



# The Financial Safety Net – a necessity in a turbulent financial world

Peter BALOGH\*, Nicu ȚOCU\*\*

---

## ARTICLE INFO

*Article history:*  
Accepted June 2012  
Available online 1 August 2012  
*JEL Classification*  
E 58, G 21

*Keywords:*  
Financial safety net; Crises; Central bank

---

## ABSTRACT

Over the last years we observed that whenever crisis hits, interest in guarantee arrangements rises. The current financial crisis is no exception in this respect. It turns the spotlight on the operation of the financial safety net and provides policy makers with a unique opportunity to monitor its performance and, more specifically, to identify its strengths and weaknesses. The aim of this paper is to demonstrate the need of financial safety nets in a world characterized by deep financial disruptions, describing also the main components of a well-built financial safety net.

© 2012 EAI. All rights reserved.

## 1. Introduction

During the past 30 years financial systems turned global. The traditional banking reflects the model under which banks funded their operations through deposits, and these operations were centered on making loans. The deregulation that occurred over the past 30 years changed fundamentally the nature of banking business. The current banking business is characterized by cross-border operations, free capital flow, and by the fact that banks are no longer concentrated exclusively on banking: they earn their income from providing financial advice or arranging large syndicated loans. Financial groups grew different from traditional banking through securities underwriting, trading, and insurance.

The deregulation of banking and finance was a core component of the free market policies pursued in 1980s. At the time, it was argued that in order to come to grips with the benefits of deregulation in other economic sectors, capital and credit had to be allocated to those who could use them most efficiently. To ensure this outcome, financial institutions should respond to the market by allocating credit. Interest rate controls and ceilings were abolished and central banks stopped trying to control the growth of credit directly by adjusting the reserve ratio on deposits.

The financial crisis that started in 2007 was one of the worst crises in history. The actions that were taken affected an array of institutions during the crisis, like any crisis before it, and set a new precedent and encouraged new risks. During the crisis, public safety nets and assistance were stretched far beyond anything that had been done in past crises. Deposit insurance coverage was substantially expanded and public authorities went well beyond this when it provided guarantees of bank debt instruments, asset guarantees at selected institutions, and many other forms of market support. Discount window lending sharply departed from previous practices in terms of nonbanks and special lending programs. Substantial public capital injections were further provided to the largest financial organizations. At the heart of the financial collapse were some of the largest commercial and investment banks, as well as the markets in which these institutions were key players (Thomas M Hoenig, 2011).

Financial institutions have set up off-balance-sheet vehicles as a means of disbursing and concealing risk, but to what extent do these off-balance-sheet vehicles during times of crisis fall under the central bank safety net? In the early stages of the subprime crisis, the Federal Reserve quickly made it clear the banks' off-balance-sheet vehicles enjoyed safety net protection, but it was not the case of the non-bank financial institutions. The question that arises is how the global safety net should be defined for the twenty-first century.

The paper is structured in three main parts. In the first part, we are defining the financial safety net and its main components, highlighting the need for financial safety nets. In the second part, we are analyzing in detail the three main components of the financial safety net (lender of last resort, deposit insurance schemes and prudential supervision). The third part comprises the conclusions drawn from this paper.

## 2. The financial safety net

Everybody is concerned about safety. Miners wear protection equipment, they have safety lamps, cruise ships stock life vests and lifeboats. In banking, we can imagine a situation in which managers of financial institutions deliberately throw themselves into risky financial operations,

When or if things turn out badly, a disaster can occur. A financial safety net consists of measures taken to restrict the risky positions that institutions assume in the first place and to limit the damage customers, employees, and stockholders suffer when and if disaster ensues.

Banks are vulnerable to sudden and unexpected loss of funding (the classic run on the bank). Also, highly interconnected financial system may cause domino-like collapses or, in recent years, asset price spirals that ultimately undermine banks' solvency. Once the plague spreads to otherwise healthy banks, the economy and society can suffer serious damage. Banking crises are extremely costly in economic terms. It is extremely difficult to measure how much output is lost during a financial crisis. Banking crises usually result in deep economic recessions, followed by several years of below-trend growth. The real economic costs are reflected by an economy that produces fewer goods and services and employs fewer people. Such huge economic costs justify attempts to protect banks against systemwide failures.

