Opinion on:

Presentation for DGF Board in Romania
Deposit Guarantee Fund in the Banking System
Prepared by Convergence team

By

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I. Introduction:

I was asked by the Convergence team to prepare an independent opinion on the presentation/model prepared for the DGF Board in Romania under the title: "Deposit Guarantee Fund in the Banking System". This opinion has a holistic approach. Its aim is not only to assess the presentation (i.e. the model presented in it), but at the same time give some additional advice and framework for the Romanian authorities which they might find useful. Therefore its scope goes beyond the narrow goals of the Convergence report. This is done in the attempt to maximize the utility for the authorities, but at the same time exploit possible comparative advantages of the author of this opinion.

II. The presentation:

It is important to point out that I support the overall concept/model explained in the presentation: "Deposit Guarantee Fund in the Banking System" for Romania prepared by the Convergence team. The presentation and the model behind it are based on modern economic principles and best international practices on deposit insurance[2]. True there is no single best model for deposit insurance for all countries and for all times. Individual authorities can chose among several options. But what is presented is within best practices. On top of this, the model has taken into account the Romanian banking system. This is important as proposals are not a theoretical "one size fits all" type of recommendations, but represent an application to Romanian data. Obviously a lot of time and space is devoted to assessing (computing) the risks of the banks (for example slides 3-5 and DGF's current risks). There is no doubt that this is an elaborate model to determine risks in the system and optimize the size of the Fund. All methodological aspects are worthy of praise. Therefore in my opinion the main objectives of the terms of reference for this project have been met. Regarding the presentation, on a more specific level, I have the following comments:

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[2] See Guidance For Developing Effective Deposit Insurance Systems (2001) or Garcia (2001).

1. I like the idea of splitting of DGF (adequate) size to „equity" and „debt" parts. I think it is a very reasonable approach that minimizes costs of intermediation for financial agents and thus deepens the financial markets (which is a worthy goal in economic policy).
2. I agree with the approach that only "watch" and "risk" banks should represent focus of interest of DGF. Deposit insurance schemes should not be designed for systemic banking crisis. They should be able to deal with several simultaneous banking bankruptcies, but not a systemic one. This of course does not mean that authorities should not have contingency plans for such events (i.e. systemic crises). But DGF should not worry about systemic issues when designing the optimal size of its Fund. However, such an approach (i.e. focus on watch and risk banks only) implies at least two points to observe: a) data on banks should be reasonably accurate[3] (i.e. they should be close to reality) and b) categorization of banks in risks categories should be regularly updated (at least twice a year, if not quarterly).
3. Another very positive element in the presentation/model is its forward looking approach with sensitivity scenarios. Needless to say, one should be aware of risks and uncertainties facing any forward looking approach.
4. Some of the elements in the model can and should be reassessed by Romanian authorities. For an outsider it is very difficult to estimate how much of DGF quick recovery is a reasonable estimate. Or what proportion of liquid assets of banks (that go into bankruptcy and activate deposit insurance) can be recovered and how fast depends on a lot of elements (from legal framework, to practice). To put it differently, the authorities should form their own judgment if they feel comfortable with the assumptions in the model or not[4] and should regularly reassess those views based on accumulated experience.
5. I support the five conclusions by the end of the presentation. A brief note on conclusion No. 4. Investment activity of the DGF (i.e. its portfolio decisions) is a very important but somewhat separate issue, from what has been discussed so far. I can only recommend that the authorities pay due attention to this issue (as the presentation indicates). The present Romanian practice that large parts of assets are invested in domestic banks in local currency sounds imprudent. I would speculate that at least the following problems exist: too large country exposure – while shocks to the system could be external, too large exposure to banking system (never put all eggs in one basket), there could be foreign exchange risks as parts of insured deposits are in foreign exchange –regardless of the payout in domestic currency only, etc

[3] This raises not only the question of possible misreporting by banks but raises the issue of accounting principles (i.e. sometimes banks could accurately report their accounts based on non-adequate accounting principles).

[4] Stress testing terminology uses the following phrase when designing shocks: They should be „exceptional but plausible". In my view only the authorities can determine what an exceptional but plausible shock is. How many banks could migrate to watch status? Or designing some other shock requires an expert value judgment.

III. Some additional recommendations (linked with but beyond the presentation):

Some of my comments/thoughts below are not criticism of the explained model. As mentioned it was hard to find major problems with the proposed system which has been well thought through. But I think that authorities (both the National Bank of Romania and Deposit Guarantee Fund) should be well advised to think about some of the topics mentioned below in the future.

