

El Salvador: Technical Note on Safety Nets and Crisis Management Arrangements

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CONTENTS	PAGE
Glossary	3
I. Introduction	4
II. Systemic Liquidity Management and Emergency Liquidity Assistance	5
A. Diagnosis.....	5
B. Recommendations	8
III. Bank Resolution and Deposit Insurance	12
A. Diagnosis.....	12
B. Recommendations	16
IV. Crisis Management Arrangements	19
A. Diagnosis.....	19
B. Recommendations	20
Annex I. Core Principles for an Effective Deposit Insurance System	22
Figures	
1. Reserves in Dollarized Economies	6
2. Deposit Withdrawals from banks and the system.....	8
3. Minimum Contribution Rate for Deposit Insurance, as of January 2010	15
Boxes	
1. Main Elements of a Comprehensive Liquidity Policy (CLP).....	9
2. Guidelines for Establishing the Financial System Liquidity Fund (FSLF).....	11
3. Minimum Requirements for a Bank Resolution Manual	18
Annex I: Core Principles for an Effective Deposit Insurance System.....	22

GLOSSARY

BCBS	Basel Committee on Banking Supervision
BCR	Central Bank of El Salvador (<i>Banco Central de la Reserva</i>)
BFA	Banco de Fomento Agropecuario
BL	Banking Law
CAR	Capital Adequacy Ratio
CISF	Inter-Institutional Financial Sector Committee
CSF	Committee on Financial Stability
CLP	Comprehensive Liquidity Policy
ELA	Emergency Liquidity Assistance
FSAP	Financial Sector Assessment Program
FSLF	Financial System Liquidity Fund
FSSRL	Financial System Supervision and Regulation Law
IADI	International Association of Deposit Insurers
IGD	Deposit Insurance Fund (<i>Instituto de Garantía de Depósitos</i>)
IMF	International Monetary Fund
LIBOR	London Interbank Offer Rate
LOBCR	Organic Law of the BCR
LOLR	Lender of Last Resort
MIL	Monetary Integration Law
MOF	Minister of Finance
MOU	Memorandum of Understanding
NIR	Net International Reserves
P&A	Purchase and Assumption
SDR	Special Drawing Rights
SIFI	Systemically Important Financial Institutions
SSF	Financial System Superintendence (<i>Superintendencia del Sistema Financiero</i>)

I. INTRODUCTION¹

- 1. In El Salvador, the banking safety net—emergency liquidity assistance, resolution and deposit insurance—faces particular challenges given it operates in the context of official dollarization.** The economy was officially dollarized in 2000 with the adoption of the Law on Financial Integration and of the US dollar as legal tender. Dollarization constrains a central bank’s ability to act as a lender of last resort (LOLR) and provide emergency liquidity assistance (ELA). Thus, it puts a premium on timely and effective regularization and resolution, deposit insurance, and crisis management. This note discusses the weaknesses of the current framework and recommendations to ensure the safety net functions more effectively and efficiently.
- 2. To address systemic liquidity risk in the context of official dollarization, the Banco Central de Reservas (BCR) should be provided with more powers and funds to provide emergency liquidity assistance to banks.** Consistent with official dollarization, the BCR cannot unilaterally increase the money supply (i.e., “print dollars”), and thus can only provide systemic liquidity to the system if it has “free” dollar reserves (i.e., dollar reserves in excess of BCR liabilities with commercial banks). However, the BCR faces legal and operational constraints, as it lacks sufficient flexibility in how it can provide liquidity as well as resources to carry out its limited ELA and LOLR functions. Consequently, the authorities have set high liquidity requirements for financial institutions. This may reduce moral hazard, but it is also costly in terms of efficiency and resource allocation, as well as a potential systemic risk in the face of large liquidity shocks. The proposed Financial System Supervision and Regulation Law (FSSRL) would grant the BCR with the needed powers to act, but acquiring resources and addressing strategic issues still would need to be tackled. In particular, the authorities should develop a comprehensive liquidity policy and consider establishing a financial system liquidity fund that can provide more flexibility in managing idiosyncratic and systemic liquidity shocks.
- 3. The bank resolution scheme, which has not been tested, and the deposit insurance fund, which has insufficient funds, both need to be strengthened.** In 2002, the Banking Law (BL) introduced new bank resolution instruments, such as purchase and assumption of assets and liabilities (P&A) and the use of the deposit insurance fund for such purposes. As yet, no financial institution has been restructured under the current scheme. However, the legal and regulatory framework for bank resolution has shortcomings that could hamper the resolution. For example, the law requires the Financial Sector Superintendence (SSF) to pre-announce to the problem bank the restructuring measures it will take, and it allows the bank’s board of directors to stay in place even after an intervention. Furthermore, the deposit insurance scheme is underfunded—i.e., it may not have enough funds to payout insured deposits in the case of the failure of several small banks—while the mechanism for emergency funding from the BCR to the IGD lacks an

¹ The authors of this report are Javier Bolzico, Jordi Prat, and Jose Rutman.

implementing regulation. The authorities should consider making the necessary changes to the Banking Law in order to strengthen the resolution and depositor insurance frameworks, as well as issue the necessary regulations and guidelines.

4. **Appropriate roles and formal mechanisms to monitor and manage systemic risk and events should be put in place.** El Salvador's regulatory framework assigns specific functions to the BCR, the SSF and the government to safeguard system liquidity risk: the government should provides resources so that the BCR can use them (i.e., through repos or asset purchases) to inject liquidity in case of a systemic liquidity risk, while the SSF regulates and monitors banks liquidity risks. It also specifies roles for bank resolution, including in case of systemic events. However, the roles and responsibilities of the various institutions involved in the safety net are not always consistent with their objectives, powers, and mandates, while a well-specified strategy to preserve the stability of the system (e.g., with clear responsibilities for monitoring systemic risks and taking macroprudential decisions) and definition or formal measurement of systemic risk have not yet been established. Furthermore, coordination with foreign supervisors of international banks does not include designing contingency plans to address a possible cross-border event. While the proposed FSSRL will improve some aspects of financial stability governance, further work is needed to ensure that there are comprehensive crisis management policies and adequate coordination in practice.

