

Technical Note

LINDA methodology for the evaluation of the Financial Safety Net

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April 2012

The LINDA methodology for the evaluation of the Financial Safety Net¹

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The LINDA Methodology described in this document was developed by Fit & Proper for the use of its own consultancy projects; the present document is for informational purposes. The assignment of a LINDA qualification could only be realized under the criteria and processes contained in the “Instructive for the application of the LINDA methodology “developed by Fit & Proper.

Comments and observations please send them to: info@fitproper.com

Translation from the original paper: Victoria Gonzalez Curtolo (February 2013).

¹ The author thanks Natalia Teplitz for her comments.

I. Introduction

The Financial Safety Net (FSN) is an integral part of the regulatory framework and financial supervision of a country; its function is to prevent and to mitigate the effects of the fail of one or several financial institutions. The FSN has been a matter of attention and increasing analyses in the last years by authorities of regulation and supervision, multilateral credit organisms, and centers of specialized studies and users.

For the moment, there is no methodology for the evaluation of a FSN which allows a systematic approach of the matter and enables making comparable evaluations of different countries.

This document presents a methodology for the evaluation of a FSN called LINDA, which is based on the analysis of five factors for each component of the FSN. This methodology assigns to each of the components of the FSN, the following qualifications: Strong, Acceptable, Weak or Non-existent.

The application of the LINDA methodology requires, in addition, the use of the "Instructive for the application of the LINDA methodology" developed by Fit & Proper.

The document is organized as follows: section II describes the basic conceptual aspects of the FSN and section III presents the LINDA methodology.

II. The Financial Safety Net. Conceptual aspects.

Definition

The FSN is defined as:

"The set of institutions, procedures and mechanisms to prevent and/or limit the impact of the fail of one or more financial institutions that face economic, financial and/or operational problems".

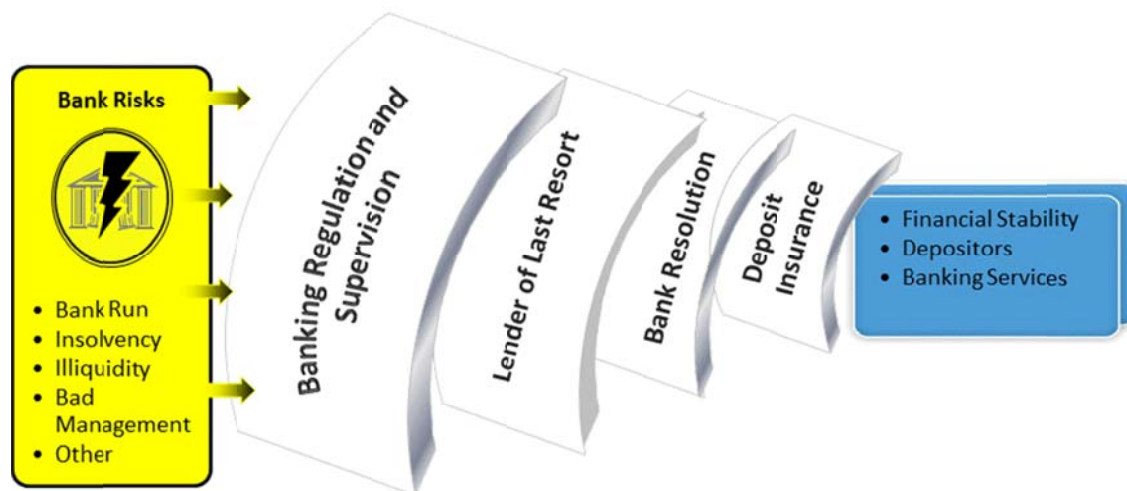
Components of the Financial Safety Net

There is consensus that the four main components of a FSN are:

- Banking Regulation and Supervision (R&S).
- Lender of Last Resort (LLR).
- Bank Resolution (BR).
- Protection for Depositors - deposit insurance or guarantee (PD).

The different components of the FSN can be conceived as successive “lines of defense” against bank risks; this vision is represented in Figure 1.

