An important relationship

Deposit insurance and payment systems are inter-related, writes **Gregor Heinrich**

In April 2008, the Financial Stability Forum's report on enhancing market and institutional resilience stated, among other things, that "[t]o be effective, the deposit insurance function needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced, and sound accounting and disclosure regimes."

Today, when the financial turmoil is making us wonder whether existing safety nets are adequate, it is useful to step back a bit and think about the relationship between deposit insurance and payment systems.

Many, if not most, of the private-sector institutions that are the major players in payment systems benefit from a substantial public-sector safety net. In many cases explicit deposit insurance provides the most visible government support. But in addition, significant support is provided in conjunction with central bank payment operations.

However, in the world of deposit insurers, one rarely finds a reference to payment systems or to best practices followed in payment system development. I think that deposit insurance entities should be aware of existing developments to strengthen payment systems, and where possible be involved in the public dialogue leading to better, more efficient and safer payment systems, for several reasons.

Raising awareness

First, I think it makes general sense if those who are involved with developing and applying standards promoting financial stability in one particular area are at least broadly aware of the standards developed in other areas. Second, as deposit insurance and payment systems are both part of the financial stability network, it could be of interest to deposit insurers to follow more closely those developments that deal with general trends, rather than particular technical developments.

And finally, differences between deposit insurance and payment and settlement systems could pose particular challenges.

First, deposit insurance is generally – at least in developed economies – considered to be part of consumer protection, an aspect that is not a core element of payment system development.

Second, the perceived "risk horizon", varies according to business areas. While insurance takes a longer view, perhaps up to five years in which they think of risk incidents and recovery, banks supervisors will think more typically in periods of months during which to remedy any given malfunction in an institution.

In payment systems however, the time horizon for risk are often mere seconds. Any incident will be felt within minutes, not only in the affected institution but possibly also at wide range of institutions connected to the system, and possibly even with the general public.

Third, while it is true that good deposit insurance systems will also build confidence in dealing with a financial institution (provided it does not increase moral hazard), deposit insurance ultimately results in a transfer of risk, for instance from the individual to the government or deposit insurance entity, but not the elimination of risk.

Good payment and settlement arrangements can, on the other hand, remove risk. Good deposit insurance can also remove risk in the sense of reducing the likelihood of self-fulfilling expectations leading to runs. These differences will surely be increasingly recognised for work between the two areas to be effective, and a first step will be to intensify the dialogue and cooperation between these two pillars of the financial safety net. ❑

This comment is made in a personal capacity and does not necessarily reflect the views of the BIS or any of the entities supported by it.

Gregor Heinrich

Gregor Heinrich is chief representative at the Bank for International Settlements Office for the Americas in Mexico City and a member of SPEED's Worldwide Editorial Board. He has written numerous articles and books on the subject of payments and settlements. He worked as a research assistant at Max-Planck-Institute for foreign and international private law (Hamburg) until 1984 before joining the Bank for International Settlements.