

Check Against Delivery

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Regional Seminar on Financial Crisis Management

“Deposit insurance and its Role in Financial Stability”

**Remarks By
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Thank you very much indeed for the introduction.

Good Morning, distinguished guests, ladies and gentlemen. It gives me great pleasure to be speaking at the Regional Seminar on Financial Crisis Management and I want to thank the Financial Stability Institute for the opportunity to share my thoughts on the role of deposit insurance and financial stability in this distinguished gathering.

Slide 1: Title

Introduction

Today, I want to discuss how deposit insurers promote financial stability and areas in which deposit insurers can mitigate the impact of a financial crisis. I will then draw out some lessons that I have gleaned from experience of dealing with 43 financial institution failures in Canada.

I have organised my presentation into 2 parts. The first is on the role of deposit insurance in promoting financial stability. I will highlight some lessons in the second part.

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Role of Deposit insurance in promoting financial stability

Globally, deposit insurance has become an integral part of the financial safety net. There exists a wide spectrum of deposit insurers with varied mandates, powers and role and responsibilities. And as important, we need to understand the term “financial crisis” in this context. No deposit insurer can deal with a meltdown of a country’s financial system by themselves-that is the role of governments. Deposit insurers are structured and are well placed to deal with one or a wave of bank failures.

Certain deposit insurers have a pay-box mandate which essentially limits them to be payment agents after a bank failure. Others have a risk minimisation mandate that require them to examine banks, intervene early so as to minimise the deposit insurer’s exposure to loss, and to mitigate that loss by implementing various failure resolutions when a bank is required to exit the market. I shall review this in a bit more detail shortly.

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Notwithstanding their mandates, deposit insurers can contribute to the overall growth of the economy. Indeed they can do so by promoting and contributing to the stability of the financial system by building public confidence through the delivery of comprehensive public awareness programmes aimed at increasing financial literacy and better informed depositors.

History shows that public confidence in the banking system can be substantially increased by publicising the existence of deposit insurance and the benefit it provides. Indeed public confidence is optimal when people believe that a dollar in the bank is as safe as a dollar in their pocket! And this sense of security has to be felt by the depositing public generally. This sense of security is the pivotal factor supporting the stability of the financial system for depositors, customers and the general population.

Therefore, during good times, public confidence provides the environment to build a savings culture, of thrift and enterprise which is so essential to economic growth. A stable financial system must be anchored strongly on the public's belief that the system is safe, strong and that their funds will always be readily available.

In bad times, deposit insurance maintains confidence amongst the depositing public and provides the incentive for depositors to retain their savings in the banking system.

But there are prerequisites that will determine the success of the confidence building and maintenance process.

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It is accepted view today that in an open competitive market economy, some banks will be successful and others will not. Thus deposit insurers must be operational ready to deal with failures and the capacity to do it successfully.

To build and maintain public confidence when banks' fail, deposit insurers have to build their credibility in good times, that is, when there are no failures. Depositors have to be aware of the benefits and limitations of deposit insurance system well before failures occur.

If depositors have access to such information, they can make informed investment decisions based on their risk profile. And such knowledge provides confidence, comfort and incentives to depositors. Thus, a deposit insurer that is only in the public eye during bank failures has no hope of generating public confidence to mitigate contagion, bank runs or minimise disruption in the banking system.

Having studied examples in other countries, MDIC implemented in 2006, a comprehensive public awareness campaign aimed at building public confidence in the safety and soundness of our banking system and the role that MDIC plays in protecting depositor funds in the unlikely event of a bank failure.

We believe we have a responsibility to inform the depositing public so as to meet the public interest and to act in the best interest of all depositors.

Presently, while continuing to build public awareness of the deposit insurance system and its features, our focus is also on building our corporate credibility and image.

We strive to develop our reputation as a best practice organisation which is well governed and well managed both as a deposit insurer and as a statutory body. We believe that with this credibility, we shall gain the trust of the public and our stakeholders.

Our five-year multi-pronged strategic communications plan outlines a number of initiatives which include media interviews and articles, training for member institutions, print and television advertising, road shows, and wide dissemination of our policies, annual reports, corporate plans which we provide in our four prominent languages.

The success of our campaign is tracked through the setting of key performance indicators based on public surveys which are updated annually.

Moving forward, we are focussing on building greater financial literacy through the development and implementation of a programme to educate youths and we currently putting in place regulations to ensure that member banks provide relevant deposit insurance information to their clients including the disclosure of the insurability of each deposit product offered.