Figure 1. Lines of defense of the Financial Safety Net



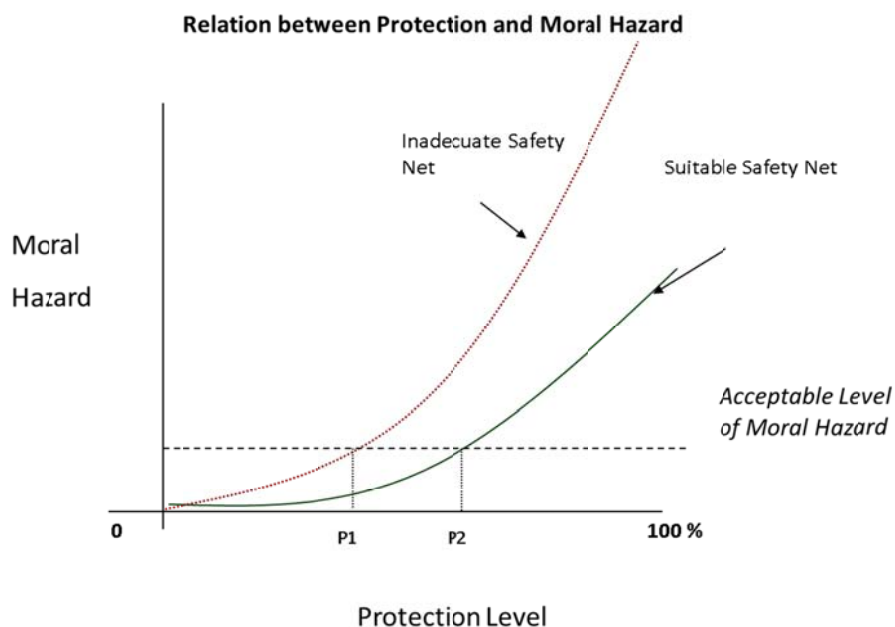
Source: Javier Bolzico, Exposición “Pilares para una Resolución Bancaria Eficiente”, Concertación Ecuador. Quito, Ecuador, 6 de septiembre de 2006.

Some considerations of the Financial Safety Net

Since the international financial crisis initiated in 2007, consensus has grown concerning the need of countries to possess an adequately constituted and operative FSN. A FSN has as principal aims to promote the stability of the financial system and to give certain degree of protection to its users.

The way in which a FSN is designed affects decisively in two fundamental aspects: the capability of anticipating or limiting the effects of a crisis and the generation of the called "moral hazard".

Therefore, a suitable design of a FSN must seek to maximize the first aspect, given a certain level of accepted moral hazard or - inversely - it must minimize the moral hazard subjected to reach a certain level of protection (Figure 2).

Figure 2. Financial Safety Net: protection vs. moral hazard

The capacity for preventing or limiting the effects of a crisis of a FSN depends on several factors, among which can be distinguished: strength of the institutions involved, quality in the design of processes, available resources and capacity of the staff at the expense of its implementation.

The generation of moral hazard can, and must, be limited through the design of each component of the FSN and of access requirements to it. In this way, for instance, those institutions which have previously had an imprudent risk management must not have access to the facilities of the FSN, the coverage for the depositors must never be total, the “rescue” of the shareholders must not be possible, etc.

When analyzing the introduction of different components of the FSN, a suitable balance between “protection” and “moral hazard” must be assured.

III. Methodology for the LINDA evaluation

The methodology for the LINDA evaluation is a guide for the evaluation of the FSN by the analysis and evaluation of its components: Regulation and Supervision (R&S), Lender of Last Resort (LLR), Bank Resolution (BR) and Protection for the Depositors (PD).

The LINDA scheme anticipates four possible qualifications for each component of the FSN: Strong, Acceptable, Weak and Non-existent.

For every component of the FSN the LINDA methodology evaluates five factors: Legislation, Institutional Framework, Normative Norms and Regulations, Disponibility of Funds and Applicability

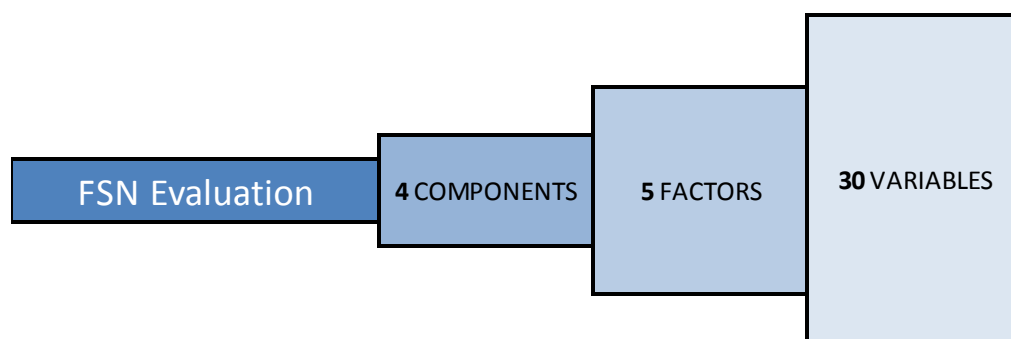
In order to obtain the qualification of every component, the previously assigned qualification to each of the factors must be taken into account, which in turn is done on the basis of the analysis of the respective variables.

