propitious and unpropitious macroeconomic conditions may be difficult to determine *a priori*.

Concerns about macroeconomic conditions often result in a loss of confidence in the entire financial system, which is difficult to restore through a single instrument such as deposit insurance. A loss of private-sector confidence is likely to result from the overall economic situation and the policy stance of the government, rather than more-narrow concerns about the state of the banking system. The introduction of a deposit insurance system, by itself, to protect depositors cannot address the basic causes of the macroeconomic deterioration. A deposit insurance system by itself cannot prevent a banking crisis, or cure one that has already begun. If introduced prematurely, a deposit insurance system can become so discredited that its reintroduction may be impractical when macroeconomic conditions are more favourable.

[4] The Strategic Analysis Model was developed to assist policymakers in the design of an effective deposit insurance system. See the Financial Stability Forum Working Group on Deposit Insurance, *A Consultative Process and Background Paper*, June 2000.

If the economic system is relatively stable, then the introduction or enhancement of a deposit insurance system is more likely to be effective in strengthening public confidence. That is, the failure of one depository institution will not necessarily spill over and affect public perceptions about the soundness of other depository institutions.[5]

State of the financial system

A situational analysis will require an assessment of the soundness of the banking system, including a detailed assessment of the condition of the depository institutions within that system and the extent of their problems. Factors that should be analysed include: capital, liquidity, credit quality, and risk-management policies and practices. An assessment also should be made as to whether these problems are confined to individual institutions or are likely to be systemic in nature. The issue is not whether there are unsound depository institutions in the system, but whether the banking system as a whole is sound.

The establishment of an effective deposit insurance system is much more difficult if underlying fundamental financial-system stability issues have not been addressed. Early introduction of a deposit insurance system, for example, could result in incentives for insolvent and illiquid depository institutions to compete for deposits by raising interest rates. Depositors, unconcerned about the financial health of the depository institutions because of the deposit insurance system, may shift resources from relatively risk-averse depository institutions to those adopting more-risky policies. This shift could increase the eventual cost of restructuring. It also is possible that policymakers, when faced with an insolvent banking system, may wish to combine the introduction of a deposit insurance system with a wide-ranging program of banking-system restructuring.

Moreover, it is important to be aware that deposit insurance, even when introduced at an appropriate time and in a well-designed form, cannot address all stability issues. Deposit insurance is one element in the financial safety net, which also includes a lender-of-last-resort facility and good supervisory and regulatory practices. If introduced in a coherent fashion, a deposit insurance system can be an important pillar of the restructuring program. If introduced in isolation, however, a deposit insurance system may not be effective.

Market-based *versus* state-directed financial intermediation

In undertaking a situational analysis of conditions in a country, policymakers need to consider whether financial intermediation is market-based or state-directed. When

[5] A distinction should be made in this analysis between the introduction of an explicit deposit insurance system and the introduction of blanket guarantees for all creditors, including depositors. Under conditions of extreme macroeconomic instability, when depositors are shifting out of the national currency and into a foreign currency held outside the banking system, a blanket guarantee, adopted in conjunction with a broad-based stabilisation plan, can strengthen confidence in the banking sector. However, there are substantial trade-offs in terms of increased moral hazard associated with blanket guarantees. See the paper on moral hazard.

resource-distribution and credit decisions are directed by the state, the state is viewed as being responsible for the results of such operations. Deposits in such systems generally are perceived as having full guarantees.

By contrast, financial systems characterised by market-based financial intermediation often can benefit from deposit insurance because they do not carry implicit government backing. A number of countries have state-owned banks that operate in response to market signals. If these deposits are not perceived as carrying a guarantee of the government, these countries also may benefit from the establishment of a deposit insurance system.

Legal, regulatory, supervisory, accounting, and disclosure regimes

It is important to assess the state of the legal, regulatory, supervisory, accounting, and disclosure regimes. If these regimes are strong, policymakers have a wider range of deposit insurance alternatives from which to design an effective deposit insurance system. Conversely, if these regimes are weak, fewer alternatives are available. In such circumstances, an effective deposit insurance system may be difficult to achieve.

Legal regime

It is important to assess the degree to which an appropriate legal regime is in place when considering the introduction of, or enhancements to, a deposit insurance system. A critical element of a sound legal regime is the ability to enforce laws. If laws do not exist, or the regime is characterised by inconsistencies, then it is very difficult for a deposit insurance system to be effective.

A well-defined legal regime, including bankruptcy provisions and certainty regarding property rights, contributes to the effectiveness of a sound deposit insurance system. Also, it is important that employees of the deposit insurer and other safety-net participants be provided with legal protection from personal liability for the actions they take on behalf of their organisations.

Deposit insurance systems with broad mandates will need other provisions established by law. Factors that should be considered include the ability of a legal regime to support early intervention and prompt corrective action by supervisory and regulatory authorities, facilitate prompt closure of problem institutions, and provide for the clear and orderly liquidation of assets and the resolution of creditor claims. If laws governing valuation methodologies, liquidation of assets, and the resolution of creditors' claims are nonexistent or deficient, it will be more difficult for the deposit insurer and other safety-net participants to fulfil their mandates.

