

THE 1st IADI INTER-REGIONAL CONFERENCE (Europe, Eurasia, Mena)

June 26 & 27 2007 ISTANBUL (TURKEY)

ROLE OF THE DIS IN ENHANCING FINANCIAL STABILITY IN DIFFERENT COUNTRIES

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- **Session IV - Who is responsible ?**

- Amongst the responsibilities, those of the Directors and who is qualified to summons them to appear before the Court ?

- **I. Introduction**

- For the free market economy, the impunity of people responsible for a company failure, in particular a banking failure, is a serious menace, perhaps the worst, for business morale and consequently for the required confidence of the general public, both consumers and savers.

- Economic and financial activity carries risks for various actors. The process of privatisation which we have seen in many countries, externalises the risks which beforehand had been managed and thus taken on by the State apparatus in cases of crises, that is to say by the tax-payer (or the saver through stronger inflation). The externalisation of the risks of banking failures which accompanies the very large privatisations within the banking sector has thus very often - if not always - justified the setting up of a body dedicated to the guarantee of deposit funds.

- This body (the DIS) is responsible for absorbing, rather than the depositors, the losses generated by such failures, particularly for the majority of those who are indemnified in full.

- The DIS is a body that is quite clearly distinct from a State apparatus, yet whatever its status, its rules and regulations, its means of finance, an essential question cannot be ignored : who is responsible for the failure of an institution whose losses are fully or partly absorbed by the DIS and who should thus shoulder the cost of such unsound and imprudent management as a last resort?

- The response to this question is very important for a country as to who exercises these responsibilities as it would seem necessary, in one way or another, that the DIS - who has sustained a loss as its reserves have been drawn down - must be able to claim compensation.

- **II. Actors directly concerned by failure and causes :**

- In effect, several actors : directors including executive managers, auditors, supervisory body (the watchdog), all those who have played a pre-determined role in the failure. Thus, each one's role needs to be identified in order to fix the levels of responsibility. Can we individualise these responsibilities? Should they not be common to all those recognised as guilty for mismanagement and complicity for having allowed it to happen ?

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- The losses linked to a banking failure have, more or less, three origins, three causes :
 - economic crises which are more or less generalised,
 - mismanagement or fraudulent behaviour,
 - weak supervision.
- Yet the two latter causes can be directly imputable to people who can be held responsible for such, unlike the first cause cited (a more or less generalised economic crisis). It is this identifiable characteristic of responsibility which is thus essential to target in order for the action to be justified - to obtain the reimbursement from those responsible, to obtain all or part of the sums paid out by the DIS, being a direct measure of its losses. However, we need to point out that other than the case of a systemic crisis the management of which can be imputed directly to the State, can we imagine that the causes of a isolated banking failure are for exterior reasons, those of a weakened economic situation but which however affect only this specific bank. It is somewhat difficult to reasonably imagine this except, of course, if we are trying to pin the blame on a scapegoat who is far removed from the directory or control of the failed institution. Experience tells us that in reality, outside of a systemic crisis and in cases of important economic difficulties, if certain banks fail, the quasi totality of the other banks will not acknowledge the failure as their directors will have managed to avoid such management faults which are irremediable.
- Moreover, privatisation and more generally the liberalisation of the banking sector has an essential counterpart which should be taken on with all its rigour, namely the acceptance of full responsibility by those actors involved in the failure. The moral of business has its price.
- Thus, the exiting of the main part of the economic players from the public sector, specifically the banks, has had legally and in reality the effect of extensively opening up the possibility of financial sanctions by having allowed individualisation of responsibility, making its more accountable and thus useful.
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- This necessary demand, this indispensable tenacity to find those responsible is justified by the fact that human nature tries to escape the sanction of personal responsibility by various means including legal ones.

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- **III. Responsibility – 3 lines**

- For each isolated banking failure, the search for such responsibilities should be oriented along the following three main lines :
- ✓ The first and without doubt most important concerns not only the managers, the president and the general manager (the legal representatives) but also the board members. In cases of banking failure, can responsibility be dissociated according to whether one is a member of the directory or a member of the internal control? It is very difficult to envisage, to justify, when a failure is borne by a DIS. In such a case, weak management, the non-respect of the banking rules and regulations, will not have been sufficiently or precisely followed. Examples demonstrate that board members showing an absence of a strong hand at the controls is a manifest cause of the emergence and then aggravation of losses.
- Thus, rather than going into great detail from the outside and dividing up the responsibilities between the groups of directors, would it not make greater sense to consider such responsibilities common to all and thus make all financial sanctions liable to the whole group ?
- Banking rules and regulations and the organisation of various checks and balances has as its prime objective the proper running of the banking system. The non-respect of this and the absence of any controlling mechanism are imputable to the directory and not the defaulting legal entity, and they should quite simply be directly sanctionable.
- ✓ The second line concerns external control, that is to say a banking supervisory body, often that is very close to the Central Bank, as well as the auditors. Each of these bodies, responsible for supervision, has an essential role for the validation of accounting information, a validation which, to a greater or lesser degree, legitimises public confidence in such and such institution. Both bodies have the means of keeping track of and estimating the situation though quite differently, making it difficult to be able to consider them as two bodies acting together. Would it not therefore be better to consider the two bodies as distinct entities separated institutionally, as one (the banking supervisory body) is practically always run by a State department or structure very close to it within the Central Bank. We should not be looking at responsibility within the State framework as we should within an auditing one, for the legal processes - that is to say, the form of the accountability of responsibility - are quite distinct and separate, while the State, by taking suitable measures, often ensures that its own responsibility is difficult to criticise ...
- Can we not put forward the hypothesis that the auditor have - through their negligence, through their approval of the accounts - failed and are in reality accomplices in the actions of the directors, actions that are in the wrong as they have seriously misled and undermined the confidence of the depositors ?