II. SYSTEMIC LIQUIDITY MANAGEMENT AND EMERGENCY LIQUIDITY ASSISTANCE

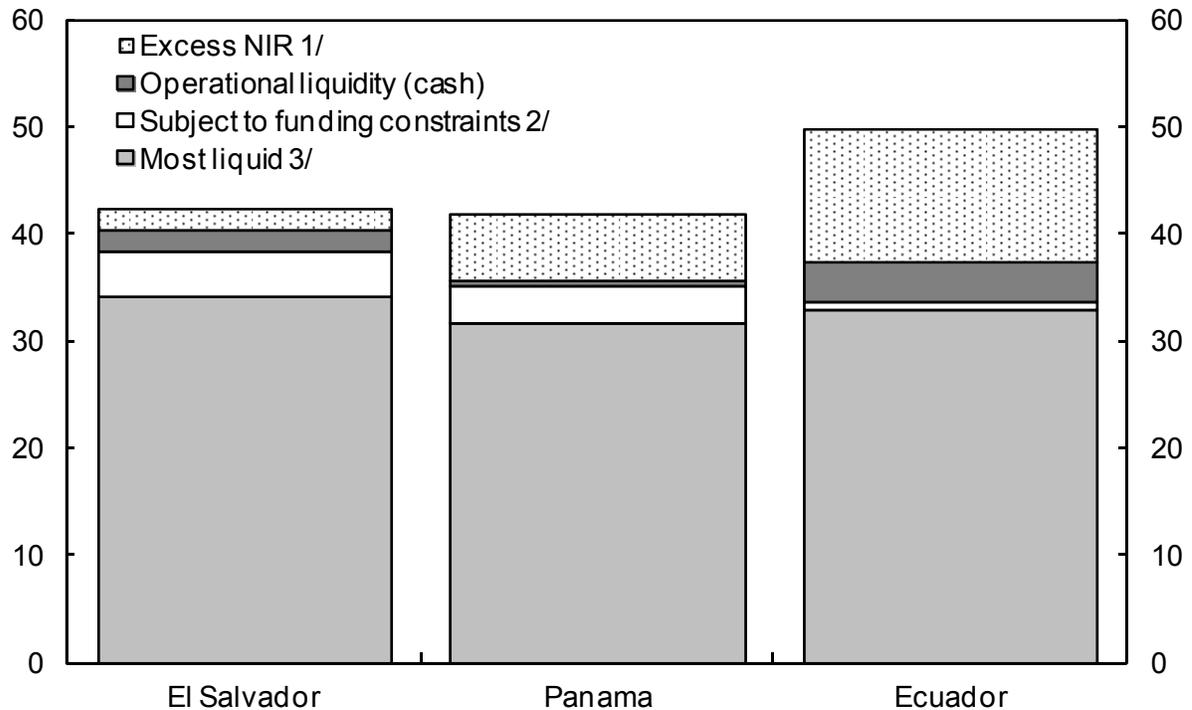
A. Diagnosis

5. **El Salvador's main tools for liquidity management are the reserve and liquid asset requirements.** Banks are required to maintain approximately 22 percent of their liabilities as cash reserves and 3 percent of liabilities as liquid assets (i.e., in foreign assets or El Salvador government securities). For the most part, these must be deposited at the Banco Central de Reserva (BCR), with the remaining assets held as BCR securities or liquid foreign assets (mostly deposits at banks abroad). The SSF may temporarily reduce or increase the requirements, which affects the level of excess liquidity in the system. For example, the SSF introduced an increase of 3 percent in liquidity requirements during the election cycle of 2009. The BCR has the power (Article 49 of the Organic Law) to issue or repurchase its own securities, which can also be used to adjust systemic liquidity, but a regulation for this has not been issued.

6. **While banks' liquid assets holdings are high, there are some weaknesses with the liquidity requirements in terms of dealing with banks' individual liquidity risks.** The level of liquid assets is high, and on average equal to about 33 percent of deposits, in line with other dollarized countries in the region (Figure 1). In case of need, a bank can access its required cash reserves in three stages: the first (25 percent of total) at no cost, the second (25 percent) at LIBOR plus a penalty, and the third (50 percent), with the approval by the Superintendence of Financial System (SSF), by submitting a regularization plan. However, as the reserve requirements were designed before official dollarization was enacted (and are

fundamentally a monetary adjustment tool), these high levels of liquid assets do not necessarily address banks' liquidity risks in the most effective manner. For example, the reserve and liquid asset requirements do not take into account residual term of banks' liabilities or that liabilities have different liquidity risk characteristics (i.e., some are less stable than others), which are important considerations for managing individual liquidity risks.

Figure 1. Reserves in Dollarized Economies
(in percent of deposit and securities liabilities, May 2010)



Sources: IMF, International Financial Statistics; and Fund staff calculations.

1/ Net international reserves in excess of commercial bank claims on the central bank.

2/ Commercial bank holdings of central bank and central government securities.

3/ Deposits at the central bank, deposits abroad, and securities abroad.

7. **Furthermore, market mechanisms for redistributing liquidity among banks are limited as there is, de facto, no functioning interbank credit market.** In 1997 some banks suffered losses from their exposure to a bank that failed. Since then, transactions in the interbank market have declined significantly, reflecting inter alia: (i) the negative view of the banking supervisor with respect to these operation (i.e., the supervisors perceives such funding as signaling financial difficulties); (ii) increased credit risk perception in the light of the experience of 1997; (iii) the lack of familiarity of banks with interbank transaction; (iv) lack of appropriate regulations by the BCR to carry out this type of transactions; and (v) high levels of liquidity in the system.

8. **The BCR currently faces important legal and regulatory constraints to act as LOLR and provide ELA in case of systemic liquidity shocks:**

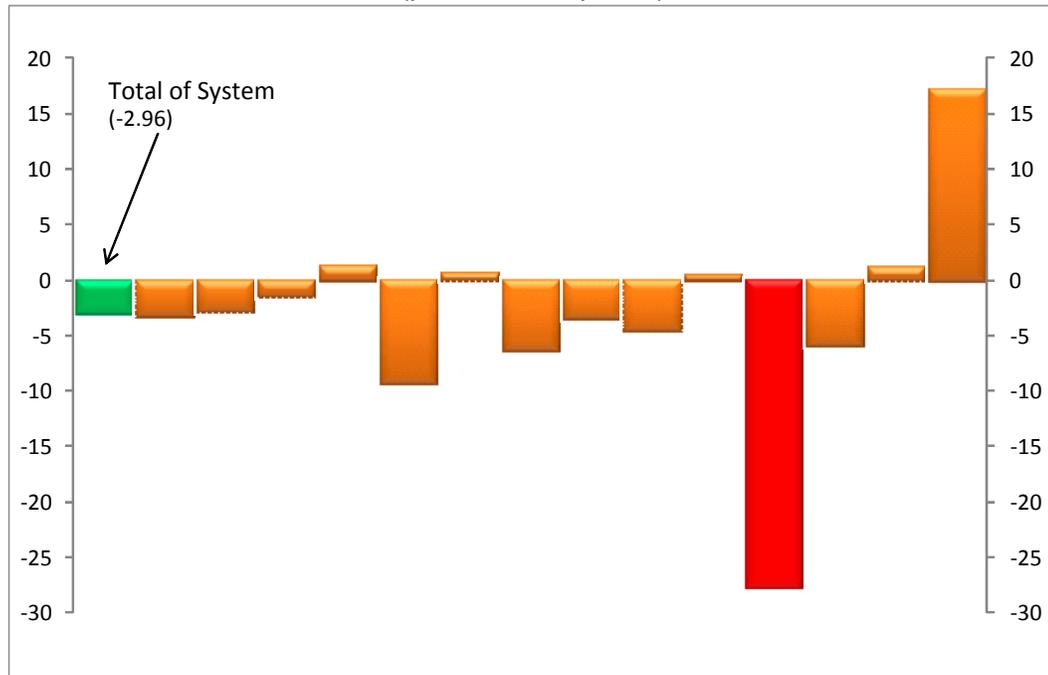
- **Legal limitations:** the Organic Law of the BCR (LOBCR) prohibits the BCR from lending or granting guarantees of any kind to the banks.² On the other hand, both the LOBCR (Art. 49 (a) and (b)) and the Banking Law (BL) (Art. 49-B) give a small margin for providing liquidity assistance to banks through repurchases of BCR or government securities or the purchase of loans and securities. However, the legal requirements to operationalize the purchase loans makes this mechanisms untenable in a crisis situation, while banks securities portfolios may be too small to cover their liquidity needs in case of a large shock.
- **Lack of regulation:** the BCR has not issued the regulations necessary to operationalize the few alternatives allowed under the current legal framework.

