

Deposit insurance and other current issues in international finance

On the occasion of the founding of the IADI and its First Annual Meeting, **MR. ANDREW CROCKETT**, General Manager, Bank for International Settlements, was invited to speak to the Association at a dinner on May 7, 2002. We are pleased to include a transcript of his remarks which were generously prepared by Instituto para la Proteccion al Ahorro Bancario, Mexico. Please note that any errors or omissions are the responsibility of the Editor.

Mr. Crockett

It is a great pleasure to be here this evening to celebrate the establishment of the International Association of Deposit Insurers and to mark its first Annual General Meeting.

Jean Pierre Sabourin remarked that this building is some 750 years old and that deposit insurance is a much younger than that. What you did not mention, however, is that this building was one of the very, very few to withstand the earthquake that shook Basel some 650 years ago. That shows, I think, that whoever insured it knew that this building was a good one to insure.

I want to pay tribute to you, the members of the Association and to JP, its first chairman, on what is I think quite a historical occasion. I feel sure that, many years hence, we will look back to this moment when the International Association of Deposit Insurers was established as an important milestone in securing the safety and integrity of the international financial system.

There are many components to creating a sound and safe financial system. Sound deposit insurance arrangements are one of them. The Financial Stability Forum, which I chair, has as its main charge to bring together those responsible for different elements of financial stability. I thought I might on this occasion, when you as deposit insurers are joining the network of bodies that help underpin financial stability, report a little on some of the activities of the Financial Stability Forum and on what is going on in other parts of the field.

The recent past has been an active and difficult time for those whose responsibilities are in the area of international financial stability. Of course in our minds right now are the difficulties faced by our colleagues in Argentina, but this is, I might say, only the latest in a number of episodes of currency or financial crises. Helping to prevent and resolve financial crises is the primary objective of the Financial Stability Forum and of all of those international organizations and national authorities that work together with us. There are two elements to this work: one is finding mechanisms for better preventing the emergence of financial fragility that leads to instability, and the other is finding better mechanisms to resolve financial and sovereign debt crises if and when they emerge. Since we cannot hope to completely eliminate financial crises, both elements deserve attention.

In the area of prevention, the international community has in effect decided that the best strategy is to devise codes and standards of best practice in prudential regulation, supervision and other areas whose implementation would strengthen national financial systems, make them more efficient, more effective in serving their economies, but also to make them more resilient to crises. These codes and standards cover the whole range of subjects that are relevant to an efficient financial system. That is to say, they cover transparency, they cover accounting standards, they cover corporate governance standards, supervision of financial institutions, banks, securities houses, insurance companies, supervision of the markets and so on. And a part of a social financial system is, of course, having an effective safety net, and a part of having an effective safety net is to have an appropriate, well structured, deposit insurance mechanism.

Although generating consensus on the international best practice to be written into codes and standards is not always straightforward, it is a relatively easy task compared with the enormous amount of detailed and painstaking effort that is needed at national levels to put best practices in place. We have in this room those who are working in one area, that of deposit insurance. But we also welcome frequently at the BIS the groupings of national authorities in other areas: banking supervision, insurance supervisors and so on and so forth. They meet to discuss developments in their fields, the challenges of implementing best practices in their own economies, and areas in which existing standards need to be updated to reflect improved understanding. This is a tradition that I hope the IADI will take up as well.

So, in the area of prevention, I think we have come quite a long way in the last few years in generating consensus of what are the appropriate standards for a safe and sound financial system. The Financial Stability Forum has highlighted twelve key international standards on which priority ought to be focused, depending on country circumstances. The IMF and The World Bank have developed various instruments (ROSCs, FSAPs) to help assess observance of these standards and to offer technical assistance to accelerate implementation. Let's remember that the long term objective is to better serve the needs of the real economies in our various countries: to provide better prospects for economic growth and development, and to strengthen resiliency in the face of the shocks that invariably occur.

But the international community also needs to address the issue of how to resolve a crisis when it emerges. This is an area which can best be described as a work in progress: we do not yet have in the international community a satisfactory means of dealing with a situation when a country finds itself, temporarily or for a longer period, unable to service its international obligations.

As you know, the International Monetary Fund and The World Bank are very important agencies for providing finance. Particularly the IMF provides finance in case of a payments crises, but that comes with a catch that you as insurers or safety net providers know very well: If you provide financial assistance, then you encourage the recipient, and its creditors and investors, to be less than adequately careful in their activities. If you

provide support too sparingly, then you may allow crises to develop that you could have prevented.

And, another problem in this area is the relative responsibilities of the public and private sectors. Increasingly now, most of the finance provided to emerging markets comes from private capital flows: portfolio flows, private direct investment and so on. So the lending activity being undertaken in the market is, in the largest part, provided by private sector individuals pursuing their own agenda, trying to respond to the needs of their shareholders to make returns that are commensurate with the risks. But what should happen when a country gets into financial difficulties?

In the past, we have seen the official sector framework leading to ever larger lending programs, at the same time as the private sector - whether domestic or foreign - has withdrawn its lending. That is not a satisfactory solution in the longer term and Parliaments in the richer countries that provide the IMF with resources have made clear that they would no longer be willing to support that approach. So the international community is now searching for a sovereign debt restructuring mechanism to find a better balance between private sector involvement and public sector support.