Another important requisite to maintaining deposit confidence is how quickly deposit insurance payouts can be made.

The MDIC Act stipulates that depositor claims must be paid not later than 3 months of the date of the winding up order of a bank.

This is a statutory imposed deadline but we are planning to be able to make reimbursement of depositors claims within days of a failure and not months.

We are enhancing our operational readiness through the development of appropriate payout systems, policies and procedures that will substantially streamline our overall process. This includes ensuring the quality of depositor records at member banks and we are confident that we can reach our target.

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Let me quickly show you the types of deposit insurance model. The range of mandate differs widely depending on the policy makers expectations of the role for deposit insurers.

In the case of MDIC, we have a very broad mandate. As you can see, our mandate is almost as broad as a cost minimiser, except that we do not have examination powers. Entry into the deposit insurance system is legislated. And MDIC has the power to terminate or cancel membership.

Mandate is important for a deposit insurer since its role and functions flow from its mandate. And it is from the perspective of a broad mandate deposit insurer that I would like to address this topic.

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Moving on, deposit insurers with broad mandates can complement and reinforce the supervisors' role. I am not advocating that deposit insurers have supervisory examination powers. I refer to the risk assessment and monitoring function of deposit insurers.

For example, MDIC conducts independent risk assessment and monitoring of the banks and the banking system based on the information database of the supervisor who also shares with us their examination findings and any relevant reports and other pertinent information.

This is important since MDIC needs to understand its risks so as to set its strategic direction including the development of its annual corporate plan and budgets including the setting of premium rates.

MDIC must be operationally ready to deal with any eventuality so as to meet our mandate of minimising the losses to the financial system.

We complement the supervisor's role in many ways.

As an example, we have the power to establish a differential premium system and impose a premium surcharge on banks, in consultation with the supervisor over non-compliance with regulations, orders or regulatory deficiencies, such as a decline in regulatory capital.

MDIC's power to do this is set out in its legislation.

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The stability of the financial system is dependent on strong and sound banks. As I mentioned earlier, a deposit insurance system has to be well-designed in order to contribute more effectively to financial stability.

One approach is for deposit insurers to work with supervisors to provide incentives for sound risk management practices in the financial system.

This role to complement other safety net players is increasingly being recognised and put into practice. The view is that all the safety net players have different roles with a common objective -- promoting and contributing to the stability of the financial system.

There are various ways to meet this objective. Well designed deposit insurance systems now have mandates that require deposit insurers to promote sound risk management practices amongst banks so as to promote and contribute to the stability of the financial system.

MDIC has both these objectives in its mandate. How is this translated into practice?

One way is to implement of a differential premium system (DPS) – a system that must be transparent and objective so as to provide banks the incentives to move towards lower risk profiles.

An effective DPS also provides financial incentive to resolve deficiencies on timely basis. Under the DPS, higher risk banks are greatly penalized through higher premiums. This removes the moral hazard issues associated with the flat premium system of the past. The DPS is primarily designed to provide incentives for banks to improve their risk management and resolve their deficiencies.

In MDIC's case, the DPS framework identifies specific indicators which measure the riskiness of banks in key broad areas, such as capital adequacy, profitability, asset quality, and includes bank supervisory ratings. This provides banks' board of directors and management with a benchmark by which to rate their institution and points to areas for improvement.

For example, historical analysis shows a strong relation between level of NPLs and level of sector concentration. The system, by providing incentives to banks to reduce high sector concentration, would help banks to lower their level of NPLs.

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Deposit insurers also promote effective early intervention and resolution of troubled banks since they have the financial exposure. This is important from the financial stability perspective. To accomplish this objective, deposit insurers require access to information critical in devising least cost resolution arrangements.

In many jurisdictions, deposit insurers also act as receivers and asset management specialists. As an example, deposit insurers have knowledge and experience on information that is needed for computation of the various cost options.

Cost comparisons would need to be made between purchase and assumption, open bank assistance or liquidation and pay-outs and other options. Indeed, the specialization and division of labour between the deposit insurer and the supervisor improves efficiency and effectiveness.

Assets acquired would also need to be disposed off. Returning assets back into the private sector helps create positive impact on the economy. And with experience, deposit insurers have also developed the necessary processes and networks for restructuring banks through mergers.

Deposit insurers also have a financial incentive to optimize recoveries on assets and minimize costs to reduce losses to the deposit insurance fund.

There is another incentive for deposit insurers to promote more effective resolution of troubled banks. Supervisory forbearance is often practiced because of the perception that a bank failure is a supervisory failure.