The institutions that attempt to stem contagion are collectively referred to as the *financial safety net*. (Schooner&Taylor, 2010). In reality, there is no generally accepted definition of the key elements of the financial safety net. A narrow definition is limited to deposit insurance and a lender-of-last-resort function. A more widely accepted one includes (at least) three elements, adding the prudential regulatory and supervisory framework to the previous components (e.g. FSF, 2001). The three main elements are also called 'lines of defense'. The first line of defense is a *lender of last resort* – a bank which has the ability to create new bank reserves and to lend them to commercial banks which have liquidity problems. The second line of defense is a *deposit insurance scheme* that guarantees depositors that their funds will be repaid in the event that a bank fails. The final line of defense could be an *effective supervision* (Kahn&Santos 2007) or a government bailout (Schooner&Taylor, 2010). An expanded definition of financial safety nets consists of four key elements, which are the three (minimum) elements already mentioned above, as well as failure resolution mechanisms for financial institutions (Schich, 2008).

But before we start analysing in detail the three main components, it is important to consider the background and history of instruments and regulations that counted as financial safety net in the past and of the common perception about them. Some believe that the banking industry is over-regulated. This may be true but we should not confuse over-regulated with well-regulated. So, in order to have a financial net which guarantees the soundness of the banks, financial systems have to be well regulated. However, there are still some economic theorists who consider that the financial safety net should be completely dismantled or at least be significantly pared back and that markets should be left to deal with instability as best they can. According to this, government intervention should be eliminated, because market participants have sufficient incentives to be self-policing. The present financial crisis nevertheless proved that without a financial safety net, financial markets are unstable and there is a great potential to create great costs on the rest of society.

Banking regulation was considerably tightened after the banking crisis suffered in the United States and Europe in the early 1930s to include strict constraints on the composition of banks' assets and liabilities, the rationing of licenses, limits on maturity transformation, separation of commercial and investment banking, and geographical segmentation of activities. Such restrictions were later relaxed throughout the world in the vast process of liberalisation and deregulation that started in the 1970s and progressed thereafter. Administrative restrictions were increasingly replaced by less intrusive, indirect prudential standards, such as capital requirements.

Deposit insurance schemes became a key component of the arrangements put in place to foster financial stability. In the United States deposit insurance was instituted after the Great Depression, while in Europe such systems were mostly established in the 1980s or later. This additional safety net to central banks' lending-of-last-resort was created to support banking sector stability (by removing incentives for depositors to join a bank run), but there was also a social concern to protect "unsophisticated" or "small" depositors. In the last quarter of the last century not only did supervisory tools and practices evolve towards a more market-friendly approach, but the involvement of the central banks in financial stability was also confronted with a number of intellectual and institutional developments that challenged the paradigm shaped by the experiences of the nineteenth century and the first half of the twentieth century.

In order to appreciate the changes in the financial system and their effect on the potential for financial instability, I shall consider first a description of what could be labeled as the "old" financial system. The "old" system was characterized by separation in four respects (Padoa-Schioppa, 2002).

*Firstly*, there was a clear separation between financial institutions and financial markets (equity, bond, and derivatives markets). The exposure of financial institutions to market volatility was limited, as they largely focused on the transformation of deposits into illiquid loans.

*Secondly*, there was strict separation between the three main categories of financial institution (banks, insurance companies and other non-bank financial institutions, such as securities houses), as well as between their products. Non-negotiable bank loans, insurance policies and negotiable securities provided completely distinct ways of allocating savings and risks.

*Thirdly*, the separation between markets and financial institutions, as well as between different types of financial institution, was reflected in the regulatory and supervisory structure. The oversight of markets was conducted by a separate entity from the one supervising financial institutions, and banks which faced a different supervisor to insurance companies.

*Fourthly*, domestic financial systems tended to be insulated from one another, through restrictions on cross-border competition and capital flows and still relatively weakly developed links between financial systems.

However, in this paper we shall consider that the contemporary, or the "new system" in which the financial safety net is made up of three main components, as stated in my aforementioned definition: (1) Lender of last resort; (2) Deposit insurance scheme; (3) Supervisory functions.

### **3. Lender of last resort (LOLR)**

Central banks are last-resort lenders. Their role was pronounced by Walter Bagehot in his famous 1873 essay when he wrote that central banks should be prepared to lend freely against acceptable collateral but at penalty rates. Central banks started performing this lending of last resort function in the second half of the nineteenth century. The Belgian National Bank started conducting lender of last resort operations in the 1850s, while the Bank of England, the Nederlandsche Bank, the Austrian National Bank and the Banco de Portugal started doing it in 1870s.

