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BENEFITS AND RISKS ARISING FROM THE EXISTENCE OF THE STRUCTURE OF THE SAFETY NET ON THE EXAMPLE OF POLAND

Abstract. Changes taking place in the financial sector within the last decades significantly affected the safety of its operations. These changes have increased the impact of any potential crisis on the national economy. Thus the activity of the financial sector is subject to specific supervision of the state. An entire structure of safety net was created to stabilize the financial system. The aim of the network is to reduce the risks associated with the operation of the financial sector which includes i.e. system risk. In the article the risks related to the functioning of the financial sector were discussed, as well as the institutional structure of safety net on the example of Poland, and risks which may arise from the operations of the presented structure. Also the rules limiting the impact of the existence of the institutional safety net structure on the negative phenomena occurring on the financial market were presented.

Keywords: Safety net, financial stability, financial safety, financial supervision, banking supervision
JEL Classification: D 81, H 11, G 28.

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ПЕРЕВАГИ ТА РИЗИКИ, ПОВ'ЯЗАНІ З ІСНУВАННЯМ СТРУКТУРИ МЕРЕЖІ БЕЗПЕКИ НА ПРИКЛАДІ ПОЛЬЩІ

Анотація Перетворення, що проходять в останні десятиріччя у фінансовому секторі, суттєво впливають на безпеку його операцій. Ці зміни збільшили вплив кризи на національну економіку. Таким чином, діяльність фінансового сектора є предметом спеціального нагляду держави. Створено цілу структуру мережі фінансової безпеки, яка працює для стабілізації фінансової системи. Метою діяльності мережі є зниження ризиків, пов'язаних з функціонуванням фінансового сектору, до яких відноситься й системний ризик. У статті представлено ризики, пов'язані з функціонуванням фінансового сектора, інституційна структура мережі фінансової безпеки на прикладі Польщі і ризики, які можуть виникнути в результаті функціонування вказаної структури. Розглянуто правила, які обмежують вплив інституційної мережі фінансової безпеки на негативні явища, які відбуваються на фінансовому ринку.

Ключові слова: Мережа фінансової безпеки, фінансова стабільність, фінансова безпека, фінансовий нагляд, банківський нагляд.

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ПРЕИМУЩЕСТВА И РИСКИ, СВЯЗАННЫЕ С СУЩЕСТВОВАНИЕМ СТРУКТУРЫ СЕТИ БЕЗОПАСНОСТИ НА ПРИМЕРЕ ПОЛЬШИ

Аннотация. Проходящие в последние десятилетия преобразования в финансовом секторе существенно влияют на безопасность его операций. Эти изменения увеличили влияние кризиса на национальную экономику. Таким образом, деятельность финансового сектора является предметом специального надзора государства. Создана целая структура сети финансовой безопасности, которая работает для стабилизации финансовой системы. Целью деятельности данной сети является снижение рисков, связанных с функционированием финансового сектора, к которым относится так же и системный риск. В статье рассмотрены риски, связанные с функционированием финансового сектора, институциональная структура сети финансовой безопасности на примере Польши и риски, которые могут возникнуть в результате функционирования данной структуры. Рассмотрены правила, ограничивающие влияние институциональной сети финансовой безопасности на негативные явления,

происходящие на финансовом рынке.

Ключевые слова: Сеть финансовой безопасности, финансовая стабильность, финансовая безопасность, финансовый надзор, банковский надзор.

Introduction.

A significant increase in the financial sector assets that has been observed recently, the development of complicated financial instruments, as well as globalization and internationalization of the financial sector's actions constitute the reasons for an increasing influence of this sector on the country's economic situation. A stable financial system constitutes the condition of economic growth. Cyclical economic crises and their costs that affect the whole societies prove that financial stability also accounts for the safety of any country. Hence, a need arises to care for the stability of the financial sector. In order to achieve this aim governments create financial safety nets (in the following work a generally accepted term 'safety net' will be used).

The aim of the following work is to indicate the role that an institutional structure safety net fulfills while stabilizing the financial sector, and to present the threats that the functioning of this structure poses. On the one hand, the activities of such institutions make one trust the sector more and help deal with crises. However, they also involve a number of threats which mainly result from the fact that economic actors are convinced that potential negative occurrences on the market will be compensated by the actions taken by the institution mentioned above.

The study has been conducted on the basis of the analysis of European bibliographic sources. In Poland the issue of safety net has been analyzed by inter alia O. Szczepańska, A. Jurkowska-Zeidler, M. Capiga, W. Gradoń, G. Szustak.

It should be pointed out that the aim of this work is not to question the justifiability of existence of the safety net institutional structure, but to draw attention to the risks that its functioning involves.