Having operationally independent deposit insurers with the mandate to minimize losses provides for the necessary checks and balances and promotes a strong accountability regime.

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This chart shows the relationship between MDIC and Bank Negara Malaysia (BNM) as an example of the relationship that can be built. The approach to designing MDIC was built on the accountability and functionality model.

Under this approach, MDIC and the supervisor (BNM) have clear roles and accountability. BNM remains the primary supervisor while MDIC is accountable for resolution of institutions that have ceased or likely to cease to be viable as determined by the supervisor. As you see, there are no overlaps and the reinforcement of functions is mutual.

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The objectives and goals of a deposit insurer cannot be achieved without strong alliances with key stakeholders. A deposit insurer needs support and collaboration from other safety net players. In many countries, safety net functions are mostly assigned to different organisations because of the need to impose appropriate checks and balances.

It is therefore critical to establish good interrelationships especially with supervisors in order to minimise potential tensions and to ensure that joint-actions are properly coordinated.

Also, with good relationships, consensus on the way forward can be achieved much quicker. However to ensure such collaboration, It is imperative that coordinating mechanisms be legislated. This is the case in Malaysia.

MDIC and Bank Negara interrelationships is formalised through a Strategic Alliance Agreement (SAA). The SAA outlines the roles and responsibilities of both agencies, arrangements for sharing of information and resources as well as a mechanism for the coordination of actions.

It should however be noted that the strength of any SAA is only as good as the commitment made by the leaders of the agencies.

Furthermore, it is important to build close working relationships with other relevant government agencies such as the Central Bank, the Ministry of Finance and the Attorney General's Office.

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In the case of Malaysia, there are four guiding principles underpinning the SAA:

- dealing with issues on an open and transparent manner;

- respecting the independence and accountability of each agency's scope of work within their mandates;

- communicating effectively through timely and up-to-date exchange of information; and

- respecting and accepting the diversity of experience and skills of each agency when addressing issues raised by either agency.

Ladies and Gentlemen,

Let us now move on to the next half of my presentation.

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I want to draw lessons from my experience in handling bank failures.

One of the important lessons learned is to have in place a comprehensive approach to dealing with troubled banks. For simplicity, I shall call it a crisis management plan (CMP).

A comprehensive well coordinated safety net crisis management plan is ideal. And each agency should have their own plan based on their role and responsibilities.

The benefits are obvious. It provides for a framework for immediate response and details action plans that have been well thought out. It avoids knee jerk reactions and gets buy-in of major public policy players in advance.

Having such plan gives an organisation direction and control. Delaying the intervention and resolution of a troubled bank would increase moral hazard and lead to greater costs for the financial system.

I should also highlight that it is not a business continuity plan for your organisation although some of the thinking process would be similar. A CMP forces your organisation to view problems with a critical eye, that is, assessing whether the problem is contained at one bank or part of a larger problem.

What about the components of the CMP?

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What I have set out in the slide are just some of the basic components.

The size and comprehensiveness of the Plan is dependent on what is to be addressed. Of course, the objectives of the Plan, the purpose of each initiative and the measurements of progress are part and parcel of any plan and need not be set out here.

In CDIC, where I worked for 35 years, we had a CMP based on our long experience in managing bank failures. In Malaysia, we are embarking on developing a comprehensive CMP next year which will have all the components that I have set out. And we plan to incorporate ours with that of BNM.

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I would like to speak on 2 specific components in respect of the approach in developing a sound plan.

Critical in managing troubled banks is to know your systems. By this I mean the legal framework, related legislation and court system. A clear legal resolution framework can have an important bearing on both the range and effectiveness of the policy options in resolving troubled banks.

The options available for resolving banks are dependent on the powers given to the deposit insurer.

In MDIC, we will be reviewing and stress-testing all our financial legislation and policies related to bank intervention and resolution to be absolutely certain that we have the powers available to manage all potential options such as liquidation, receivership, bridge bank, purchase and assumption, agency and asset and disposition management .

Another critical element to preparation is to **know oneself**. By this, I mean a deposit insurer must be clear on its mandate and powers. And there should be clarity and acceptance among all safety net players in respect of the role, functions, responsibilities, and accountability of the deposit insurer.

Another aspect of this principle is to know the **organisation's capacity** to deal with the troubled banks in a manner to meet its mandates.

This entails having a clear organisational framework including appropriate IT systems, sound internal control systems, policies and procedures manuals and the necessary human capital with the requisite experience and expertise.