Central banks' options as last-resort lenders are influenced by each country's institutional arrangements. One size does not fit all. A central bank's lending procedures cannot be the same in a country with a faultily designed deposit insurance scheme as they are in one where depositors are less prone to panic runs. The role of central banks has been changing throughout time. Their capacity to act covertly has been eroded by the widespread availability of information and the growing scrutiny of market participants. Their job as last-resort lenders has been further complicated by the stigma attached to borrowing from a central bank.

Central banks, as promoters of financial stability and managers of each country's ultimate settlement and clearing system, are also responsible for providing financial markets with liquidity. The aim is not to alleviate the situation of any particular institution, but rather to facilitate the normal functioning of markets when extraordinary events hinder operations. Financial markets need certain amounts of liquidity to settle and clear operations. Under normal conditions, liquidity is provided by market participants themselves in the shape of bilateral credit lines. These lines allow participants to settle their transactions without having to use large amounts of cash balances.

When certain shocks hit the markets, credit is usually squeezed. In this case, market participants need larger amounts of cash balances to settle their transactions, resulting in higher and more volatile interest rates. Under these circumstances, the role of a central bank, as manager of the ultimate settlement system, is to provide enough liquidity to prevent impairment of financial markets.

Surprisingly, there is no accepted definition of the term lender of last resort. Meltzer (1986, p83) summarized this term stating that:

„The central bank is called the lender of last resort because it is capable of lending - and to prevent failures of solvent banks must lend - in periods when no other lender is either capable of lending or willing to lend in sufficient volume to prevent or end a financial panic.”

He considers five main points, the first four are derived from Bagehot (Fischer, 1999) :

- The central bank is the only lender of last resort in a monetary system.
- To prevent illiquid banks from closing, the central bank should lend on any collateral that is marketable in the ordinary course of business when there is no panic. It should not restrict lending to paper eligible for discount at the central bank in normal periods.
- Central bank loans, or advances, should be made in large amounts, on demand, at a rate of interest above the market rate. This discourages borrowing by those who can obtain accommodation in the market.
- The above three principles should be stated in advance and followed in a crisis.
- Insolvent financial institutions should be sold at the market price or liquidated if there are no bids for the firm as an integral unit. The losses should be borne by owners of equity, subordinated debentures, and debt, uninsured depositors, and the deposit insurance corporations, as in any bankruptcy proceeding.

So, in the traditional framework the role of the lender as last resort is to provide liquidity to the market, as required, against good collateral, for a short period of time, at a „premium” rate. Thus it is the role of the LOLR to step in if the normal market fails for some reason to ensure that financial stability is maintained.

As long as banks are able to borrow funds to cover any sudden and unexpected withdrawal of deposits, a cascade effect can be stopped in its tracks. Providing banks with a guarantee of funds to cover any deposit withdrawal is one of the functions of the central bank, acting in the capacity of lender of last resort. However, private lenders are not always willing or able to lend and in period of turbulence they are not willing to extend loans at any price. Runs on several banks simultaneously or a period of widespread system instability may cause the interbank market to cease functioning. There are some circumstances in which a bank needs liquidity, but it might be the case that this liquidity is unavailable. Mark Twain observed that a banker is a fellow who lends you his umbrella when the sun is shining and wants it back the minute it begins to rain.

Historically, most central banks have had the responsibility for the lending of last resort function in their countries. This is still true today. There are some exceptions. One of the most important exceptions is Germany. Here the central bank does not provide liquidity support to individual financial institutions, at least not directly. This function is fulfilled by the Liquidity Consortium Bank, the so called Liko-Bank, which is a bank jointly owned by the central bank and the banking industry. Besides its own funds, this bank may have access to supplementary funds for which its owners are obliged if necessary and has access to a rediscount line set up by the central bank. Another exception is the European Central Bank, the head of the European central banks joined in the European System of Central Banks (ESCB). Even if neither the Maastricht Treaty nor the ESCB Statute give the European Central Bank an explicit mandate for providing emergency liquidity support directly to individual financial institutions, the responsibility for promoting the smooth functioning of the payment system is the ESCB's task. Officially however, the task of providing emergency liquidity remains the responsibility of national central banks.