9. **Furthermore, the BCR has limited resources with which to provide ELA.** Freely available excess net international reserves (NIR) and government deposits at the BCR, which would provide funds for repurchases or purchases of eligible assets, are very low (Figure 1). Additional NIR would enhance the BCR's ability to provide liquidity to banks in situations of systemic liquidity stress (e.g., to purchase less liquid securities and assets as under the current law or, to lend against collateral, as under the proposed FSSRL). This resource constraint was substantially relaxed by the approval of the \$800 million Stand-By Arrangement in March 2010, which provides the resources for the BCR to provide liquidity assistance in case of a large deposit run (equivalent to about 34 percent of deposits). However, access to these funds is subject to compliance with quarterly fiscal targets.

10. **Despite the low-probability of occurrence, a fall in deposits in an amount exceeding a bank's own liquid assets is an important risk in El Salvador.** When the financial system experiences a drop in deposits, national and international experience shows that banks are usually affected asymmetrically, with a wide dispersion between the entities (Figure 2). Consequently, a fall in deposits that might not be considered systemic could generate liquidity needs at some institutions that go beyond their own liquid assets. However, the limited means to assist institutions of the system in a timely and sound manner is a risk to the payment system and systemic stability.

² LOBCR, Art. 51.

Figure 2. Deposit withdrawals from banks and the system^{1/}
(percent of deposits)



Source: BCR.

1/ 19 days before elections in 2004.

B. Recommendations

11. **The government should provide the necessary resources to ensure the appropriate level of systemic liquidity.** Even in a dollarized economy, a central bank could act as LOLR to the extent that it has the available resources (i.e., excess international reserves).³ Furthermore, providing the BCR with additional resources could reduce the social cost of managing systemic liquidity. For example, in a crisis situation, the BCR could more easily procure funds and at lower costs if its balance sheet is strengthened, while in normal circumstances it could conduct operations to reducing excess volatility in interbank interest rates. In this respect, the authorities should consider allocating all the SDRs granted in 2009 (half of which is currently at the Ministry of Finance) to strengthen the balance sheet of the BCR.

12. **The authorities should modify the legal framework, and allow the BCR to lend to solvent banks in case of a systemic liquidity shock.** The law (Art. 51 of the LOBCR) should be modified so that the BCR is able to act as a LOLR with funding from multilateral agencies, other countries, the government or other alternative sources (e.g., a liquidity fund). This could be accomplished by the passage of the proposed Financial System Supervision and Regulation Law (FSSRL), as Article 130 would allow the BCR to lend government or external borrowed funds to banks in case of systemic liquidity shock.

³ See for example the high level of government deposits under Hong Kong's currency board.

13. **The authorities should design and implement a comprehensive liquidity policy, which could include a liquidity fund.** This policy, agreed between the relevant institutions (MOF, BCR, SSF, and IGD), should set medium-term objectives and criteria for the use of tools or mechanisms at different stages of liquidity problems at an individual bank or in a systemic situation (see Box 1). As part of the policy, the authorities could consider the level of government deposits that could be used to deal with a systemic liquidity shock, as well as establishing a financial system liquidity fund (FSLF), which would be a vehicle to pool and accumulate liquid resources and distribute liquidity to solvent, but illiquid banks.⁴ This fund could complement the interbank market (e.g., in case a liquidity shock causes a breakdown in the market), and save on scarce public and private resources, by reducing the amount of self-insurance needed by each bank as well as by ensuring that private funds are used before public funds are accessed. The FSLF should be governed by rules and principles similar to those of a traditional LOLR, e.g., lending only against good collateral and to solvent banks (Box 2). If the authorities decide not to create the fund (given that over 95 percent of the Salvadoran financial system is foreign-owned), the SSF should, at the very least, require irrevocable letters of credit from parent companies to their local banks.

Box 1. Main Elements of a Comprehensive Liquidity Policy (CLP)

- Define systemic liquidity **objectives and key principles**, which must be consistent with official dollarization.
- Identify and assign **roles and responsibilities** according to the legal framework and the objectives of the CLP, including on government deposits to be used in case of a systemic liquidity shock.
- Define a **strategy** for managing individual and systemic liquidity shocks. Identify systemic liquidity needs, sources and uses of funds, and tools (including the FSLF).
 - Develop the **methodologies and criteria** for establishing a target for government deposits and/or the FSLF and identifying systemic liquidity risks.
 - Define how the different **tools** will be used to implement the CLP.
 - Design **communication and coordination mechanisms**.
 - Design and implement a system to **monitor** systemic risk.

14. **The BCR should regulate and define the procedures for performing its limited functions of LOLR.** The BCR should issue the necessary regulations and define operational procedures so that it can assist financial institutions facing liquidity shortages, in the context

⁴ The latter is already part of the authority's agenda as Art. 2 (f) of the Presidential decree establishing the Cabinet of Financial Management calls for the design of a special liquidity fund, as part of the financial safety net, that could be used in the resolution of contingencies and crises.

of the current legal framework (Section 49B of the BL and 49 (a) and (b) of the LOBCR). Specifically, it must regulate the following:

- Repurchase operations with government bonds using government deposits at the BCR (Art. 49-B of the LB).
- Purchase of its own securities (BCR, Article 49 (a) of LOBCR).
- Purchase of loans and securities of financial institutions (Art. 49 (b) of LOBCR).