It is to say that in order to reach the qualification of every component the analysis must begin by analyzing the variables. Then, the qualification of the factors is obtained and, finally, the component is qualified. For the evaluation of the variables the conceptual developments and the best practices in the matter are taken into account; additional variables to the listed in the methodology can be considered if necessary.

A LINDA qualification can be given to the FSN as a whole as well, after considering the evaluation of its components altogether.

Figure 3 shows the scheme of qualification until it reaches the evaluation of the FSN.

Figure 3. Scheme of the LINDA methodology



Requirements for the application of the LINDA methodology

The application of the LINDA methodology needs the participation of experts with knowledge and practical concrete experience in: regulation and bank supervision, lender of last resort, bank resolution and deposit insurance.

Likewise, the assignment of a LINDA qualification will only be able to be realized under the criteria and processes contained in "Instructive for the application of LINDA methodology" developed by Fit & Proper.

Below, the LINDA methodology is exposed schematically.

	Components	Factors	Variables
Financial Safety Net (FSN)	Regulation and Supervision R&S	Legislation	<ul style="list-style-type: none"> - Legal capacity for regulating and supervising in consolidated bases - Legislation according to the best practices of R&S
		Institutional Framework	<ul style="list-style-type: none"> - Capacity and organization of the entity at the expense of the R&S - Existence and quality of supervision manual - Fulfillment of the principles of Basle and other standards
		Norms and Regulations	<ul style="list-style-type: none"> - Regulatory framework according to the best practices in regulation
		Disponibility of Funds	<ul style="list-style-type: none"> - Budget and available funds to carry out the functions of R&S
		Applicability	<ul style="list-style-type: none"> - Suitable and enough staff to carry out the tasks of R&S - Suitable training of the supervisors in the processes of supervision in force
	Lender of Last Resort LLR	Legislation	<ul style="list-style-type: none"> - Legal Aptitude to act as LLR - Limited to solvent entities - Amounts, rates, guarantees and other conditions of the financial assistance according to the best practices
		Institutional Framework	<ul style="list-style-type: none"> - Operative capacity and entity organization at the expense of the LLR
		Norms and Regulations	<ul style="list-style-type: none"> - Existence and sufficiency of regulation procedures
		Disponibility of Funds	<ul style="list-style-type: none"> - Economic - financial aptitude to carry out the LLR's functions (without generating inflation, exchange imbalances or negatively impacting the financial condition of the LLR)
		Applicability	<ul style="list-style-type: none"> - Existence of processes, manuals and qualified staff for making effective the shares of the LLR in a suitable form
	Bank Resolution BR	Legislation	<ul style="list-style-type: none"> - Capacity to apply BR's processes according to best practices - Clear assignment of functions - Limited periods - Legal Protection
		Institutional Framework	<ul style="list-style-type: none"> - Capacity and organization of entity at the expense of BR
		Norms and Regulations	<ul style="list-style-type: none"> - Existence and sufficiency of regulation procedure of BR's processes
		Disponibility of Funds	<ul style="list-style-type: none"> - Financial-economic capacity for BR's processes, under the least cost rule
		Applicability	<ul style="list-style-type: none"> - Existence of processes, manuals and qualified and trained staff in BR's processes in suitable form
	Protection of deposits PD	Legislation	<ul style="list-style-type: none"> - Explicit system of insurance or guarantee of deposits - Fulfillment of the international standards as for protection of deposits (IADI, Basle, etc.)
		Institutional Framework	<ul style="list-style-type: none"> - Capacity and organization of the entity in charge of the assigned tasks in relation to payment of deposits and bank resolution
		Norms and Regulations	<ul style="list-style-type: none"> - Existence and sufficiency of the regulations
		Disponibility of Funds	<ul style="list-style-type: none"> - Availability of funds to face the potential payments of deposits
		Applicability	<ul style="list-style-type: none"> - Availability of processes, manuals and qualified and trained staff in processes of payments of deposits.

IV. Final considerations

The LINDA methodology constitutes a technical objective framework for the evaluation of a FSN, on which the assessor's subjective criteria will be applied.

The LINDA methodology is a tool that allows the evaluation of an FSN at any given time, as well as its comparison with any other moment or with other countries' FSN.

The application of the LINDA methodology needs qualified experts with concrete experience in the topics involving FSN, as well as the use of the "Instructive for the application of LINDA methodology".