In the aftermath of the crisis, there seems to be a case for improving the menu of instruments and institutions to protect against global liquidity crunches in a preventive way. One solution that was put forward in November 2010 by Arias and Yeyati is an International Lender of Last Resort (ILLR). They think that it is important to consider the complementary relationship between a global liquidity facility to address liquidity crises and solvency-related arrangements. For example, a global liquidity facility may be unable to successfully solve the systemic financial crisis in all affected countries—whether because the facility is not fully effective in avoiding permanent economic damage or because some countries are also hurt by real shocks that call for corrective policies (e.g., the Greek crisis in 2010)—and it may be necessary to consider the transition to adjustment and restructuring arrangements in a seamless fashion.

In the last twenty years many emerging countries (Argentina, Brazil, Ecuador, Indonesia, Korea, Mexico, Russia, Thailand, Turkey, Uruguay) have experienced different kind of crises: currency, debt, financial and banking crises. These countries faced large drop in asset prices and economic activity, massive reversal of capital flows. The external financing was not enough, because of strong capital outflows and the unwillingness of important investors to rollover short-term credits. There has something to be done at international level. International financial institutions have get to involved to resolve this problem. There is a debate on the issue of using a combination of official financing by international financial institutions and private financing, or should it be whether a private or an official involvement in crisis resolution. (Corsetti et al, 2003)

The issue of ILLR was also studied by Mishkin (2000), who has proved that an international lender of last resort has important role in improving the functioning of the international financial system. He suggested eight principles to guide the operations of an ILLR in order to ensure the proper functioning and to limit the moral hazard that such an arrangement creates:

- 1) restore confidence to the financial system;
- 2) provide liquidity to restart the financial system;
- 3) provide liquidity as fast as possible;
- 4) restore balance sheets;
- 5) punish owners of insolvent institutions;
- 6) encourage adequate prudential supervision;
- 7) engage in lender-of-last-resort operations only for countries that are serious about implementing necessary reforms; and
- 8) engage in lender-of-last resort operations infrequently and only for short periods of time.

Mishkin considers that the only institution that is able to act like an international lender of last resort is the International Monetary Fund. He also considers that the IMF's current activities interfere with effective performance of this role, but reforming the IMF could solve this problem and it is desirable for improving its capability in managing financial crises. Fischer (1999) considers that the IMF is already playing the role of ILLR, but IMF cannot act as a lender of last resort because it is not an international central bank and cannot create international reserves.

In conclusion, an international lender of last resort (ILLR) is prepared to act when no other lender is capable or willing to lend in sufficient volume to deal effectively with financial need to avert a crisis. Institutions of domestic lending of last resort (LLR) are a good starting point as a model for an ILLR. An ILLR system would work best when countries arrange their participation in a precautionary mode so that facilities act with speed and certainty and, crucially, agents anticipate such a behavior. It is crucial that ILLR has the widest participation possible, so that ILLR protection is known to be in place and is therefore powerful as a preventive instrument.

#### 4. Deposit insurance

Another component of an effective financial safety net is a deposit insurance scheme (DIS). A well-developed system of deposit insurance is a key element of a sound and stable financial system. Whereas the lender of last resort is designed to provide liquidity to illiquid but still solvent banks, a deposit insurance scheme has the different objective of ensuring that in the event of a bank failure, depositors are guaranteed to receive back at least the minimum insured amount of their deposits. Deposit insurance schemes covering the entire banking system of a country are a more recent regulatory device. The oldest deposit insurance scheme in operation is The United States Federal Deposit Insurance Corporation, established in 1934 with an initial coverage amount of up to 2.500 USD.

Reflecting the increased international adoption of these schemes, the International Association of Deposit Insurers (IADI) was formed in 2002 to give guidance and to encourage international cooperation in making deposit insurance schemes more effective. In 2009, the IADI issued a set of Core Principles for Deposit Insurance. According to a Financial Stability Forum's report from 2001, the principal objectives of a deposit insurance system are: (1) to contribute to the stability of a country's financial system; and (2) to protect less financially sophisticated depositors from the loss of their deposits when banks fail.

The motivation for deposit insurance is to help prevent the risk that a bank run will grow to a broader bank panic. Knowing that their deposits would be repaid fully or in most part even if the bank were to fail means depositors have fewer incentives to withdraw their funds from an institution even when there is news that the institution is about to fail. So, deposit insurance reduces bank runs, bank panic and contagion.

