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Dinner Remarks

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Good evening ladies and gentlemen.

It is both a pleasure and a challenge to address you on the occasion of IADI's Annual General Meeting and Fifth Annual Conference. The pleasure comes from meeting in this beautiful city and having the opportunity to discuss IADI's important policy initiatives. The challenge, however, comes from addressing such a distinguished group during a period of significant changes in the global financial markets.

Many of these changes represent very positive developments for the financial stability of the global financial system. Let me mention two important examples of these positive developments: first, the improvement in risk management practices in financial institutions over the past few years. I think that better risk management is a key factor in explaining the higher resiliency of the financial markets at present. The second example, very different from the first, is the significant improvement in debt management in many emerging countries. Many countries have substantially improved the structure of their sovereign debt and their domestic capital markets. This country, Brazil, is a good example of this recent development.

However, financial systems are becoming more interrelated, and more complex. They change rapidly, and these changes require us to think about the appropriate policy responses.

The main point I want to make tonight is that, in this changing financial environment, we need to ensure that both supervision and deposit insurance, which are the two critical features of the financial safety net, evolve to meet the challenges of this new world.

The global financial markets are evolving at a rapid pace. Spurred by technological change, the costs of international transactions have fallen, the range of services and products considered tradable has expanded, and the time required to make transactions has fallen. In response, we have seen a significant growth in new types of markets—both securities and derivative markets—the globalization of finance and an expansion of capital flows.

Global financial firms have responded to the incentives implicit in this market evolution. They are increasingly managing risk and operations on a global basis, blurring, to some extent, the traditional distinction between branches and subsidiaries. They have realized that better risk management is a key element of their competitive advantage. Having a global view of risks that is also consistent with the specific features of the local market, improves the stability and efficiency of the financial system and therefore should be encouraged.

The tension between firms managing risks and operations at a global level and national regulations raises many important questions.

The important question today is: “To what extent is the underlying safety net evolving at the same pace, thereby resulting in challenges for us all?” By safety net, I mean the role of supervision in ensuring a safe and sound financial system, and the role of the crisis resolution framework, including deposit insurance, in allowing the closure of failed financial institutions without jeopardizing overall financial stability.

Let me begin by discussing in a bit more detail this evolving role of banks.

Banks continue to have a critical function in the financial system because they have a vital role to play in satisfying the credit needs of various sectors, in underwriting the myriad of financial transactions, and in contributing to the efficient functioning of the payments system. It is important that banks also are able to act as a safe haven in times of financial disruption. In periods of financial stress, investors often return to the banking system. By necessity, this entails a high degree of depositor confidence, which in turn requires a well developed and efficient safety net.

Both parts of the safety net, supervision and deposit insurance, are necessary and play different roles at different times in the “life cycle” of a financial institution.

I have no need to tell you that deposit insurance systems come in different “flavors.” A deposit insurance system may well operate as a simple paybox, reimbursing deposits in failed banks. Alternatively, it could act as a “risk-minimizer” system, with an active role in maintaining financial system stability. Supervisors relate differently to different types of deposit insurers. Operating as a simple “paybox,” the deposit insurance agency needs mainly to verify depositors’ claims and make payouts. A risk-minimizing deposit insurance agency has a broader mandate and needs correspondingly broader information needs.

You may ask: “How do these traditional arrangements among members of the safety net change in light of the evolution of both global financial firms and global markets?”

Bank supervisors are making significant efforts to respond to these challenges. They are trying to make the exchange of information and the coordination of actions more effective across countries. The Basel Committee on Bank Supervision has established a voluntary coordinating group of supervisors—the Basel Accord Implementation Group—to strengthen cooperation among supervisors. There is work also at the regional level. For example, the EU has moved towards harmonization of legal and regulatory regimes and elimination of legal barriers to information sharing among supervisors. “Colleges of supervisors” have also been established to ensure cooperation between the lead supervisor and local supervisors.

An important policy initiative for both national authorities and the international community, therefore, will be to continue to enhance these mechanisms for supervisory cooperation. Strengthening confidence among supervisors and creating mechanisms to ensure improved information sharing is better done in good times, so this is a good time to provide impetus to these initiatives.

A more difficult question is: “How do the deposit insurance arrangements need to be adjusted to operate in this new, global environment?” Since I am more familiar with the European case, let me say that measures have been taken by European countries to remove competitive distortions that arise when branches in a single country have different levels of protection. Depositors in branches are normally protected by the parent’s deposit insurance system. But distortions are introduced when branches operate in countries with a higher level of protection than in the parent’s country. In this case, European legislation allows to “top up” protection, so all depositors in a country will have the same level of protection.

Nevertheless, many issues remain; in fact, the elimination of this competitive distortion is only part of the story. I will mention three additional concerns.

First, we need to consider how to ensure adequate information sharing with deposit insurance agencies in the event of the failure of a global institution. Given the different mandates of insurance systems, they need different types of information at different stages of the “life cycle” of an institution. How should such information sharing be

conducted across borders, particularly when legal constraints on information sharing may exist?

Second, we need to consider how to deal with the failure of a parent institution when some branches are of systemic importance in the host country. I believe that there is nothing wrong in letting some institutions fail, but we need to consider options when the failure of an institution has disproportionate effects on the home and host economies.

Third, although related to the issues already mentioned, how do we develop adequate burden-sharing arrangements that equitably cover the resolution costs of a global institution? How do we allocate responsibility and authority between the home and host countries?

These are difficult challenges and I do not think there are easy answers. So, in addition to your dessert and coffee, I leave you with more questions and a possible policy agenda for further development. This is a challenging agenda but, at the same time, it is an essential agenda. It is one that is best addressed now, as the extent and range of global financial firms is just beginning to expand and the economic environment appears benign, at least for the time being. After all, “The best time to fix the roof is when the sun is shining”.

It also underlines the important role that IADI can play in this regard, and I am very pleased to know that these issues will be part of your meetings next year. I look forward to learning about your deliberations and conclusions.

Let me end briefly by describing the activities of the Fund's newly established department, the Monetary and Capital Markets Department, in this area.

The IMF has been giving much greater attention to financial sector issues in recent years. Financial issues are an important part of the Medium Term Strategy, which as you may know is the strategy to adapt this institution to the challenges of today's globalized world. We are engaged in financial sector surveillance through both our Financial Sector Assessment Program (FSAPs) and Global Financial Stability Report, and we are working so that financial issues will have a more prominent role in the Article IV processes. Part of the job of this department will be to bring the financial perspective into the mainstream of the Fund's analysis. In our bilateral work with countries, the word that I would like to emphasize is cooperation. We would like to strengthen this cooperation in the future.

Beyond the direct, bilateral contacts, the IMF is helping coordinate regional activities. Three areas of coordination stand out. First, we are well placed to collect and disseminate information on cross-border flows. Such information is limited and we can help countries gain a better understanding of the importance to them of cross-border flows. Second, the IMF can help to bring a cross-country perspective that will enhance country experiences. Third, going forward, we may be able to play a role in conducting regional exercises, identifying the policy options in the event of a regional cross-border failure or providing a forum for countries to consider different paths towards reconciling their legal and supervisory frameworks.

I know the Fund will be working in this area. I look forward to working closely with IADI and with everyone here as we seek appropriate responses to these important and exciting issues.

Thank you