1. Defining economic stability and phenomena destabilizing financial system.

The financial stability of the financial system is defined in two ways. On the one hand, it is understood as a lack of crisis and the situation where risk system does not occur. [1] On the other hand, it is defined as a situation where the financial system fulfils its functions in a proper manner, and at the same time ensures smooth flow of funds and payments as well as correct valuation of assets. [2]

Due to changes in the financial systems in recent decades, such as deregulation and liberalization, the dynamic growth of financial assets to GDP and emerging phenomenon of considerable price increase [3], the activity of the financial sector brings an increasing risk, the fulfillment of which can lead to a reduction of economic growth and also the emergence of crises. It should be noted that the costs of the latter are borne by the entire society. They may also threaten the safety of the economy and thus the security of the country.

In market economies based on banking oriented systems, which include Ukraine and Poland, the stability of the banking sector is particularly important. Hence, further analysis of the work will be subject to this particular sector.

The risk connected with the functioning of the banking sector is caused by a specific type of its activities, namely: funding sources are normally distributed and are repayable on demand, whereas assets are typically long-term, their value is variable and they do not always qualify for a quick sale. In addition, there is a high leverage. [4] These facts entail risks characteristic of the discussed sector.

The main risk in case of the banking system is system risk which entails danger of transferring the crisis from one bank to another. The risk is related to two effects [5]: bankers' panic and contagion effect.

Bankers' panic consists in depositors withdrawing substantial amounts of money. That kind of behaviour is caused by a lack of trust and confidence that depositors who first withdraw funds do not lose them.

Contagion effect spreads directly through the mutual relationship between the institutions (payables and receivables), and indirectly through loss of confidence in the sector.

Another feature of the financial systems influencing the creation of new risks is the asymmetry of information which consists in the fact that one of the actors has less knowledge about the transaction carried out.

This feature results in two types of risks: adverse selection and moral hazard. [6] The first risk results in the fact that banks having less knowledge about the project than the potential borrower may decide to finance more risky investments, or, because of the difficulty in estimating the risk, refrain from granting credit. Consequently, the market eliminates its honest participants to the advantage of the borrowers who do not provide banks with sufficient information.

The temptation of the abuse consists in the conscious use of the fact that in case of the success of the project - the borrower obtains the benefits; however, in the event of failure - the lender incurs the costs. The same applies to depositors consciously investing funds in banks with unfavourable financial situation - they are convinced that if the bank is solvent, they will receive a higher percentage, whereas, in the case of the collapse of the bank - the losses will be spread over the entire market.

2. Safety net structure on the example of Poland.

Due to the occurrence of the above risks and the enormous impact that the banking system has on the economy of the country - countries take special care of this sector. Maintaining the stability of the sector in question is both an important and complex task and thus it is carried out by the whole network of institutions. Since the activities of public institutions alone would not be sufficient - actions in this area are also undertaken by the participants of the sector - the market. [7] However, due to the limited size of this work - the author analyses only the institutional structure.

In a broad sense safety net "includes the entirety of institutions, legal regulations and codes of good practice of the financial market, protecting the economy and society against the effects of the loss of liquidity and insolvency of financial institutions." Safety net is also recognized as "a team of institutional solutions and legal regulations aimed at protecting the financial system against destabilization." [8]

The basic functions of the safety net include:

- supervision over the activities of financial institutions;
- lender of last resort;
- guarantee deposits.

Activities of the institutions comprise two stages [9]: crisis prevention, and in case the crisis occurs - managing it. The boundary between these stages is vague and inaccurate. It is understood, however, that the supervision of the activities is carried out at the stage of crisis prevention but the lender of last resort and guarantee deposits at the stage of the crisis management.

In all countries, these institutions have similar goals, yet, their institutional structure varies. [10] The institutional structure of the safety net includes: governments, banking supervision, central banks and deposit guarantee schemes. Depending on the model developed in the country, particular functions are also adopted by the Central Bank.

The following table shows the phases and tools by which individual institutions operate safety net.

Table 1

Division of function in safety net

Phase	Tools	Supervision	Central Banks	Deposit Guarantee Schemes	Government
Crisis reverentia	Regulations	X			X
	Control	X			
	Sanctions	X			
	Security of the payment system		X		
	Macroprudential analysis		X		
Crisis management	Lender of last resort		X		
	Recovery program	X		X	
	Payment of guaranteed depositors			X	
	Public assistance				X

Source: O. Szczepańska, *Stabilność finansowa jako cel banku centralnego. Studium teoretyczno-porównawcze*, Wydawnictwo Naukowe Scholar, Warszawa 2008 p. 62

In Poland, the safety net functions are carried out by the National Bank of Poland, the Polish Financial Supervision Authority and the Bank Guarantee Fund.

Table 2

Safety net structure

Safety net functions	Poland	Ukraine
Supervision	Polish Financial Supervision Authority, National Bank of Poland	National Bank of Ukraine
Lender of Last Resort	National Bank of Poland	National Bank of Ukraine
Deposit Guarantee	Bank Guarantee Fund	Deposit Guarantee Fund

Source: Own work

2.1 Government.

Being the regulator and administrator of public funds, the government play a specific role in the safety net. However, due to the lack of consequence in taking stabilization measures, which is caused by political changes, as well as the temporary character of the actions [11], the government is often excluded from the safety net and it will not be further discussed in this work.