15. **The SSF and BCR should promote the development of the interbank market.** A well-developed interbank market could allow liquidity to be distributed between institutions and facilitate the management of cash and liquidity requirements, thus lowering individual liquidity needs and increasing efficiency. To promote the development of the interbank market the authorities could adopt, among others, the following actions: (i) update the rules so that the interbank market develops under the new real time gross settlement (RTGS) system for large value payments, (ii) establish mechanisms that allow institutions to use the third reserve tranche (constituted by securities) as a guarantee for interbank lending, and (iii) communicate to the regulated institution the intention to develop a well-functioning interbank market. Additionally, the authorities could explore the possibility of tasking the BMI to actively participate and be a leader in developing and deepening the interbank market in a prudent manner.

16. **The SSF and BCR should review the composition and level of reserve and liquidity risk requirements to ensure they are consistent.** In particular, the SSF should establish a liquidity risk requirements that take into account the following: the degree of volatility of the different types of liabilities, the residual term of liabilities (rather than the current contractual basis), and the similar treatment of liabilities with similar risk characteristics. Committed credit lines with investment grade foreign banks could be accepted, if these could be executed given a certain percentage fall in the deposits; the regulation should establish the type of contract that is acceptable, and outline the type of treatment to be given in the case of related entities. The authorities should further distinguish when requirements are designed with the aim of addressing prudential issues related to the individual entity (i.e. its own liquidity risk) or when they geared toward strengthening systemic liquidity (i.e., reserve requirements).

Box 2. Guidelines for Establishing the Financial System Liquidity Fund (FSLF)

There are different alternatives for how a FSLF could be constituted. However, regardless of what specific form the FSLF takes, there are some minimum elements (e.g., objectives, mandate, powers, funding sources, and target amount of fund) that the authorities should clearly specify. Below are suggested guidelines for establishing a fund consistent with best practices.

Objective: in the context of an officially dollarized economy, provide liquidity assistance to individual banks to preserve financial stability.

Mandate: provides funds only to solvent banks facing temporary liquidity shortages, i.e., when the interbank market is not functioning or a bank has used up the non-operational tranches in its required reserve account.

Strategic and operational decisions:

- **Institutional Form.** The FSLF could be structured as an institution separate from BCR, an account on the BCR balance sheet, or some intermediate alternative (e.g., a special purpose vehicle).
- **Powers.** Permissible operations and limitations or prohibitions should be specified.
- **Governance.** Rules governing the decision-making and accountability processes must be established.
- **Target amount of resources.** A criteria or methodology should be established to determine the total amount of resources to be accumulated in the FSLF.
- **Source of funds and contributions scheme.** The sources of funding for the FSLF (for example, banks, government, or IFIs) should be specified. If the contributions come from the financial sector, a methodology for determining each institution's contribution would need to be established.
- **Documents and instruments to operationalize the FSLF**
 - Legal instruments (i.e., law, decree, or resolution) creating the FLSF.
 - Appropriate guarantee policy.
 - Eligibility rules and regulation of terms and conditions (amount, terms, rates, etc)
 - Investment Policy.
 - Procedures Manual.

Steps to implement the FLSF:

- Take the political decision to create the FSLF.
- Make the necessary strategic decisions mentioned above.
- Develop the documents and instruments needed for the functioning of the FSLF.
- Formalize the documents and instruments.

III. BANK RESOLUTION AND DEPOSIT INSURANCE

A. Diagnosis

17. **The Banking Law (BL) clearly establishes the criteria, terms, and measures that can be used to stabilize (regularize) a troubled financial institution, however the SSF may be hampered in taking preventive and corrective measures.** A bank is placed under regularization in case of the following: (i) its capital adequacy ratio (CAR) is less than 10 percent; (ii) it accesses the third required reserve tranche; or (iii) the SBS assesses that the solvency and liquidity of the bank are in danger (e.g., lack of adequate risk management). During the implementation of a regularization plan (which should be completed in 90 days, but may be extended up to 180 days), the SSF may demand a special report by external auditors and require the bank to make the necessary adjustments, impose limits on lending and investment policies, appoint a special supervisor (supervisor delegate) with veto power over all board decisions, or dismiss the board. However, it does not have the power to limit the distribution of dividends. Furthermore, the SSF has not yet issued prudential requirements for credit risk management, market risk, and best practices in corporate governance or issued a regulation on the degree of violations and penalties (sanctions), nor has it formally defined responsibilities and the intensity of follow-up to corrective actions based on risks. This could limit the SSF's power to demand some preventive or corrective measures and the lack of mandatory measures may lead to some forbearance, in particular given the lack of legal protection for supervisors.

18. **The legal framework also establishes the situations that might trigger suspension or resolution (restructuring), but lacks specific thresholds or viability criteria.** If a bank fails to submit a regularization plan, fails to remedy its shortcomings during the period outlined by the SSF or the law for the regularization process, or if the bank's situation cannot be solved with a regularization plan, then the shareholders must adequately capitalize the banks within 30 days or else the bank should be subject to suspension or resolution (restructuring). However, although, the legal framework states that the SSF can resolve a bank if its solvency and the recovery of deposits from the public might be at risk, specific capital or liquidity thresholds (or other characteristics) are not outlined in the law.

19. **The SSF may suspend temporarily the operations of the bank, but there are no regulations that outline the criteria and triggers for this.** With the prior favorable opinion of the BCR, the SSF may suspend, in whole or in part, the operations of a financial institution when it is not able to pay its liabilities in order to protect depositors or for 'social interest reasons.' The initial period of suspension is 30 days, and may be renewed for successive periods of equal time, but should not exceed 90 days.⁵ It is best practice that the suspension of a bank should not be lifted until the necessary measures to rectify its liquidity and solvency problems have been adopted. However, the lack of specific parameters and

⁵ In most cases, the suspension ends in the resolution of a bank.

processes for the suspension of operations, together with the weak legal protection, could delay or reverse the adoption of these measures.⁶

20. **The legal framework for bank resolution has been amended to include new instruments, but significant shortcomings remain that may stymie the process and increase costs for the deposit insurance fund.** The Banking Law (BL), enacted in 2002, included new bank resolution instruments, such as purchase and assumption of assets and liabilities (P&A) and the use of the deposit insurance fund to provide financial assistance in case this is the chosen resolution option. The law also requires that the SSF should notify the BCR and the deposit insurer (IGD) whenever it adopts an action related to bank resolution, and it must request a favorable opinion from the IGD for the use of resolution mechanisms that rely on financial support from IGD (e.g., financial guarantees or funds for P&A). Since the 2002 amendment, only one small bank was asked to submit a regularization plan, and a resolution process was not necessary as the bank was acquired by a new bank. However, legal deficiencies remain, in particular:

