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Speech By

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**Macroeconomic Policy and the Role of Deposit Insurance in the
Era of Globalisation**

Introduction

Good Afternoon. It is wonderful to be in Vietnam. There is so much happening and so much to look forward to for this great country. And I am pleased to attend the 5th IADI-Asia Regional Committee Meeting and International Conference as President of the International Association of Deposit Insurers and Chair of IADI's Executive Council.

I wish to thank the hosts – the Deposit Insurance of Vietnam and the Asian Development Bank. The ADB has been a great supporter of our objective to enhance global financial system stability by working towards building effective deposit insurance systems in our respective countries!

The theme of this session is *Macro Policy on Deposit Insurance Operation*. It is an appropriate theme since the unique safety net role of deposit insurance requires deposit insurers to also assess their contributions to their government's overall macroeconomic policy. So today, I will give you my perspective as a seasoned practitioner, of a deposit insurer's role in macroeconomics, in the context of globalisation.

I have organised my speech in three parts. First, I would give a short perspective on how globalisation complicates the conduct of macroeconomic policies, and the benefits and rewards of globalisation. Second, I would discuss the role of deposit insurers in macroeconomic management. Third, I would

focus in depth on the critical success factors necessary for developing and maintaining effective deposit insurance systems.

Importance of Globalisation

Ladies and gentlemen, as you are aware, pro-active and sound macroeconomic policies, combining prudential oversight with market discipline to preserve financial stability, are crucial to the development and economic well being of a nation. The ultimate aim of policymakers is to put in place mechanisms, such as a well-functioning and robust financial system, that prevent financial problems and external shocks from seriously destabilising the economy without, at the same time, inhibiting market efficiency and dynamism.

This task, however, has become more complicated due to the rapid pace of globalisation. Globalisation complicates the conduct of macroeconomic policies in a number of ways. First, the new challenges that organisations face would put new burdens on policymakers. As the business environment changes, designing and implementing national policies, which need to take into account global developments, would become more challenging. Second, as a consequence of markets becoming increasingly integrated, macroeconomic linkages would continue to be fundamentally altered. The resulting increase in uncertainty and risks would complicate the policy making process of determining the appropriate policy antidote when economic episodes erupt.

Globalisation is a double-edged sword, offering both risks and rewards. The rapid rise in per capita income during the unprecedented integration of markets over the past two decades bears evidence to the indisputable gains of globalisation. On the other hand, the great difficulties that East Asia went through in 1997/98 led to questions about its efficacy.

It is self evident that Vietnam, which rightly moved away from a centrally-planned economy and embraced capitalism in 1986 under *doi moi* (innovation), has benefited immensely from globalisation. The expanded trade and investment ties have propelled Vietnam to be one of the fastest growing nations in East Asia, second only to China. Its income per capita has risen sharply from US\$170 in 1993 to US\$620 in 2005. These are impressive gains by any standard. Vietnam's recent admission to the World Trade Organisation (WTO), the world trading system would, no doubt, result in further integration. With greater incentives from globalisation, the speed of economic reforms would be faster than before. An even playing field between local and foreign companies and a more predictable regulatory landscape would surely boost investors' confidence, encouraging more trade, more foreign investment inflows and more multinationals expanding their operations to Vietnam. In fact, foreign direct investments last year reached a record high US\$10.2 billion¹, surging by about 50 per cent from 2005.

But like other developing countries, Vietnam would also need to contend with the negative pitfalls of globalisation, such as managing the income disparity between the rich and the poor, which may become even more apparent. Some sectors would surely face greater competition with the ascension to WTO. In

¹ Vietnam's Economic Performance – Round Up, (March 16, 2007), Embassy of the Socialist Republic of Vietnam in the United States of America.

particular, greater competition in agriculture, a critical sector in Vietnam accounting for 57 per cent of total employment in 2005, may result in rising unemployment.