At the end of 2008, there were 100 countries with deposit insurance system in operation, and 19 countries with deposit insurance systems that are pending, planned, or under development. Several countries have multiple deposit insurance schemes. For instance, Austria has five different deposit insurance providers. Most of the countries have an *explicit deposit insurance system*, where the government, through an agency, has created a deposit insurance system to guarantee deposits. This system relies on regulation, banking and other legislation, active involvement of regulators. There are several countries that provide *implicit deposit insurance coverage*. This is a system where the government has not created a specific agency providing deposit insurance, but has stated its willingness to guarantee deposits when so needed.

Within the European Union, the DIS are organized according to national regulation and with the support of the common guide represented by the Directive 94/19 EC and its subsequent amendments (Directive 09/14 EC). The organization of the European DIS varies from entities located within the central banks to independent bodies, either public or private, one or more for the same banking market, with resources derived from ex-ante (which equals a deposit insurance) or ex-post contributions (drawing when needed) of the member banks.

In the fall 2008, following the bankruptcy of Lehman Brothers Holdings, confidence among banks fell further. At the same time, it became increasingly clear that the policy interventions to date were not successful in restoring confidence in markets and among the wider public.

A great number of emergency policy measures were implemented, several of which related to deposit insurance arrangements, such as:

- raising the maximum levels of coverage. In the US, the ceiling of the deposit insurance was raised from 100.000 USD to 250.000 USD per depositor per bank on a temporary basis. In Europe, several countries including Belgium, Greece, Luxembourg, Netherlands, Portugal, and Spain raise deposit insurance to 100.000 euro,
- reducing the role of co-insurance arrangements,
- taking steps to ensure timely access to insured deposits, and
- policy makers in some countries made statements that suggested (either explicitly or implicitly) that deposit insurance coverage would be unlimited. Coverage of guarantee arrangements was also extended in some cases to wholesale bank liabilities that were not traditionally covered by such arrangements.
- extending coverage to a wider range of deposits.

These and other related actions were aimed at restoring confidence among both financial intermediaries and the wider public. They tend to reduce the threat of bank failures by raising the likelihood that depositors and creditors continue to provide a stable source of refinancing for banks.

## 5. Prudential supervision

Effective bank regulation and supervision represent in my opinion the first lines of defense. The regulation and supervision of financial institutions and markets must always aim to maintain financial system stability. Regulation and supervision, of course, must be guided by best practices and applicable standards.

Prudential supervision is aiming at safeguarding the solvency of financial institutions and as a consequence their ability to honour their promises to depositors or policy holders, from conduct of business supervision which is aimed at insuring honest dealing both in the markets and in individual contacts with investors. This is pursued by requiring adequate disclosures about the proposed products or transactions, by prescribing protective contract clauses and increasingly by imposing a specific conduct. Another type of monitoring relates to the “oversight” function of the central banks, aimed at safeguarding the smooth functioning of the payment systems, and more generally the overall financial stability.

In some countries, bank supervision is performed by institutions other than the central bank, but often with important links to the central bank. In most cases, the bank supervision is allocated to the regulatory authority that has the primary responsibility for this function. However, central banks continue to have the key role in supervision of banks. Supervision is normally the task of the specialized public authorities that in most cases enjoy an independent status.

There are some recent debates on whether bank supervision should be housed in the central bank or moved to an independent authority. Some central banks have pleaded strongly for entrusting banking supervision to the bank, in order to enable the bank to work out its policies, especially in the monetary field, on the basis of the intimate knowledge and information about the banking system. The same applies to its lender of last resort function, where timely information may be of the utmost importance. In both cases the needs of the central bank are formulated in terms of information.

In order to enable the central bank to execute its tasks both in the monetary field and in terms of supervising systemic risk it is widely admitted that it should be fully informed about the main evolutions in the financial system, especially but not only in the banking sector. Bridges between the two domains should be effective and ensure information flows in both directions. On the one hand, the central banks’ oversight should include the financial supervisor’s information on the major or systemic firms and, if needed, include market infrastructure. On the other hand, the oversight’s findings should be included in the financial supervisor’s analysis of the individual firms involved, e.g. by way of early warnings.

The ECB considers that the attribution of prudential supervisory responsibility even beyond the national central banks in the euro zone is desirable from two points of view (Duisenberg, 2000). It allows central banks first, to understand the financial condition of financial intermediaries better, and second, to make possible a closer implicit coordination with the monetary policy function. The regulators’ responsibilities on banking supervision are decentralized at the national level in the EU. However, in the case of cross-border operations and banking crises, it relies on the existence of an established network of contacts among supervisors.