- **The requirement to notify the bank three days before the suspension of operations or other measures of resolution can increase the costs of resolution and complicate the use of P&A.** The BL (Section 112B) requires the SSF to notify the bank three days prior to the suspension of its activities or to exclusion and transfer its assets and liabilities for P&A operations. This notification constitutes a significant obstacle in the resolution process (i.e., the preservation of the bank's financial assets and other valuable resources, such as contracts, records, etc.). In the case of suspension of activities, prior notification on the adoption of this measure can accelerate asset deterioration (i.e., due to asset stripping) and a run on deposits by related parties, managers and employees. Additionally, bank resolution through P&A is typically carried out quickly (e.g., over a weekend) to avoid any negative impact on depositor confidence. Hence, with the prior notice requirement, implementing a speedy, swift, and orderly resolution process becomes very difficult.
- **The cost-benefit criterion is not clearly bounded and does not necessarily lead to least-cost resolution of non-systemic financial institutions.** Article 175 of the BL requires the IGD to carry out a cost-benefit estimate of the direct and indirect costs of resolution, including those arising from the impact on the stability and confidence in the financial system. If the study shows that bank resolution has a lower cost than the payout to insured depositors and liquidation, then the IGD will issue a favorable opinion for the SSF to go through a bank resolution process (if not, IGD proceeds with the payment of the insured deposits once the bank's authorization is revoked).

⁶ By establishing clear parameters to take certain actions, the supervisor would have more objective criteria and be more protected; however, adequate legal protection is still the first best solution as it is impossible to specify all potential situations in a regulation.

This cost-benefit criterion exposes the IGD to legal risks⁷ and may bias the process away from liquidation even when it is the least-cost option for non-systemic banks.

- **The judicially appointed receiver of a failed entity must co-manage with the bank’s board of directors (Article 104 of the LB) and may stymie or increase the cost of resolution.** The request for judicial intervention in an institution is usually associated with a situation that cannot be reversed. It is at this stage where shareholders have nothing to lose and, consequently, could be willing to take disproportionate risks (“gamble for resurrection”), including through fraud. Additionally, there may be situations where an agent of the financial institution receives conflicting instructions from two authorities at the same time (i.e., the board of directors, representing the interest of the equity shareholders and managers, and the legally appointed receiver, representing all creditors, not just shareholders).
21. **Additionally, the decision criteria for bank resolution is overly complex and the process is not clearly regulated:**
- **The IGD has a number of internal norms to assess the cost-benefit for their participation in the bank resolution process, which is complex and not transparent.** The IGD evaluates two alternative scenarios: bank resolution or payout of deposit insurance. After setting ranges for the variables associated with each alternative, the authorities determine a final value which will determine whether to proceed with the payout of the deposit guarantee or resolution. The weights, scores, and ranges for each of the variables lack technical support. Furthermore, some of these variables have a qualitative element (e.g., moral hazard, financial system image). In contrast, the standard least-cost solution criterion is clear and objective, i.e., the maximum contribution of the deposit insurer to a bank resolution process cannot exceed the cost of paying out the deposit insurance minus the expected recovery.⁸
 - **The requirements and selection criteria for banks participating in the resolution of failed banks have not been established in regulation.**
 - **Comprehensive procedures, manuals, standard contracts, and training for the resolution mechanism are also lacking.**

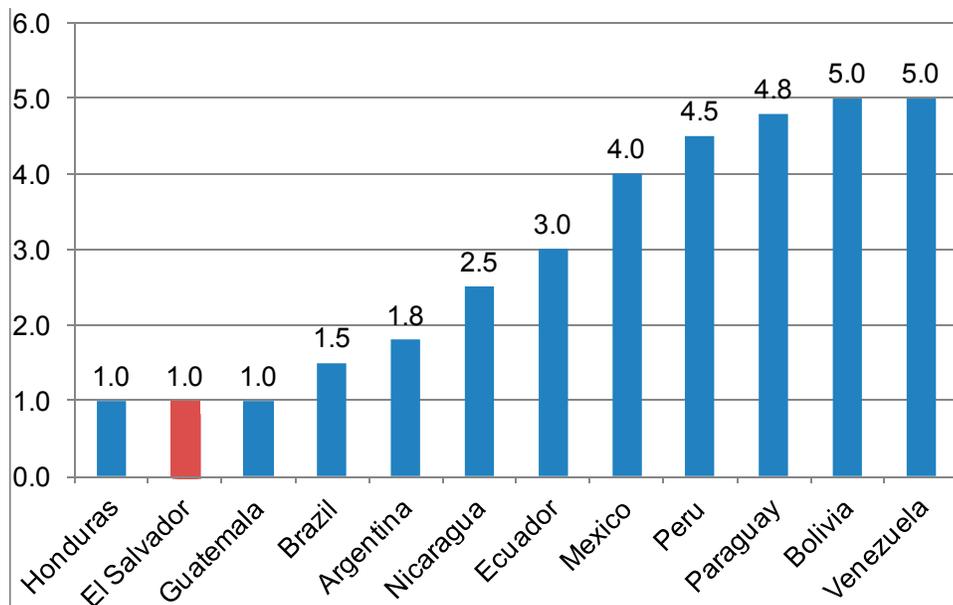
⁷ Since it is based on a qualitative analysis of certain variables, the criterion exposes the IGD to legal risk, given that it could either have adversely affected the capital of the IGD (scenario in which the contribution exceeds the amount of the payment of the deposit insurance) or by having imposed losses on creditors (e.g., where deposits are only partially covered by the amount of the deposit insurance).

⁸ The recovery rate of the contribution of a deposit insurance agency to a bank resolution process could be based on a pre-determined percentage (for example, on past recovery experience with failed banks) or computed on a case-by-case basis based on the expected recoverable value of the assets of the failed bank in question.

22. **The resolution process to be used for cooperative banks is not clear.** The amendment to the Cooperative Banks Act establishes in Article 106 that those entities are members of the IGD (as of January 2009) and have the same obligations and rights that the law gives to banks (i.e., the provisions of parts four and six of the Banking Law with respect to adjustment, restructuring, settlement and the IGD would apply). However, the second section of the law (which deals with the adjustment, special monitoring, intervention, dissolution, and liquidation of these institutions) was not repealed. Therefore, cooperative banks could appeal any regularization or resolution adopted by the SSF, citing the uncertainty of the legal framework that applies to them.