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- ✓ The third line is more centred on time, concerning the mismanagement of a banking failure. The management of the banking failure in its immediate aspects : organising the indemnification process or more generally saving the depositors, and its long-term aspects : specifically the re-evaluation of assets which have been compromised by the failure. The split of these functions is not, of course, the same according to the respective roles of the Banking Supervisory body and the DIS: these should be treated with care :
 - In the case of a « pay box », the essential responsibility in the good or bad management of an individual banking crisis, concerns the supervisor who declares at one moment or another (too late or too early ?) the unavailability of funds triggering the indemnisation process. The management of this phase of the process can prove to be hazardous and prove to be costly, thus needing to be analysed with more precision. The fault, if there be one, of the supervisor comes about very often because of the administrative jurisdiction and thus from a certain jurisprudence which is either largely exoneratory or implies proof of gross fault.
 - In the case of a joint overview of a banking failure (supervisor, DIS), the examination of responsibilities and above all their separations, may be more difficult but may also be unnecessary if the co-ordination between these two bodies is as sound as it is confident. It is possible if not always ensured.

IV. Who should subpoena ?

In principle, those who can prove that they have incurred a loss. According to the concerned country, the law organises it so that the creditors (or their representative such as the receiver) to act responsibly, though the legal framework here needs to be more precise and the less ambiguity, the better.

The DIS should have the right to act directly, allowing it to subpoena those responsible for the banking failure. Effectively, the intervention given, normally via subrogation, should be the same as those of the depositors, being in fact the main creditor at the time of the liquidation, and should be able to give advice concerning a flawless management of the liquidation process. If subrogation seems to be the normal way for the rights of the DIS, we can also state that some DIS's have a preference right, more important to those of the depositors, concretising their major importance in the resorption of a banking failure ; it should be our hope that this become as generalised a rule as possible. The preference right should also be a watermark in the progressive emergence of the rights of depositors, going beyond the sole rights of an unsecured creditor.

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- **V. The Court**

- Overall, the sound running of a bank system rests on public confidence, that is to say an acceptance of depositing one's rights within the entities, the banks, which are consequently subjected to various activities allowing an effective financing of the economy. This confidence is an essential collective asset, given over to various entities charged with its upkeep, in particular the banking supervisor and the DIS as a last resort. The country's legal system is also an essential participant in the preservation of this collective asset as it has the means and the place where the various actors and responsibilities can be decided upon and sanctioned.

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- **VI. Conclusion**

- The absence of sanctionable power structured around law and competent courts is, as experience has taught us, a source of the absence of responsibility which lead to some very penalising confusions and in each case, to the exercise of the profession of bankers which little respects prudential criteria or sound management, thus ruining public confidence.
- Thus, to be able to assume its role to serve the society, the DIS must have powers allowing it - following an intervention in favour of the depositors - to act with responsibility against the directors, taken as a whole, against the auditors considered to have been an accomplice in the guiltily-taken decisions by the directors, but also able to act against the banking supervisor body who - while working for the State - should not be sheltered from sanction. It will have as role to prove mismanagement of the directors while at work, possibly the negligence of various controllers and the link between these faults and the losses of the DIS. A good legal basis of such a role for the DIS, being the substitute for the ensemble of the depositors, is surely a sound step towards a sounder management in the banking sector and towards a greater respect of the duties that the directors of the banks should hold, namely to participate more actively in the maintenance of public confidence in the solidity of its country's financial and banking sector.

BANK FAILURE : WHO IS RESPONSIBLE ?

I - INTRODUCTION

- ✓ Impunity equals no confidence
- ✓ Privatisation equals externalization of risks
- ✓ DIF founded to bear the losses
- ✓ DIF must be able to claim compensation

II - ACTORS DIRECTLY CONCERNED BY FAILURE AND CAUSES :

- ✓ 3 Main Actors
 - Directors
 - (Including Executive managers)
 - Auditors
 - Supervisory bodies

- ✓ 3 Main causes
 - Economic crises
 - Mismanagement
 - Weak supervision

III - RESPONSIBILITY – 3 LINES

- ✓ The Director / A common Responsibility
- ✓ The Auditor and Supervisory Body / A useful split
- ✓ The management bank failure / Don't forget the aspects and the possible responsibility of the DIF

IV - WHO SHOULD SUBPOENA

- ✓ The Subrogation of depositors
- ✓ The DIF and the Preference Right

V. THE COURT

- ✓ Needs of no ambiguous Laws and competent Court

VI. CONCLUSION