Yet, if properly managed, globalisation could arguably serve as the best platform for nations to generate economic growth and wealth, reduce poverty, and promote international trade. To avoid the pitfalls of globalisation, nations need to put in place mechanisms, such as an effective legal system and financial infrastructure, and effective regulation and supervision, including governance, to manage its inherent risks. Gaps in these areas could undoubtedly leave nations vulnerable.

One important feature of globalisation is the prominent role played by the banking and financial services sector. With banking crisis a major source of financial instability, it is not surprising why this sector is subject to the most intense scrutiny and supervision by regulators. Although lagging behind the liberalisation of product and factor markets, the globalisation of banking and financial services has been encouraging. In fact, Vietnam's WTO commitments have paved the way for 100 per cent fully foreign owned subsidiary banks to operate on equal footing with local banks starting April this year.

However, liberalisation without the necessary safeguards, accounting and auditing standards, sound legal, regulatory and supervisory systems, effective deposit insurance systems, could seriously undermine the effectiveness of a financing system.

Broadly, to be effective, a deposit insurance system, first, needs to be well-designed with good structure and organisational arrangements and the system needs to be well understood by the public. Second, even a well-designed deposit insurance system cannot be effective if the other components of the financial system are weak. A financial sector is often broad, encompassing inter-related components such as the financial markets, institutions and infrastructure in which a deposit insurance system is only one sub-set. Therefore, it is unrealistic to expect a deposit insurance scheme to, on its own, assure stability in the financial system. Such a scheme can only be effective when it is part of a well-designed and coordinated financial safety-net.

Role of Deposit Insurers in Macroeconomic Policy Management

I would now like to discuss the role of deposit insurers in macroeconomic policy management. To manage globalisation, the general policy responses often prescribed are 1) a shift towards more flexible exchange rate regime, 2) a proper sequencing of liberalisation and institution building, and 3) regulation and supervision. While the conduct of exchange rate policy and the sequencing of liberalisation are the responsibility of central banks and the treasuries, deposit insurers, depending on their mandates, can exert influence in institutional building, regulation and supervision.

Although somewhat passive, the role of deposit insurance is essential for a well-functioning and robust financial system since deposit insurance can

provide incentives for sound risk management in banks and deal effectively with troubled banks.

I have identified 5 areas that deposit insurance play in macroeconomic policy. The most important macro objective of a deposit insurance system is to contribute to the **stability of the financial system**, an essential support for economic growth. A deposit insurance system contributes to the stability of the financial system by:

- **instilling public confidence in member banks;**
- **encouraging banks to managing risks responsibly and reducing moral hazard.** A well designed deposit insurance system can contribute to financial system stability by reducing excessive risk taking in the banking sector. This would involve providing incentives for sound risk management of banks, allowing troubled banks to fail and providing limited insurance coverage at a level that would strike a fine balance between supporting financial stability and maintaining market discipline. With limited coverage, financially-sophisticated depositors continue to have the incentives to exert market discipline, penalising weak banks by reducing their access to credit;
- **reducing the likelihood of bank runs** and preventing banking panic from spreading quickly to other banks, the so-called contagious effect!! And effective deposit insurance system is the policymakers' best defense against bank runs. Without an effective deposit insurance system, bad press coverage or financial trouble could prompt the public to withdraw deposits, both from good and troubled banks. A credible deposit insurance system can reduce the likelihood of a run in the banking system by educating and assuring depositors that their deposits are protected from losses and they would be repaid promptly, in the event of a bank failure. An effective system can also contribute to stability by
- employing a **formal mechanism for early bank resolution;** and
- supporting and contributing to an orderly or proper functioning **payments system.** The payments system, in which the banks play an intermediary role, is vital for the proper functioning of an economy. Indeed, the public need to believe that a dollar in their bank account is the same as a dollar in their pocket!! By maintaining public confidence in the payments system, an effective deposit insurance system removes the risks for the majority of depositors to participate in bank runs; and by
- reducing the severity of an economic down turn by **mitigating the consequences of failures of insured institutions for depositors.**

The second important role of deposit insurance is to **promote savings** by instilling confidence in member institutions. High domestic savings are utilised to finance domestic investments and these allow a nation to develop without relying too heavily on foreign borrowings.