23. **The deposit insurance premium is relatively low and the IGD cannot anticipate premiums to increase available resources, although it can borrow.** The IGD covers deposits of up to \$9,000. The annual premium is only 1 dollar per one thousand dollars, increasing 50 percent for those entities that do not qualify to accept deposits from pension funds. Additionally, once the accumulated funds at the IGD exceed 1 percent of total deposits, the IGD must transfer to the BCR 50 percent of the premia collected (around US\$4.5 million per year) to repay the credit received from the BCR as part of its initial capitalization (US\$13.0 million). As of end-March 2010, the IGD fund for banks amounted to US\$97 million—about 1.1 percent of total deposits—which would cover fully the insured deposits of 7 small banks (individually). As it was only established in January 2009, the IGD fund for cooperative banks amounted only to US\$500,000. Furthermore, the current legal framework does not allow the IGD to request, or require, members to prepay future premiums to increase available resources, although it does allow the IGD to place securities with financial institutions (including the BCR).

Figure 3. Minimum Contribution Rate for Deposit Insurance, as of January 2010



Source: IADI.

24. **Furthermore, not all IGD funds may be available for cooperative banks.** Even though the IGD has a consolidated balance sheet, the management and accounting of the commercial and cooperative bank deposit insurance funds are separate. Given that the President of the IGD (double vote in case of a tie) and the BCR representative are both members of the commercial banks and cooperative banks fund management committees (each committee is completed by two representatives of the commercial or cooperative banks, respectively), they could push for a resolution, if necessary, that would allow for the use of funds from the entire balance sheet of the IGD for the resolution of cooperative banks. However, it is possible that the two representatives of banks would appeal the legality of that decision.

B. Recommendations⁹

25. **The corrective action framework should be strengthened to ensure compliance and timely implementation of corrective measures prior to regularization.** The draft law on supervision and regulation of the financial system has some aspects that would address existing weaknesses in the corrective actions framework (e.g., a specific regime of sanctions, and the creation of a Standards Committee which could accelerate enactment of regulations related to risk management and corporate governance of supervised banks). However, the framework should be reinforced with a broader mandate for the Superintendent to take corrective actions as a precursor to regularization.

26. **The lack of formal procedures, limited resources, and the legal and regulatory deficiencies should be addressed comprehensively.** Hence, the authorities should amend the legal and regulatory framework to:

- **Provide legal protection for supervisors and establish a clear capital deficiency threshold for resolution.** While the Financial Sector Supervision and Regulation Law (FSSRL) would provide legal protection to the Superintendent, it would only provide legal assistance to those supervisors involved in the resolution process, which is a more limited form of protection when compared with international standards and other countries in the region. It is recommended that the law establish legal protection for all staff, except in the case of deliberate malfeasance. Further, setting a lower bound for capital deficiency would help reduce the likelihood for clearance and delay in the resolution process.
- **Eliminate the requirement to notify the bank three days before the suspension of operations or other measures of resolution, and ensure that these measures are not reversible.** Suspension of bank's operations (in whole or in part) should only be reversed when problems have been fixed. Resolution measures should not be reversed; rather they can be subject to compensation following a judicial review.
- **Dismiss the bank's board of directors at the start the judicial intervention.**

⁹ See Annex I for detailed recommendations on the deposit insurance system based on the Core Principles for Effective Deposit Insurance Systems.

- **Clarify the least-cost solution criterion as the limit to IGD’s support for bank resolution.** The qualitative elements in current cost-benefit criterion should be dropped and the necessary regulations for least-cost solution should be issued.
- **Regulate those aspects that would facilitate the bank resolution process under the current legal framework.**
- **Clarify that the resolution framework for cooperative banks is that established in the BL, and that the resources of the IGD are available for the resolution of these banks.** The IGD should seek a legal opinion supporting in this regard, ideally before a situation might arise that triggers the need to restructure a cooperative bank. Furthermore, the IGD should clarify that its deposit insurance reserves, whether funded by contributions from banks or cooperatives, will be available for the resolution of cooperative banks.
- **Consider increasing the current premiums and contingency funding for IGD.** While the BL allows the IGD to place securities with financial institutions (including the BCR), it is possible that private financial institutions will not be predisposed to purchase these securities from the agency during times of stress. Hence, the IGD could need, if necessary, to require the prepayment of premiums. This should be complimented by recapitalizing the IGD through an increase of the premium it charges to financial institutions and target fund for deposit insurance. Additionally, a regulation on IGD contingency funding through a loan from BCR (as provided for in Article 179 of the BL) should be issued.
- **Define a strategy and establish a target for the IGD’s reserve fund.** The level of the reserve fund should be determined after taking into account the characteristics and structure of the Salvadoran financial system (which is officially dollarized and very concentrated), as well as the premium and contingency funding available. It should cover the expected cost from covering the guaranteed deposits of all non-systemic banks. In addition, a study of the suitability of the current level of coverage should be done, taking into consideration the percentage of depositors and amount of deposits covered in the region. The strategy for the accumulation of funds could include the reduction or suspension of premiums once the target is reached.
- **Develop a strategy to address systemic banks.** The recent global financial crisis highlighted the need for tighter supervision and regulation of systemically important financial institutions (SIFIs), including through sharing of information and coordination with other sectoral and home or host supervisors. It also highlighted the need for enhanced resolution mechanism, such as “living wills,” as well as the accumulation of ex-ante resolution funds so that SIFIs internalize their negative externalities.¹⁰ Given that IGD’s deposit insurance reserve funds are insufficient to

¹⁰ The Financial Reform Law in the United States incorporated the requirement that large financial holdings (with assets larger than US\$50 billion) present their own recovery and resolution plans (“living wills”). The aim of requiring these living wills is to increase recognition of the difficulties that arise in resolving a holding

resolve a systemic bank, the authorities could consider imposing a special fee to these banks to cover the potential fiscal cost of resolution.

Box 3. Minimum Requirements for a Bank Resolution Manual

- Conceptual framework
- Legal and regulatory framework for bank resolution in El Salvador.
- Scope of bank resolution manual.
- Units and individuals involved in the implementation of bank resolution manual.
- Preparatory work for bank resolution.
- Start of the bank resolution process:
 - Diagnose status of the entity
 - Develop possible scenarios
 - Plan the logistics
 - File necessary documents, including issuing the official resolution that begins the bank resolution process
 - Designate judicial auditor
- Operational tasks of bank resolution.
 - Specify the information and data required to assess the resolution options and determine the least cost option
 - Create a data base (assets and liabilities)
 - Establish the residual balance and trust fund where the excluded assets of the failed banks are transferred
 - Create the business unit (to be transferred to one or several banks)
 - Put together the package information for potential buyers
 - Identify potential buyers
 - Select banks eligible to participate
 - Exclude and transfer residual assets and liabilities
 - Establish a contingency plan in case P&A fails
 - Other tasks
- Official resolutions, and standard forms and contracts
 - The transfer of assets
 - The creation of trust for bank is residual assets and liabilities
 - The administration of the trust
 - Service to pay the deposit guarantee
- Process Flow Chart.
- Deadlines for each stage of the process.

company and potentially, to limit intra-group exposure that might complicate the ring-fencing or splitting-off of the banks that form part of the holding company.