1. As with any policy change, thorough preparations for implementation are needed. In other words, testing domestic capacities is relevant because one could reasonably expect rapid structural changes in the Romanian financial system in the future (EU convergence, strong capital inflows, rapid development of the financial markets etc.) and the authorities have to have the know-how to deal with those new risks in the future. The authorities would be well advised to continue following closely best practices with deposit insurance in the word. Financial standards, just like the ones in medicine, do change with time. Furthermore authorities should continue paying attention to new EU regulations in general but to experiences of its peer countries in particular[5] (as competition with deposit insurance could develop).
2. Financial safety net is a very complex product. Deposit insurance is one of many important elements in the equation whose outcome if financial stability. Therefore it is important to think of a broader context of financial stability**.** This broader context is not part of the presentation on DGF and it should not be elaborated. However, deposit insurance is typically only one part of a broader financial safety net. Other parts are: the quality of prudential regulation and supervision (including licensing of deposit taking institutions) and Emergency Liquidity Assistance (ELA) sometimes called lender-of-last resort[6]. Some add a well defined finality of payments (settlement) as an additional element in a country's financial safety net. *In ultima linea* monetary policy (market operations) could be viewed as an element of financial stability. Therefore, it might be a good idea to consider that the safety net should be looked upon as a whole and deposit insurance is only a part of it. For example, if supervision is successful in keeping only viable banks in the system, deposit insurance should not be activated at all.
3. Beware of over insurance and take into account the significance of the moral hazard problem that can arise with a high amount of insured deposits. This is not the focus of the presentation, but it should be stressed out. If not fully based on market principles (which are very difficult to quantify) deposit insurance is de facto a subsidy to banks so that they can be more risk-prone. The higher the amount of insurance the higher the probability that banks will be involved in moral hazard behavior. The amount of € 20 000 is EU directive. But in my opinion this amount is too high for Romania. Nominal harmonization should be carefully reexamined in this case. Over insurance is an issue in other accession countries (now EU members) as well (see: Nenovsky, 2003). In real life it may

[5] For a comparative approach to accession countries see Nenovsky (2003).

[6] Sometimes those facilities are differentiated on the grounds if the provision of liquidity goes to the market or to an individual bank(s), but sometimes they are used as synonyms (ELA being a more modern term).

be too late to renegotiate this amount (and/or prolong the time span for its implementation) due to EU constraint. But at minimum the authorities should be fully aware of the excessive amount that is insured and moral hazard issues that can arise. It would be worthwhile to keep this in mind and strengthen banking supervision (both regulation and enforcement) to counteract this problem. Furthermore it is well known that over insurance leads to higher costs which can harm financial intermediation. The tradeoff with long term stability should be pointed out as well (over insurance means more volatility in the long run)[7].

4. Think of public relations (PR). The purpose of the deposit insurance system is first and foremost to preserve credibility and financial sector stability i.e. act as a deterrent to bank run and contagion effect from one bank to another[8].The more people believe in the DGF the less the likelihood of run on banks and collateral damage of a failure of one bank. So one has to make depositors believe in the product called deposit insurance. Public has to understand the system well. For this one needs transparent rules and swift payout. Public relations may be viewed as part of capacity building of the DGF. Romania cannot avoid its socialist heritage (and implicit full guarantee schemes). How strong is this implicit contract that the state is behind larger banks and larger deposits in Romania?
5. Think of risk based premium for individual banks in the future. At this level there is no need to introduce additional complexity to the model. But it may be a good advice to keep in mind that in theory best practice would require differentiated insurance premiums. Otherwise this will represent subsidies for risk prone banks (or vice versa, taxation for those that are more prudent). Truth to be told, EU directive does not promote the risk-based premium differentiation, but authorities should think of it if not in the immediate future, than as a goal in the long run. Ultimately the authorities should think whether to implement this model based on a cost-benefit analysis. Differentiated risk premiums may require more resources, good data, more work and all this need not be the highest priority in the short run. There are not many countries in the world today that have explicit limited deposit insurance and use differentiated premiums. Some countries in the region have opted for a single premium. For example, Galac (2005) is of an opinion that risk-based premium is not suitable for Croatia.

[7] Cull et al. (2004) is an interesting paper which points out that overly generous deposit insurance schemes result in long term instability in the system.

[8] I personally do not see much economic content in the usual argument that the deposit insurance funds should compensate the uninformed depositor on top of contributing to financial stability of the system. But this discussion is beyond the scope of this opinion.

IV. References:

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3. Garcia, G. (2001): *Deposit Insurance. Actual and Good Practices*. IMF Occasional Paper 197.
4. *Guidance For Developing Effective Deposit Insurance Systems* (2001). Financial Stability Forum (from www.fsforum.org)
5. Nenovsky, N. and K. Dimitrova (2003): *Deposit Insurance during EU Accession.* The William Davidson Institute Working Paper Number 617. (From http://wdi.umich.edu/Publications/WorkingPapers/WP601to700)