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Marko Skreb[1]

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Some comments on the DGF Romania project – interim phase.

I. Introduction:

This short note is a result of an agreement that I will prepare a brief comment on the interim phase of the assessment of the Deposit Guarantee Fund (DGF) in Romania[2]. We have agreed that I will devote some more time once the project will be finished (in about a month from now).

My understanding of the objective of the project is that the Romanian authorities wanted an update of the DGF situation and an answer to the question how to determine the optimal size of the fund (with external constraints in mind like the institutional rigidities with the increase of deposit coverage and decrease in premiums in the future). As is well known the adequacy of the fund is firstly a dynamic variable (thus changes with time) and secondly depends on the goals established for deposit insurance. Besides we are faced with imperfect information about the potential losses, therefore there is no simple answer to the question of the optimality of the Fund.

At this stage I have focused more on general issues, i.e. the primary objective of the deposit insurance in helping maintain the financial stability of the system (therefore a broader context is taken into account). At the final stage of the project I will focus more on the concrete proposals for Romanian authorities, based on available information. Thus at this stage the main aim is to initiate additional thinking, not assess the practical usefulness for authorities.

II. Comments:

1. **First impressions after reading the available documents are very positive.** There is no doubt that the project is on the right track. Relevant literature has been consulted, Romanian deposit guarantee fund examined, tools for future

[1] Contact markoskreb@yahoo.com,

[2] This project is done as part of the Convergence.

decision making prepared. The way I see the project is that it should: a) assess the present situation with DGF (comprising the Romanian financial system-banks in particular), give international perspective of deposit insurance (best practice, standards in the world today) and c) give recommendations, options for Romanian authorities to upgrade their system in the future. Below are some comments on each phase of the project (without detailed specifications).

2. **There is a need for more caution in assessing the soundness of the Romanian financial system, banking in particular, which is undergoing structural changes.** I would express more caution than is done in the project, when speaking about the Romanian financial system, especially the banks. Data may not be excessively reliable. Second element is that the Romanian financial system is undergoing rapid structural changes. Therefore there is a need to reassess the risks regularly (EU accession, capital inflows, rapid credit growth to mention but a few of elements). Having in mind the banking crisis in the past, clean-up of the banking system and presently small share of banking assets in Romanian GDP, the reasonable assumption is that the risks will increase in the future, not decrease. This is not negative, because financial intermediation is below average in Romania[3], but should be monitored carefully. Banking is by its very nature a risky business, so the point is to measure, manage and price risks adequately, not avoid them.

3. **Point out additional references on Romanian financial system.** Additional elements to be mentioned (when speaking about the system) are: Romania had an FSAP. FSSA[4] (published document) for Romania should be used as some type of benchmark or at least references[5]. Additional information on the Romanian financial system can be found in different IMF papers (Article IV, Working Papers etc.) or WB materials (Romania had numerous WB projects). True, this is not a core of the presentation or papers, but there is a close link between the stability of the financial system and deposit guarantee fund. This

[3] In Croatia share of bank assets are more than GDP.
[4] FSSA is available at www.imf.org under information on Romania.
[5] FSAP has designed a number of stress tests. It would be interesting to compare them with the scenario analyses done in the working papers here.

cross-referencing could be important for two reasons: a) show due dilligence to readers and b) be a benchmark for risk assessment and financial system overview.

4. **When assessing the stability of the system use FSI.** Papers have used a variety of indicators to assess the stability of the system. The suggestion is to use standard indicators for the banking system developed by the IMF: the Financial Soundness Indicators (FSI). Why not use them (if data are available), when presenting the soundness of the system[6]? This is a standardized set of indicators (recommended by the IMF) and I would recommend to "follow international standards" (if not now think of it for the future). The importance of this is to increase the international comparability of indicators (but keep in mind that FSI are still in their experimental phase).

5. **More focus on recommendations is needed**. Based on the work that I have seen (three papers and a presentation) I would focus the future work much more on practical advice and options to Romanian authorities. No more theories or backgrounds, but practical advice with emphasis on different options and trade-offs. Firstly they need to understand that there is no magic formula, no panacea that will resolve their dilemmas (this is well explained in documents). Secondly, general guidelines exist (the best that I know are supported by FSF, see the list of references). So, give options to them and cut out the fat that they may not be interested in. Give them clear recommendations, and prioritize them. Some outline of action plan with deadlines could be helpful in final phases as well (depending on what the authorities want).