IV. CRISIS MANAGEMENT ARRANGEMENTS

A. Diagnosis

27. **Coordination between the different financial safety net providers is limited.** An informal Inter-Institutional Financial Sector Committee (CISF), composed of representatives of the BCR, the IGD and the SSF as well as with several working groups exists, but the committee tends to act reactively and roles and responsibilities are not well-specified. The agenda of the working group on risks focuses on specific short-term needs (for example, banks in distress or illiquidity risk during election periods). Once the situation is resolved or has subsided, the findings of these projects are not formalized. Furthermore, issues such as regulatory arbitrage, monitoring of the regulatory perimeter, systemically important institutions, markets, and infrastructure, or potential systemic stress scenarios, among others that may impact financial stability, are not a regular part of the priorities of the various inter-institutional working groups. Also, all the safety net providers conduct some sort of stress testing, but these are not well coordinated and are not based on a common stress scenario.

28. **There is no definition or systematic measurement of systemic risk and roles and responsibilities for monitoring systemic risks are not well-specified.** Relevant legislation does not define systemic risk and responsibilities. And even though members of the safety net (BCR, SSF and IGD) monitor financial institutions closely the safety net providers have not agreed on a methodology and procedures for calculating and monitoring of systemic risk. The CISF would be the natural setting for developing this methodology and for systematic monitoring of systemic risks on an on-going basis.

29. **Furthermore, the roles and responsibilities for managing a systemic crisis are not well-specified.** The IGD must assess whether bank insolvency could create systemic risk and financial instability, while the decision to financially support the restructuring falls on a committee formed by the BCR, the SSF and the Ministry of Finance (Section 176 of the BL). However, the role and responsibility of assessing whether a situation creates systemic risk and to cover all depositors in such a case is beyond the typical mandate and competencies of a deposit insurer and in El Salvador's case also beyond the limited resources of the IGD. Furthermore, its ability to address systemic risk is more limited than that of the SSF (which has powers of regulation and supervision), or the BCR (which seeks to analyze and monitor financial flows and risks of the system at widest) and the MOF (who would potentially assume the fiscal cost of a systemic crisis).

30. **Despite limited exposure to the parent bank, there is still a potential risk of transmission of local subsidiaries and specific mechanisms should be put in place to better manage this risk.** The association between the local bank and its parent (including in the name of it) is relevant, and may generate a level of contagion mainly based on reputational risk (identification of local bank with headquarters outside) in a situation where the parent presents problems of solvency or liquidity. While that scenario has a low probability of materializing, a crisis of the parent may trigger a significant impact on the liquidity of the local subsidiary (from a run on deposits). Even if communication with

external supervisors is fluid, there are no specific arrangements under the existing Memorandums of Understanding (MOU) to address these situations. Although the level of exchange of information (including frequency and channels of communication) seems appropriate for evaluating cross-border risks of banks, the SSF has not developed, with the corresponding cross border supervisors, contingency plans to address a potential cross border banking crisis.

31. **Currently, access to confidential information for effective crisis prevention and management is limited**, although this would improve with the passage of the proposed FSSRL. The draft FSSRL explicitly allows the sharing of confidentiality of information between the Superintendence to the BCR, IGD and foreign supervisory agencies (Art. 29), which may contribute to better coordination and information sharing between different agencies involved in crisis management and the safety net. At the same time, the new law provides legal assistance (Art.90) if the Oversight Committee, its members, or the staff of the superintendence were sued as a result of adopting and implementing corrective measures or undertaking a bank resolution (such as suspension of bank operations, its intervention, or its restructuring).

B. Recommendations

32. **Coordination between the safety net providers should be strengthened by establishing an institutional mechanism and strategy for financial stability monitoring and policies.** While the proposed law overhauling financial system oversight would require the BCR and SSF to coordinate with respect to financial stability, specific policies and procedures for information sharing, systemic risk monitoring and crisis management (including a communication strategy) still should be mutually agreed, formalized and implemented by all the safety net providers, including the IGD. This could be done by formalizing a Committee on Financial Stability (CSF), and establishing clear roles, responsibilities and information sharing agreements. In particular, the financial stability strategy should establish that the BCR focus on macro prudential policies and monitoring, while the SSF focus on micro prudential issues, and the IGD on least-cost resolution, with clear, transparent and candid communication between them with regard to their individual areas of responsibilities. The diverse interagency working groups (within the current CISF) should include in their agenda, among others, issues such as regulatory arbitrage and moral hazard, the regulatory perimeter and interconnectedness, and possible crisis scenarios. The findings at the technical level of these interagency groups should trigger coordinated decisions at higher levels of entities involved. Given the importance of sharing critical information in a timely manner to ensure financial stability, communication between agencies should be clear, transparent, straightforward, and on-going.

33. **The authorities should establish formal mechanisms to monitor and manage systemic risk, including establishing the roles and responsibilities of a high-level committee that includes the MOF.** As such, the CSF should establish a methodology for defining systemic risk, based on different variables (size, interconnectedness, regional

impact, contagion risk, payment system risk, etc.). This methodology should be approved by the high-level financial stability committee that includes the MOF and that currently is responsible only for approving the IGD's involvement in resolution in case of the failure of one or more systemically important financial institutions. The high-level committee, with technical inputs from the CSF, should decide on whether a systemic risk situation exists and how to proceed according to well-defined roles and responsibilities. In particular, the ministry of finance should take responsibility for financing systemic bank resolution, with appropriate transparency and accountability for the use of public funds. With respect to SIFIs, the authorities should consider what would be their optimal strategy and how to implement it. If the need were to restructure them, the authorities should consider the use of a 'bridge bank' to ensure operational continuity of such entities.¹¹ On the other hand, if the high-level committee concludes that there is no systemic risk to the resolution, the decision to participate in the restructuring process of the failed bank would be taken exclusively by IGD on a least-cost basis.

34. **Despite low direct exposure, there should be more specific agreements between countries to manage a cross-border banking crisis.** Coordination between supervisors in the country of origin and the host countries to prevent and mitigate the effects of a potential crisis should be established. Regulators should assess information needs, establish appropriate communication strategies, and should design contingency plans for managing crisis situations of cross-border institutions.

35. **The authorities should undertake a comprehensive simulation exercise of a bank resolution.** All relevant agencies in the bank resolution process should participate in the exercise. The findings of this exercise should be used to set up a reform agenda that would include changes to the legal framework, as well as to regulatory and bank resolution procedures. The scenarios could include, among others, problems in a small bank, in a group of small banks, and in an international bank (spread either from its parent or domestically originated). The exercise should also consider alternative resolution mechanisms, such as exclusion and transfer of assets and liabilities to one or more entities, use of a bridge bank (where the failed institution has systemic impact and no bank has interest and/or capacity to absorb its assets and liabilities) or simply pay out guaranteed deposits. As the Salvadoran financial system has not experienced a deep crisis of a bank or its financial system, the design of the crisis simulation could take as a reference point, the experience of other emerging countries.