Employee competencies in specialist areas should also be assessed and developed. These would be in key areas, such as viability assessments, asset valuations, asset management, receivership and legal expertise in insolvency and other laws.

This is an important lesson as the effectiveness of any CMP is tied closely to how and who manages it. I would also advocate assessing the competencies of service suppliers who would be involved in bank resolutions, such as law firms, accounting and consulting firms. This is critical for deposit insurers who outsource a number of functions for efficiency.

Let me address specifically the level of readiness required.

The level of readiness to intervene is dependent on the availability of information that would enable the deposit insurer to assess its risks including the probability of a bank failure. Information sharing amongst policymakers is critical to the success of any CMP.

A multi-disciplinary team should be identified and well trained in implementing the crisis management plan and be ready to act when called upon.

Obviously, one would not want a number of employees who only responsibility for crisis management. Apart from being trained in crisis management, they should be tasked to fulfil other key functions. In this way, one has a ready pool of specialist talent to draw on in times of need.

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With a CMP, safety net players can be sure of the consistency and transparency of actions and messages. This is important to maintain the public's trust and confidence in the banking system. Any intervention actions taken by the deposit insurer to assist a troubled bank should not give the perception that such assistance would also be given in future (moral hazard).

Another important lesson learned is to have a crisis communication plan in place that would include media and public relations strategies and action plans.

This would include a toll free call centre where the public can receive information as well as a dark site that can be activated immediately in the website to provide up-to-date information to the public. Pre-prepared press releases, communiqués and other statements should also be available to minimise delays in communications.

One more lesson is to have available adequate physical facilities to house the command centre and to coordinate the necessary actions.

CMP all look good in theory. Real life is more complicated. There are many nuances. Therefore an accountability regime and reporting mechanism is important to measure the efficiency and effectiveness of each financial safety net player.

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In reviewing the legislation and resolution options, the CMP should also take into account the ranking of depositors vis-a-vis other creditors. I would like to spend a few minutes on this issue.

There are several issues to look out for. And my views are strictly from the perspective of a practising deposit insurer. Typically, depositors rank after receivers, statutory claims like tax payments, staff salaries and secured creditors.

Depositors are therefore ahead of debt and shareholders. In some countries, depositor preference laws place depositor claims ahead of all creditors. The intention is to minimise the cost of a bank failure to the deposit insurer.

It also aims at promoting an equitable sharing of loss, depending on their legal status. The effect, however, may not necessarily be consistent with the intent. The other advantage of having a depositor preference is the enhancement of market discipline on other creditors. This is achieved by encouraging other creditors to monitor the banks closely.

Creditors can find various ways to protect their interests and mitigate their risks. They do this by securitising all their debts or they do not extend credit at all.

In addition, many large depositors withdraw their funds at the slightest rumour of impending trouble. Other creditors protect their claims by taking security, shortening terms of maturity, exercising early-withdrawal provisions, or imposing additional penalties or charges. The central bank, for example, is likely to be one of the largest creditors. Their claims would, however, be fully secured. Such actions may offset the effects of preferential ranking

Countries have different depositor ranking. For example, some rank depositors ahead of secured creditors. Others rank depositors ahead of trade creditors while others rank insured depositors ahead of other depositors.

Furthermore, depositor preference could apply to local deposits and not to foreign deposits. In addition, subordinated debts have all kinds of negative covenants that trigger their repayment even before the bank is in serious trouble.

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In relation to this, I have several points to make.

- First of all, be absolutely certain that one understands the law.
- If uninsured depositors believe they will not sustain losses because of their priority ranking, they may have less incentive to exercise market discipline.
- The effect of netting agreements on depositor ranking should also be considered.
- The ranking of Shariah deposits should be properly noted. Deposit products based on the Al Wadiah concept, which is a concept based on custody, takes priority over Mudaraba deposit products. I would therefore advise that the ranking of new Islamic products be considered well at their launch.

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Conclusion

Ladies and Gentlemen,

A deposit insurance system that is well publicized and well understood mitigates bank runs.

Effective deposit insurers can complement and reinforce the supervisor's role by having the power to impose premium surcharges on banks that are not in compliance with regulatory and supervisory requirements.

Deposit insurers can provide incentives for banks to practice sound risk management through the implementation of differential premiums systems.

Deposit insurers can also promote effective resolution of troubled banks since they have the financial incentive to do so.

Deposit insurers require strong alliance with all safety net players, specifically with supervisors. Such arrangements should be formalized in legislation and agreements.

A well thought out crisis management plan, including comprehensive communications strategies is critical for mitigating the cost of failures.

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