The IMF's First Deputy Managing Director, Ms. Anne Krueger, has suggested what is sometimes called a statutory framework, that is to say, national parliaments would pass rules amending the statutes of the IMF that would enable the international community to endorse a standstill by a country facing difficulties that would then be followed by negotiations between the creditor and the debtor country and the results of those negotiations, when agreed to by the majority of all the creditors, would then be enforced on all the creditors. This might involve a haircut, or it might involve a rescheduling for the agreement to become generally applicable. And as I describe it, this is not dissimilar to the kind of bankruptcy procedures that exist in national jurisdictions. There are other attractions, I think, to that approach. The international community has now endorsed further work to follow this up. But there are also difficulties in this area, not least because sovereign liquidity crises are not quite the same as corporate crises. A country cannot be eventually dissolved and its assets distributed, nor can the management of the country, that is to say the government, be replaced the same way that management in companies can be replaced.

So the comparison is not exact. In part for this reason, there has been more interest in pursuing what is sometimes called a contractual rather than a statutory approach. That is, should we not try to get creditors and governments to agree, when they sign the terms of bond issues or other lending instruments, to include in those contracts clauses which define how the creditor and the debtor will resolve problems that might arise in the event that the original contract cannot be serviced on the original terms?

These two approaches, the statutory one working through the IMF or the appropriate authority and the contractual one with the voluntary inclusion of debt clauses in the original contracts are both being debated. I think the debate will probably go on for some

time. It is, I would say, the single most difficult unresolved question in the international financial architecture.

The fact that it is a relevant question can be realized by looking back over the past five or seven years when we have had difficult crises in Mexico, in 1994-95, in Russia in 1998, in the East Asian countries in 1997-98 and now, a particularly intractable one in Argentina. And the solution that is sought, I should emphasize, will mark a break with the current model. It is very much an attempt to build a stronger basis for the future.

I do not want to spend a long time talking to you this evening. I know you have a very full day and you are looking forward, I am sure, to dinner. But, I think Jean Pierre was very wise to suggest that we should have the speeches before dinner so that we can relax and adjourn after the speech. But let me just mention a couple of other elements that you will think of when you come to Basel.

One is the Basel Capital Accord. As deposit insurers, you will have a particular interest in how your work interacts with that of the Basel Committee in defining adequate capital standards for banks, that is, standards that hopefully prevent banks from getting into difficulties that would require the intervention of deposit insurance.

But we have to balance things here. While more capital would make banks less vulnerable to risks, of course it would also make them less competitive relative to other institution and intermediaries that do not face such requirements. So, the challenge for the Basel Committee is to find capital standards that are more risk sensitive than the present standards but not so onerous as to prevent them from playing their full role in the financial system.

The old Basel Accord, which was signed here some 15 years or so ago, has by now become out of date. I am sure you all know that the risk weight applied to all lending to the private sector is identical and that does not make too much sense because we know that different borrowers have different degrees of risk or creditworthiness. The old standard also attached a uniform lower risk weight to banks and we all know too that some banks are more risky than others, or more risky than high quality corporations. So a more risk-sensitive approach is needed. What the Basel Committee has come up with is what is now called the "Three Pillars Approach" to assessing capital adequacy.

Pillar one defines, on the basis of quantitative criteria, what is the minimum capital ratio. The minimum ratio will be the same as the previous Basel minimum of eight percent, but with much more sophistication and differentiation in assigning risk weights to different credits.

The second and third pillars are innovations relative to the previous approach. Pillar two will give more weight to the judgment of supervisors in assessing capital adequacy. This makes a lot of sense, because we all know that a bank can have a portfolio that looks similar on the surface, but if supervisors drill down and understand the banks' risk management practices and internal controls, they can get a pretty good idea of which is

the riskier institution by virtue of its culture, its lack of diversification and so on. So we need supervisory judgment to add to the minimum capital ratios established by quantitative calculations.

And finally, and this perhaps is the most significant innovation for the longer term, supervisors will be enlisting market forces in the supervisory task. Markets are sensitive to risk and communicate that sensitivity through the equity values of corporations and through credit risk spreads on e.g. bond issues. Pillar three tries to give to the market two things to enable it to participate in the supervision of banks. One is the information to judge the situation of individual institutions, that is to say, a level of transparency and disclosure by banks so that market participants can understand how they are doing and where they are going. And the second is to give markets an incentive to judge. Under the new capital accord, market participants' differentiation of banks according to their financial position will have implications for their own costs of providing capital for exposures.

The revised Basel Accord has taken quite long time to be negotiated. But there is a very good chance now that by the end of this year, the quantitative impact study will be completed and definitive proposal put forward for adoption in 2006.

I do not need to tell you as deposit insurers what a strong interest you have in making sure that a good, robust, appropriate, harmonized set of banking capital regulations is put in place. It will enormously affect and facilitate your tasks. But, I want to say this, and these will be my closing words: both, in relation to banking regulation and supervision, and in relation to deposit insurance, the job is never done. The financial world changes all the time and those who supervise and regulate the financial world have to be prepared to change too. So I do not have any doubt that soon after Basel II is in place, we will have to start to think about Basel III. I do not like to say this to my colleagues in the Basel Committee because they say "*oh no, I have been up all night for years doing Basel II*". But there is no doubt that the task will have to be engaged.

Yours is a very important task. Few things are more important in modern economies than making sure that the financial system works well. The financial system distributes the real resources of the economy to their uses. If it works badly, then the best that happens is that resources are used inefficiently. But the worst of course is a financial crisis, which we know are enormously costly. So, I want to assure you that those who are not in your area recognize the importance of what you are doing.

We wish you well, we congratulate you and we congratulate Jean Pierre Sabourin as the first chairman, on setting up what is, and for some time will remain, the newest international financial organization.

We are very happy that you decided to establish your headquarters in Basel and we look forward to welcoming many of you frequently to the conferences and working sessions you will have.

And with that, we are done with speeches for this evening. Please enjoy your dinner and I hope you have a chance afterwards to take a walk outside and enjoy this meeting by the Rhine.

Thank you very much.