6. **Moral hazard is well explained** but the tradeoff with long term stability should be pointed as well. 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. On a more general level, it is true that a well designed deposit insurance system removes the incentives for a run on banks (and decreases risks of contagion) but at the same time it may eliminate the need to police a bank and can be a strong incentive for more risk taking by banks (than optimal). My

[6] For more info on FSI please check: http://www.imf.org/external/np/sta/fsi/eng/fsi.htm

initial feeling is that the Romanian system is too generous (with the increase of the insured amount to E 20.000). The Romanians may not have a saying in this (due to EU convergence) but they have to be aware of the moral hazard and distortions in the incentive system for banks. So, this is mentioned, I personally would like this to be stronger (with emphasis on supervision).

7. **More emphasis on transparency and public relations (PR) would be welcomed.** This may be viewed as something that is out of focus but the authors should at least think about it. Transparency of financial agencies is gaining in importance[7]. Transparency policy will not be explored in more details here, but IMF's Transparency policy should be examined more closely (i.e. one should advice the DGF to do so). Public relations may be viewed as part of capacity building of the DGF. This is not in the initial TOR the way I have interpreted it, but it might be worthwhile thinking about it. As is well known, 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]. So, to be successful in this there is a need for a clear PR campaign. For this one needs transparent rules and swift payout. Do they have adequate capacity for PR? How aware is the public of what is to happen? Romania is a former socialist country. How strong is the implicit contract that the allmighty state is behind larger banks and larger deposits (small banks were tested)? What are the expectations of depositors? The more people believe in the fund the less the likelihood of run on banks and collateral damage of a failure of one bank.

8. **Think of a broader context of financial safety net in Romania.** This advice may again sound contrary to the advice of more focus. But, deposit insurance is typically part of a broader financial safety net in a country. Other parts are habitually: prudential regulation and supervision, and Emergency Liquidity

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[7] For more details on transparency of financial institutions see: http://www.imf.org/external/np/mae/mft/code/index.htm#goodtrans2

[8] I personally do not see much economic content in the usual argument that the deposit insurance funds should compensate the uninformed depositor. But this discussion is beyond the scope of this note.

Assistance (ELA), sometimes called lender-of-last resort[9]. Some add a well defined finality of payments (settlement) as an additional element in a country's financial safety net. It might be a good idea to draw the attention to authorities that the safety net should be looked upon as a whole, not only part by part. So, the system of deposit insurance (its design etc.) should be evaluated in the context of other parts as well[10]. Again, no detailed analysis is needed, but I recommend to point out to authorities (especially central bank and commercial banks) that the holistic (not necessarily holy, though) view is necessary for both of them (banks cannot view the deposit insurance as a premium only, it is de facto a subsidy to them so that they can be more risk-prone and marked based premium would probably be significantly higher than the present ones).

9. **Some additional advice:**

a) I would advice that in the future they do not have a rigid law determined system of premium. The Law should specify how to broadly determine premium, maybe put some upper bound (more as a protection of banks). Limits, but the fine-tuning should definitely be left with authorities i.e. Agency in cooperation/confirmation of the Romanian Central Bank).

b) In the context of a safety net have contingency plans for systemic crises. Deposit insurance should not be designed for a systemic crisis issues. But this should not be neglected so one should check with authorities if they think about such a scenario.

c) In recommendations I would advocate a three pillar approach. First pillar is capitalized fund. Second pillar is some type of stand-by loans or letters of guarantee from larger (presumably sounder) commercial banks to support the

[9] Here I use them as synonims. Sometimes those facilities are differentiated on the grounds if the provision of liquidity goes to the market or to an individual bank(s).

[10] The better the supervision (and prudential regulation) and a well defined ELA the lower the probability of activation of the Deposit insurance (which is activated only in the case of bank bankruptcy). In other words they are to some degree substitutes. Good supervision should prevent bank bankruptcy and either revitalize the bank or perform an orderly liquidation. However it is important to understand the relevance of market discipline and not shy away from closing down the bank if necessary.

system in case of insufficient funds and the third pillar would be a state guarantee (which is implicitly most probably there anyhow).

d) My view is that the final output should be a single, unified paper for the Romanian authorities (with possible annexes for specific stakeholders like DGF, Central bank, banking association). Transparency is important and all stakeholders should have the same information from you.

III References

1. Cull, Robert, Lemma Senbet and Marco Sorge (2004): Deposit Insurance and Bank Intermediation in the Long Run. BIS Working Paper No. 156. July (from www.bis.org)
2. Guidance For Developing Effective Deposit Insurance Systems (2001). Financial Stability Forum (from www.fsforum.org).