Regulatory and supervisory regimes

The quality of regulation and supervision will have implications for the type of deposit insurance system chosen. If a country has strong prudential regulation and supervision, and pertinent information is shared with the deposit insurer, an explicit deposit insurance system is more likely to be effective. There are many aspects to a good supervisory and regulatory system. Such a system should allow only viable institutions to operate. In many countries this is done by ensuring that institutions are well-capitalised and follow sound and prudent risk management, governance, and other sound business practices. Other characteristics include a sound licensing or chartering regime for depository institutions, and regular and thorough examinations or risk assessments of financial institutions.

In addition, supervisory and deposit insurance authorities require skilled and motivated staff, an adequate infrastructure, and access to sufficient funding to assist them in fulfiling their mandates. Authorities that are subject to an accountability regime, such as regular performance reviews, can provide additional integrity to a financial system.

Accounting and disclosure regimes

The effectiveness of a deposit insurance system is enhanced by accurate and reliable accounting and financial reporting systems. If information is readily available, accurate, and timely, it can be used by management, depositors, the marketplace, and regulatory and supervisory authorities. The better the information that is disclosed by institutions, the more effective is market discipline.

Attributes of a sound accounting system include accurate and meaningful assessments of information in areas such as: asset valuation; the measurement of credit exposures, loan-loss provisioning, and nonperforming loans; the treatment of unrealised losses and off-balance-sheet exposures; and capital adequacy, bank earnings and profitability. Sound external auditing and reporting systems for individual financial institutions help to foster market discipline. In many countries this has been achieved through adherence to sound-and-prudent accounting principles and practices, and methods to ensure compliance with agreed-upon accounting conventions. In order to be effective, accounting rules need to be applied consistently by all interested parties.

The presence of a system to provide for good public disclosure of financial information helps to ensure that accurate information on the state of financial institutions is transmitted on a timely basis to all interested parties. To be effective, a sound disclosure regime needs to provide detailed information and frequent disclosure. In addition, many countries hold directors, auditors, and senior management accountable, in part, for the level, accuracy and consistency of disclosure. This can enhance the exercise of market discipline over institutions and improve the effectiveness of a deposit insurance system.

Structure of the banking system

The structure of the financial system is an important consideration when adopting a deposit insurance system or enhancing existing deposit insurance arrangements. For instance, the number, type and characteristics of financial institutions have implications for the design of a deposit insurance system.

Countries faced with a highly concentrated banking system have adopted one of several approaches. First, some countries have opted not to offer deposit insurance. In the absence of a deposit insurance system, it is recognised that taxpayers likely will be called on to provide resources to resolve any serious problems. Second, some countries have chosen to rely on privately funded, mutual guarantees among the large depository institutions in the financial system. Those depository institutions may understand each other's business better than public authorities and can be in a better position than public authorities to exert market discipline on one another. Third, some countries have chosen to establish a publicly managed and funded deposit insurance system. Such a system may be chosen because the government provides backing to the deposit insurer and to support public regulation and supervision of the activities, including competitive practices, of a concentrated banking system.

Countries that have banking systems characterised by a low degree of concentration may be well-suited to a publicly managed deposit insurance system. In this case, the exposure of the deposit insurer is likely to be more diversified and the failure of one or a few banks may not represent a major financial burden. As a result, the requisite resources to protect depositors under such conditions are likely to be within the capacity of a deposit insurance system to fund. However, the existence of a large number of institutions may place greater burdens on the supervisory authorities. Moreover, if individual institutions are not diversified geographically, they may be more vulnerable to local economic problems, and may thereby pose greater risks to the deposit insurer.

The type and characteristics of financial institutions have implications for deposit insurance. For instance, when countries undertake their situational analysis, they may encounter the issue of foreign ownership. Branches or subsidiaries of foreign banks may have the backing of the home-country bank. It may be more appropriate, however, to treat the branch or subsidiary as any other bank in the country's system as regards deposit insurance. There are several reasons for this approach. First, the home bank may fail. Second, some jurisdictions do not extend deposit insurance to deposits in foreign branches or subsidiaries and do not insure deposits of non-residents. Finally, many jurisdictions require that the worldwide assets of a failed bank be frozen and used to cover home deposits first. If deposit insurance is extended to branches and subsidiaries of foreign banks, the deposit insurance authority will need to consider how it will manage its risks.

Implementation Considerations

Public attitudes and expectations regarding deposit protection are important factors to be considered. The more aligned a deposit protection system is with public attitudes and expectations, the more likely it is that the system will be effective. For instance, if public awareness of the benefits and limitations of new or existing deposit protection systems is limited, then it may be more difficult for such systems to achieve their public-policy objectives. Therefore, it is important to undertake an analysis of public attitudes and awareness before the introduction of a new system or major modifications are made to an existing protection regime. If there are significant gaps between expectations and planned systems or reforms, then they will need to be addressed through public awareness programs.

Conclusions

Countries considering the introduction or modification of a deposit insurance system should conduct a systematic situational analysis to guide their deliberations. In conducting such an analysis, the economic and institutional conditions and their effect on the options available for a deposit insurance system must be considered. Country-specific, historical factors and public sensitivity to the relevant issues also must be taken into account.