2.2 The Polish Financial Supervision Authority.

In Poland, the supervisory functions are exercised by the Polish Financial Supervision Authority. This body takes stabilization measures both at the stage of crisis prevention and crisis management. While overseeing operation of individual banks, it prevents the spread of critical situations on other institutions. The Polish Financial Supervision Authority controls the activity of individual institutions and in the event of a crisis it becomes a source of information on the situation of individual banks as well as the condition of the entire sector. [12]

The Polish Financial Supervision Authority is responsible for the supervision over the banking sector as well as, among many, over the capital, insurance and pension market.

2.2 The National Bank of Poland.

The Central Bank is an institution serving the function of the lender of last resort, as well as informative and monitoring functions in a number of countries. The Central Bank in Poland is the National Bank of Poland. Its basic function is to care about stability of prices. As far as the safety net is concerned, the National Bank acts as a lender of last resort, participates in the process of supervision, cares about the safety of payments system and is responsible for macroprudential analysis. [13] A separate authority is jointly responsible for supervisory functions. This solution requires close cooperation between the institutions.

Carrying out the abovementioned functions, the National Bank of Poland operates both in the crises prevention and management.

2.3 Bank Guarantee Fund.

In Poland, the body responsible for ensuring deposits is the Bank Guarantee Fund. Likewise in Ukraine, it is a risk minizer fund, so it is not only responsible for the disbursement of funds but also helps in emergency situations.

Membership in the fund is mandatory. Actions of the body are held at the stage of crisis management and provide financial assistance to banks facing insolvency, assistance in merging of vulnerable entities with stronger ones, gathering information and the disbursement of guaranteed funds in case of an event. In Poland, the guarantee funds are subject to both natural persons and legal entities. The guarantee amount was gradually increased: before the crisis it amounted to 1,000 euros in 100% contribution and 22 500 euros in 90% contribution, during the crisis the amount was increased to 50 000 (100% contribution), the current amount of the guarantee is 100 000 (100% contribution). [14]

It needs to be stressed that the safety net institutions work together to financial stability, which means that they are not a guarantee of the stability of the system. Their actions are focused on providing confidence in the whole system and not rescuing individual banks or institutions. [15]

3. Risks and costs associated with the functioning of the institutional structure safety net.

The institutions forming the safety net are to limit the risks associated with the operation of the financial system. Their existence, however, beside generating costs associated

with the operation, may result in the formation of different types of risks.

The most transparent costs are those incurred for the functioning of the institutions themselves, the creation and enforcement of law and possible aid measures in the event of an emergency.

There are also immeasurable costs which include, in particular, the costs generated by reduced effectiveness of the system in the event of over-regulation as well as changes to keep market participants (moral hazard and free rider). [16].

The first approach is based on the belief of some market participants that in order to achieve higher profits, they may take excessive risks, as together with the safety net possible negative effects in the form of losses will be incurred by the entire market. As a consequence, the costs of such activities shall be borne the entire banking sector.

The free rider approach consists in taking advantages of the benefits offered by the functioning of the safety net but without the costs associated with functioning of the system.

An entirely different kind of a risk is the danger of over-regulation - preventing smooth functioning of market participants. [17]

Further risks are not connected with the very existence but the way the structure of safety net is organized in Poland.

The risks associated with the safety net structure existing in Poland include the shortage of information flow between the National Bank of Poland and the Polish Financial Supervision Authority. Yet, the positive aspect is the application of consolidated supervision of banking sector and insurance, capital and pension markets, thanks to which the controlling authority has a direct impact on institutions strongly affecting the banking sector.

Summary.

Safety net is an integral part of the financial system; its activities to a big extent minimize the risks associated with the functioning of the financial systems. However, they may also result in additional risks associated with changes in the attitudes of market participants believing that the potential costs of irrational decision will be spread to the whole sector. Therefore, the decisions of market participants should be made rationally, taking into account the associated risks. In order to achieve this, an important part of the network's activity is information policy. Market participants should receive a clear message that safety net institutions work for the stability of the financial system, yet, do not guarantee the stability of the system.

Sharing responsibility would also affect the rationality of the decisions made by market participants. An important element is therefore not to increase excessively the amount of guaranteed deposits. Full guarantee of the funds should comprise rather small depositors.

An aid to institutions at risk should be granted only under conditions of severe system's risk. Poorly functioning institutions should be eliminated by the market. The banks whose collapse would cause a significant risk to the system should be covered with the special supervision. (banks System Important Financial Institutions).

Safety net institutions' activity in accordance with the abovementioned rules greatly reduce the risks associated with the operation of the banking sector without increasing excessively the risks associated with the operation of the structure itself.

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