In the EU beginning with January 2011 was established a new supervisory framework. The new institutional framework called European System of Financial Supervision (ESFS) is made of a two pillar supervision structure: macro- and micro-prudential supervision. The macroprudential supervision is in the authority of the newly created European Systemic Risk Board (ESRB). The microprudential supervision is based on the interplay between the national competent supervising authorities and the three European Supervisory Agencies (ESAs): European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), European Securities and Markets Authority (ESMA). This new structure will ensure that risks will be identified and addressed at macro and micro level in the European financial system.

One of the lessons drawn from the recent financial crisis is the necessity to supervise the entire financial system. The European System of Financial Supervision was created in order to complement the traditional micro-prudential supervision with a systematic analysis of systemic risks and a framework for targeted action to address these risks. The ESRB is mandated to monitor, assess and prioritise threats to financial stability in the EU. This mandate covers all segments and areas of the financial markets, including market infrastructures and guarantee schemes. It will perform stress tests to determine the sensitivity of the financial system to shocks. Based on its analysis, the ESRB is entitled to issue risk warnings and recommendations for remedial action, if it comes to the conclusion that such an action is required. The ESRB is also tasked to monitor the implementation of these recommendations. However, the ESRB neither has macro-prudential tools directly at its disposal (e.g. the right to impose counter-cyclical capital charges) nor does it have sanctioning powers against financial institutions or authorities that fail to respond to a risk warning (Deutsche Bank Research, 2011).

The European Banking Authority is in charge of the microprudential analysis of risks and vulnerabilities of the EU banking sector. The EBA acts as a hub and spoke network between the EU and national bodies safeguarding public values such as the stability of the financial system, the transparency of markets and

financial products and the protection of depositors and investors. The EBA has some quite broad competences, including preventing regulatory arbitrage, guaranteeing a level playing field, strengthening international supervisory coordination, promoting supervisory convergence and providing advice to the EU institutions in the areas of banking, payments and e-money regulation as well as on issues related to corporate governance, auditing and financial reporting.

Another problem of the prudential supervision is the surveillance of the shadow banking system, which can be a source of systemic risk. The „shadow banking system” can be described as “credit intermediation involving entities and activities outside the regular banking system”. Intermediating credit through non-bank channels can have advantages. For example, the shadow banking system can be an alternative, cheaper source of funding and liquidity for market participants and corporates. (FSB, 2011)

There are also some opinions that another component of the financial safety net is the government bailout, i.e. the fiscal authority of a country provides capital support to a bank. The problem with this procedure of public-sector capital injections is that the emphasis is often on wiping out the existing bank shareholders. Rather, the aim should be to allocate losses fairly between bank owners and depositors and minimize costs to the taxpayers, while preserving incentives for infusion of new private capital. If the scale of banking system losses is deep – as they were in Iceland, Ireland – there is a risk that the government will not have or will not be able to borrow the resources to recapitalize banks. Banks would change their situation from *too big to fail* to *too big to save*.

## 6. Conclusion

***The financial safety net is basically an insurance against a collapse of the banking system.*** Like any form of guarantee, financial safety net gives rise to moral hazard, particularly by encouraging banks to take on greater risks than they otherwise would. It is important to limit the moral hazard generated by the financial safety net.

***The task is rendered even more strenuous when we think that the creation and implementation of an effective system to resolve failing banks does not have fixed rules. On the one hand, the appropriate approach depends on the circumstances prevailing in each particular country and its past experience. On the other hand,*** safety-net design must address differences in transparency and accountability that exist across countries. The weaker a country’s informational, ethical, and corporate-governance environment, the greater the danger that a wholly governmental system of explicit deposit guarantees will undermine bank safety and stability.

Central banks are bound to be involved in financial stability. They are banks, they must control the soundness of their counterparties, they are entrusted with the exclusive task of creating ultimate liquidity, and they are driven by public interest. No other public or private institution has been invented which is equally capable of avoiding and mitigating the “indiscriminate public terror” (Bagehot) of a financial crisis. Thus, central banks do play and should play an important role in maintaining financial stability, regardless of the institutional structure for supervision which happens to be adopted in their jurisdiction.

The nature of the financial net can not be defined in advance for conditions of the twenty-first century. Circumstances change unexpectedly, and the authorities and central banks must adapt rapidly. It can be the case that the safety net needs to be stretched beyond the traditional banking system, but it remains important to avoid the so-called moral hazard problem.