Third, deposit insurance can **instill discipline** on member banks and elicit responsible behaviour. Deposit insurer complements the supervisory processes

in mitigating risks by providing incentives for banks to manage their business prudently with sound corporate governance and risk management systems.

Exerting financial discipline can include demanding higher premium payment from riskier banks, providing incentives for banks to diversify risks, prescribing early corrective actions for troubled banks, imposing sanctions for non-compliance with regulatory rules and imposing premium surcharges. Deposit insurers can also enforce licensing discipline through the threat of termination and cancellation of membership or even the removal of directors and officers.

Fourth, deposit insurance **promotes competition**. Deposit insurance helps smaller and newly chartered institutions compete for deposits against larger and well established institutions by removing the perception that they are riskier. Depending on its mandate, a deposit insurer can enhance bank operational standards by enforcing good governance and high banking standards, including prudent risk management practices, integrity and fair/equitable consumer treatment. Indeed, banks which align their business and institutional strategies to these factors would have a competitive advantage, be better placed to succeed and create added value for their shareholders.

Finally, deposit insurance facilitates the transition from blanket guarantee provided by governments to an explicit-limited coverage and if done properly instill public confidence by its establishment!! This helps **governments reduce their financial exposures**.

Critical Success Factors for Deposit Insurers

Let me now move on to discuss some of the critical success factors for deposit insurers. And these factors are important. No deposit insurer can be effective if it is not operating with the right enablers or tools.

Good structure and organisational arrangements are vital if a deposit insurance system is to effectively carry out its public policy objectives. Regardless of their mandates, deposit insurers, at the minimum, need the following basic authorities and powers to be effective. They are a) clearly defined and legislated mandates, b) high degree of operational independence, c) access to adequate, timely information and appropriate funding, (d) and public awareness objectives. Otherwise, deficiencies in its infrastructure could hamper effectiveness and efficiencies.

Regardless of the variations in mandates, it is highly important that all deposit insurers be given appropriate powers, sufficient legal authority and adequate resources to act and fulfill their mandates. Mandates need to be **clearly defined and legislated in laws**. Also, the functions and responsibilities of deposit insurers should be explicitly differentiated from those of the other financial safety net players. This is highly important and especially crucial for deposit insurers that are mandated to assess and mitigate exposure to banking

risks, intervene and resolve troubled and ailing banks. Given the importance of maintaining and promoting a sound financial system and the large cost of bank failures, there cannot be ambiguity, either constructive or otherwise. Deposit insurers should be given broad authority and the necessary powers in law to resolve troubled banks effectively and in a timely manner. To do this, a well designed deposit insurance system would, at the minimum, have a mandate to intervene early and meet least cost solutions for the financial system. This is for the benefit of the public interest!!

Deposit insurers must be given a **high degree of operational independence** to carry out their public policy objectives effectively without undue interference. With independence comes stated responsibility and accountability which in turn, promotes transparency, efficiency and effectiveness. Not unlike other corporations, public trust and integrity are central to the success of a deposit insurance scheme. To maintain and enhance public confidence, deposit insurers must also demonstrate they are well-governed and well-managed. Integrity and efficiency of operations can be enhanced by making deposit insurers accountable to Parliament. They should also have in place a strong governance system, comprehensive business plans including performance indicators, a robust enterprise risk management framework and sound accounting, internal controls, auditing systems and a reporting framework that provides for transparency and public disclosure!

The deposit insurer's mandate, roles, responsibilities and actions should be transparent and be clearly communicated to all stakeholders. How a deposit insurer operates or is to act should not be a black box!! Deposit insurance laws should prescribe clearly responsibilities, coverage limits and circumstances for making obligatory or discretionary payments to depositors. The conditions and criteria for intervention in banks cannot be arbitrary and clarity in law is especially critical if a deposit insurer is to meet its public policy objectives and mandates effectively.