¹¹ Sub-section e) of Art. 93 of the BL allows the SSF, in the scope of a bank restructuring, 'all necessary measures that might be technically necessary in line with the nature of the problem'. Outlining different alternatives (including the bridge bank) could ease the use of the chosen instrument in the process of resolving a systemic entity.

ANNEX I. CORE PRINCIPLES FOR AN EFFECTIVE DEPOSIT INSURANCE SYSTEM

Introduction

During the visit of the FSAP mission to El Salvador, in the context of the analysis of the financial system safety net, staff conducted an exercise to detect weaknesses and room for improvement in the deposit insurance system. Hence, the deposit insurance system was preliminarily evaluated using the Core Principles for Effective Deposit Insurance Systems (published on June 18, 2009), produced jointly by the Basel Committee on Banking Supervision (BCBS) and International Association of Deposit Insurers (IADI). Because the methodology for the evaluation of these principles has not been published yet, the exercise does not include an assessment of the level of compliance.

Principle	Weaknesses/room for improvement
1. Public policy objectives	There is no explicit mention of systemic stability (although it is implied).
2. Mitigating moral hazard	Greater granularity in the risk category for the calculation of deposit insurance premiums (currently there are only two categories, with little sensitivity to risk).
3. Mandate	IGD should not be responsible for calling for a meeting of the high level committee composed of the BCR, SSF and the Minister of Finance, to analyze systemic situation and the potential contributions of the IGD in the resolution process.
4. Powers	IGD should have prompt access to SSF qualitative information on banks, before entering into a regularization plan.
5. Governance	The two IGD funds (for banks and cooperative banks) and their balances are managed separately. The human resources for performing that task are shared, which complicates proper corporate governance. The operating budget limit of 5 percent of annual premiums set by law may not be sufficient in case of simultaneous banks under regularization plans (the budget can only exceed this limit in cases of bank resolution). There is no specification of the reasons (and processes) for which members of the Council or Committee of the IGD could be removed before the expiration of their mandates. There is no formal arrangement for SSF administrative support to IGD, which could cause a conflict of interest during a crisis situation; in contrast, Art. 164 of the BL establishes an arrangement between IGD and BCR for this purpose.
6. Relations with other participants in the safety net.	There are no formal procedures among the agencies involved in the process of resolution (BCR, IGD and SSF). The IGD does not have access to SSF qualitative information before a bank is put under a regularization plan.
7. Cross-border Issues	There is no cross-border contingency plan for crisis situations.
8. Compulsory membership.	The Banco de Fomento Agropecuario (BFA), which takes deposits from the public, is exempt from membership because its total deposits are guaranteed by the State. The IGD does not participate in the vetting of a financial institution prior to the approval of the license. There are (small) deposit-taking entities which are neither regulated nor supervised, but these not members of the IGD.

9. Coverage	No analysis of the reasonableness of the level of coverage has been conducted. The current level (US\$9,000) comes from the amount originally determined by law (1999) indexed to the consumer price level. The updated coverage should consider other aspects such as GDP per capita, the distribution of deposits, and comparisons with countries at similar level of development or in the region where small depositors could feasibly transfer deposits.
10. Transition from a blanket guarantee to a limited coverage deposit insurance system	Not applicable.
11. Funding	Available funds are insufficient to pay the deposit insurance of any cooperative bank and it is unclear whether resources can be transferred from the Fund for banks to the Fund for cooperative banks. The minimum premium (0.10 percent per annum on deposits) is one of the lowest in the region. BCR contingent financing to IGD is not regulated and of the IGD does not have powers to require compulsory advancement of premiums by financial institutions.
12. Public awareness	There needs to be a better dissemination of information on the deposit insurance system. Possible mechanisms includes: require banks to print the deposit insurance coverage on deposit stubs and accounts statements; measure, through surveys, public awareness of the deposit insurance system.
13. Legal protection	Currently, there is legal protection only for members of the Board of IGD (Art. 160 of the LB). Protection should be extended to other staff of IGD.
14. Dealing with parties at fault in a bank failure	This function is under the responsibility of the SSF (Art. 32 of the BL).
15. Early detection, and timely intervention and resolution.	The lack of an adequate framework for enforcement, based on clear and mandatory rules, and insufficient legal protection, could delay the implementation -at an early stage- of corrective measures. The legal framework should explicitly include the possibility that the SSF take proactive preventative measures to limit excessive risk-taking by financial institutions and, for example, limit or prohibit dividend distribution. Under the current framework, El Salvador has had only one experience of a bank facing weaknesses and that was about to enter a regularization plan; however, it was acquired in a market transaction by a new bank and no further intervention was necessary.
16. Effective resolution processes	There are no comprehensive procedures, manuals and standard contracts for the resolution of a bank; this affects the effectiveness of that process. The cost-benefit analysis that the IGD carries out to determine their involvement in the resolution of the bank or paying the guaranteed deposits lacks sufficient technical support; it includes qualitative variables (such as moral hazard and financial system image), weights and scores that could then be appealed. There is no limit to the IGD support that can be provided in a resolution. Also, the IGD must define when systemic risks could arise, and then presents its views to a committee (formed by the BCR, the SSF and the Ministry of Finance) who defines whether or not the IGD should participate

	in this process. Alternatives for systemic bank resolution (e.g., “bridge bank”), when the acquisition and transfer of liabilities and assets is not feasible (either because the acquiring banks are unwilling or are unable to absorb them), have not been established.
17. Reimbursing depositors	There is no formal procedure for payment of insured deposits. Under the current legal framework, to the IGD must consider information on deposits provided by bank officials and documents submitted by the depositor; additionally, the depositor must sign an affidavit that includes information on his or her deposits and debts with the failed bank (Article 173 of the LB). These requirements could jeopardize repayment flexibility and effectiveness; the only requirement should be limited to the identification of the depositor and the accessibility of information (which must be reliable, with a continuous monitoring by the IGD and SSF, to be reinforced when the bank enters into a regularization plan). A preset time (target) for payment of deposit insurance has not been established, although the law states that up to 80 per cent of covered deposits could be paid within 30 days after the bank’s license has been revoked.
18. Recoveries	The structure of the commissions paid to the trustee and administrator of the trust of the excluded assets should be designed according to the rate of actual recovery of assets. This would generate the correct incentives to maximize the recovery of the assets transferred to the trust. IGD monitoring of the liquidation process (Art. 110 of the LB) should be handled with caution, since it involves the risk that other creditors could sue the IGD for their performance.