A safety net should be used mainly to assure the public that the payment systems will continue to function smoothly and the core savings will remain essentially inviolable. A central bank should be able and willing to lend on an emergency basis to financial institutions. But such emergency lending should be very rare indeed in order to keep the central bank’s balance sheet itself from becoming part of the problem and also from rising more acute moral hazard issues. As to off-balance sheet items, it is not a matter of whether they should have safety net protection or not, but a matter of oversight of how they should be handled in measuring and publishing bank capital positions, so that financial transparency helps tone down the excesses of the ever-greedy market.

## References

- [1]. *A symposium of views, Defining the financial safety net, The international economy – The magazine of international economic policy, Washington, 2008;*
- [2]. *Apostolik, R., Donohue, C., Went, P., An overview of banking, banking risks, and risk-based banking regulation, John Wiley&Sons, Inc., Hoboken, New Jersey, 2009;*
- [3]. *Bagehot, W., Lombard Street, A Description of the Money Market, New York, 1877, www.gutenberg.org;*
- [4]. *C.M.Kahn, J.A.C. Santos, Institutional allocation of bank regulation: a review, in D.G. Mayes, G. E. Wood (2007), The Structure of Financial Regulation, Routledge, London, 2007;*
- [5]. *Corsetti, G., Guimaraes, B., Roubini, N., „International Lending Of Last Resort And Moral Hazard: A Model Of Imf’s Catalytic finance”, NBER Working Paper Series, 10125, 2003;*

- [6]. Davis, E. P., Obasi, U., *Deposit Insurance Systems and Bank Risk*, Brunel University West London, Department of Economics and Finance, Working Paper no. 09-26, June 2009;
- [7]. Deutsche Bank Research, „Financial Supervision in the EU: Incremental Progress, Succes Not Ensured“, *Financial Market Special, EU Monitor* 84, 2011;
- [8]. Dijmărescu, E., *Deposit guarantee schemes join financial safety-net*, *Romanian Journal of European Affairs*, vol.11, no.1, 2011;
- [9]. Duisenberg, W., „The future of banking supervision and the integration of financial markets“, conference organized by the Euro Group on improving integration of financial markets in Europe, 22 May 2000;
- [10]. Fernández-Arias, E., Levy-Yeyati, E., *Global Financial Safety Nets:Where Do We Go from Here?*, IDB Working paper series No. IDB-WP-231, November 2010;
- [11]. Financial Stability Board, „Shadow Banking: Scoping the Issues A Background Note of the Financial Stability Board“, 2011;
- [12]. *Financial Stability Review*, European Central Bank, June 2010;
- [13]. Fischer, S., „On the Need for an International Lender of Last Resort“, *International Monetary Fund*, 1999;
- [14]. H. M. Schooner, M.W. Tayler, *Global bank regulation. Principles and policies*, Elsevier, 2010;
- [15]. International Association of Deposit Insurers, *Country System List* dated May 1, 2008;
- [16]. Kane, E.J., *Financial regulation and bank safety nets: an international comparison*, Boston College, 2004;
- [17]. Krimminger, M., „Deposit insurance, banking resolutions and moral hazard: considerations in system design, in Mayes, D., Pringle, R. and Taylor, M., *Towards a new framework for financial stability*, Central Banking Publications, 2009;
- [18]. Mayes, D.G., *The lender of last resort in the safety net*, in Mayes, D., Pringle, R. and Taylor, M., *Towards a new framework for financial stability*, Central Banking Publications, 2009;
- [19]. Meltzer, A., „Financial Failures and Financial Policies“ in G. G. Kaufman and R. C. Kormendi (eds), *Deregulating Financial Services: Public Policy in Flux*, Cambridge, Massachusetts: Ballinger, 1986;
- [20]. Mishkin, F., „The International Lender Of Last resort: What Are The Issues?“, *Kiel Week Conference, "The World's New Financial Landscape: Challenges for Economic Policy," Kiel Institute of World Economics, Kiel, Germany, July 2000*;
- [21]. Padoa-Schioppa, T., *Central banks and financial stability: exploring a land in between*, Second ECB Central Banking Conference, Frankfurt am Main, „The transformation of the european financial system“, October 2002;
- [22]. Schich, S., „Financial crisis: Deposit insurance and related financial safety net aspects, OECD – Financial Market Trends, 2008.