In order for them to carry out their responsibilities efficiently, deposit insurers, should also be provided with **legal indemnification** for their employees in the normal course of deposit insurance activities or supervision. Without the fear of personal litigation, employees are able to act promptly and decisively with respect to fulfilling their responsibilities and acting in the best interest of the deposit insurer they represent. And the speed of action required to be taken can have crucial impact in limiting the contagion effects of bank failures, not only during an economic crisis.

Deposit insurers must also have **access to adequate and timely information**, and should, therefore, be empowered in law to obtain detailed and timely information on member banks either through the regulator, supervisor or the banks directly. Deposit insurers need to assess the inherent risks of insured banks so as to deal with these problems early through an early intervention framework, before banks become too hopelessly insolvent. If losses are to be reduced for the financial system, a new early trigger for

intervention should be implemented. In Malaysia, the trigger for intervention in law is not solvency but the viability of a bank!

Deposit insurers also need to know their funding requirements and the level of annual premiums to be assessed. In addition, understanding the risk profile and control mechanisms in each bank would help deposit insurers develop sound contingency plans. Since bank information is confidential, deposit insurers should also have in place confidentiality provisions in statute. Deposit insurers also need to publicise the benefits and limitations of deposit insurance to the public through a comprehensive public awareness and education campaign – If the public doesn't know or understand about the deposit insurance system in place, it cannot hope to be effective in times of need.

IADI as the Voice of Deposit Insurers

Ladies & Gentlemen, the above critical success factors are not exhaustive. These factors are also not new and are drawn from the Financial Stability Forum's *Guidance for Developing Effective Deposit Insurance Systems*.

These guidance have been endorsed by IADI. Over the past 5 years, IADI has worked tirelessly to share knowledge and expertise on deposit insurance internationally, aiming, ultimately to contribute to the stability of global financial system. We will continue to press on over the next five years with this mission and to propagate deposit insurance as an essential element of financial stability. We shall also work towards issuing sound and effective deposit insurance principles and practices. IADI is providing added value for our members but we need to do more!!

This seminar is yet another example of where we come together to share knowledge and build corporate and personal relationships. Of interest to you, we will be launching our first training program in July this year and we plan to develop other training programs over time.

Another core area of IADI's work is in research. We have issued various research papers which have received very favourable comments from our members, IADI participants, academics as well as non-IADI members.

For example, IADI's research papers on Governance, Claims and Recoveries and Funding for Deposit Insurance Systems issued for discussion at its Annual Conference in Rio were commended for the depth of the practical contributions. And this is IADI's unique niche. We defer from academics as we provide value and contribute in the form of practical advice and knowledge, gleaned from the store of experience of our 47 members, which include all of the most advanced and experienced deposit insurers in the world. From our research work, IADI is hopeful to issue core principles or best practices on many key areas of deposit insurance. We shall not be prescriptive but it is my hope that we provide benchmarks to different deposit insurers depending on their mandates.

Conclusion

Let me conclude with the following comments. Globalisation is a double-edged sword, with both risks and rewards. But nations are now better prepared by laying the institutional foundations for steady growth. And the establishment of an effective deposit insurance system, within a sound regulatory system, reinforces the financial market infrastructure to better manage globalisation.

Broadly, to be effective, a deposit insurance system, first, needs to be well-designed with good structure and organisational arrangements. Second, even a well-designed deposit insurance system cannot be effective if the other components of the financial system are weak. Such a scheme can only be effective when it is part of a well-designed and coordinated financial safety-net.

Lastly, I want to congratulate Vietnam for achieving such incredible economic strides in such a short period. Building on such achievements is one key challenge which I am sure Vietnam is well positioned for. Given the track record and the commitment of Vietnam's policy makers, depositors of Vietnam would continue to reap the fruits of economic development within the protection of a sound and effective deposit insurance system. As you work your vision into reality and move your system towards best practices, let me take this opportunity to wish you every success!!

Thank you.

Malaysia Deposit Insurance Corporation

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