

Notes for Remarks by

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To the Downtown Economists Club
New York, N.Y.

September 7, 2000

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Introduction

If you ask people to think about deposit insurance, they will most likely recognize its importance – trouble is, they don't think about it much (It's a problem deposit insurers share with the local PUC.)

Nevertheless, deposit insurance does deserve discussion in public policy debates, especially among those with interest or expertise in financial matters.

One argument for this is the amount of money involved: C\$327 billion insured deposits by CDIC in Canada, US\$2.8 trillion insured by FDIC (bank insurance plus savings association insurance) in U.S (*data from FDIC 1998 annual report*).

But there is a second, even more important argument.

Importance of financial stability

That argument, and my premise here today, is that deposit insurance is a key tool – an almost essential tool – for stabilizing the financial system. It's an important complement to effective financial sector regulation, or a central bank.

Context for my premise is something that we are all familiar with: the large number of countries that have experienced financial crises. These crises have affected developed countries (U.S., Japan, Sweden) as well as developing ones (Mexico, Indonesia, Brazil). While the costs of these crises vary, they can top 20 per cent of GDP in some cases – as in Japan or Mexico – once economic losses are factored in.

It is also interesting to look at some recent headlines in the London Financial Times as financial sector regulation is gaining prominence and international attention. To illustrate: It was reported on Aug 1 that “New watchdog faces uphill battle to restore financial policy credibility” in Japan, and on July 5, “Romanians run scared of their failing banks”, and on July 28 “Brussels to act over German bank guarantee system”.

The international financial crisis demonstrated the importance of transparency and accountability. The lack of transparency and accountability exacerbated financial weakness at both the institutional and national level and complicated efforts to resolve the ensuing crisis. Transparency and accountability would have helped to build up of financial and economic imbalances. In short, they would of helped to improve economic performance.

In many cases, where no deposit insurer is in place, the countries involved have had to provide blanket guarantees to depositors to prevent financial and payments systems from collapsing.

Such responses are expensive, and bring with them a number of problems, such as moral hazard. Consequently, governments are exploring ways to limit the costs and negative consequences of blanket guarantee. One popular approach is by setting up a deposit insurance system.

There are now about 70 countries with deposit insurance systems in place – and a large majority of them were set up in the last decade or so, usually in response to an economic disaster triggered by a banking crisis.

How a deposit insurance system can foster stability

Where the conditions exist for a deposit insurance system to be credible and sustainable, it demonstrably promotes public confidence and contributes to financial stability.

A paybox system – usually the first step a country takes – has the greatest effect in one area: the restoration and maintenance of depositor confidence. Consequently, the prospect of bank runs is greatly reduced, along with the chance of the associated breakdown in banking system.

Paybox systems also performs three additional tasks:

- Contributing to the smooth functioning of the payments system;
- Reducing the potential for moral hazard by placing limits on insurance or introducing co-insurance; and
- Facilitating the exit of problem banks.

In some countries, the provider has a mandate that goes beyond that of a paybox. If the proper resources and public mandate to minimize risks, it can play a strongly proactive role in contributing to financial stability.

CDIC, for its part, has one of the most proactive mandates of any deposit insurer. Its success owes much to the clear division of roles and responsibilities between Bank of Canada (payments system), OSFI (supervision and regulation) and CDIC.

As supervision moves towards a more flexible model that relies increasingly on disclosure – in response to increasing complexity and change in financial marketplace – a deposit insurer can play two important roles. One is as a proxy for the interests of retail depositors. Deposit insurers are unique in this regard, since supervisors typically have their focus at the institution level or system-wide level.

The second role is as force to further reduce potential for moral hazard, through differential premiums, a mandate for timely interventions in troubled institutions, etc.

Finally, deposit insurers can be mandated to minimize the cost of providing insurance. This not only reduces the potential liability of the state in the event that financial institutions fail, but adds to the system's credibility.

Financial markets (and governments) are complex systems. Therefore, establishing a deposit insurance system is not a cookie-cutter exercise, nor should it be expected that existing deposit insurance providers will evolve towards a common point – i.e., towards one “ideal” model.

How to make sure a deposit insurance system *does* foster stability

Last November, the Financial Stability Forum set up a study group to look at deposit insurance systems around the world, and make recommendations on feasibility of setting out international guidance and guidance on establishing and maintaining deposit insurance systems.

Based on the work of the study group, a background paper was issued in June.

Paper outlined key steps that must be taken to ensure an effective deposit insurance system:

- Explicitly define benefits of the scheme, including coverage and limits;
- Enforce mandatory bank participation;
- Set clear mandates and defined roles/responsibilities for deposit insurer, supervisory agencies, and central bank;
- Create well defined funding mechanisms; and
- Inform the public of key elements of system to instill confidence.

There are also a number of operational considerations that must be addressed to ensure that the system delivers on its promise of fostering financial stability. These include:

- Sound corporate governance framework, including internal controls;
- Availability of skilled human resources and up-to-date technology; and
- Adequate funding.

A number of local conditions were also identified as important for the successful creation of a limited-coverage deposit insurance system:

- A sound legal regime;
- A stable macroeconomic environment, and policies consistent with safe and sound banking system;
- Appropriate regulation and effective supervision of the financial system;
- Compliance with accounting, auditing and regulatory standards; and
- An effective disclosure regime.

As countries make the transition from blanket guarantees (often in the wake of a financial crisis) to a deposit insurance systems, not all of the above attributes might be in fully place. However, if a country waits for all the deficiencies to be fully addressed, blanket guarantees might become entrenched. Reliance on such guarantees can ultimately prove costly, especially if banks and others view it as a licence for excessive risk-taking (moral hazard). Blanket guarantees can also obscure problems in economic policy and in the legal, regulatory and supervisory regimes.

Given the local context, a number of public policy issues must be considered:

- coverage and limits;
- private- vs. public-backed system;
- funding mechanisms; and
- depositor preference.

As well, public policymakers must consider the scope of responsibilities of a deposit insurer: should it be a paybox system only, or should it have a risk-minimizing role?

The Working Group on Deposit Insurance

We have a three-prong approach to our consultative process. A web site, outreach sessions and seminars.

We have already held a number of outreach sessions with a large number of countries and through international organisations (The World Bank, IADB, EBRD). We have developed close working relationships with the FSF and we have agreed that we will co-ordinate our efforts in the area of deposit insurance education and guidance.

As an example, during a week in May, the Working Group held its first meeting in Basel and it was followed by an Outreach Session with 12 country representatives that are in the process of establishing or reforming their deposit insurance system. This was followed by a deposit insurance seminar with 130 representatives from 67 countries. The feedback was extremely positive and this has encouraged us to do further consultation, outreach sessions and seminars. There is great interest in the work that is being done.

We are planning a very similar format for sessions in the following months.

Other FSF Activities

Work on deposit insurance is just one of the areas being looked at by the FSF. At the meeting in Singapore last April attention focused on Offshore banking centers, Highly Leveraged Institutions, Standards, Capital Flows, Disclosure and vulnerabilities in the financial system. At the meetings this week, the FSF will receive the interim report of the Working Group on Deposit insurance, examine the implications of e-commerce transactions on supervision, regulation and market functioning and follow-up on work on international standards.

All this work is aimed at improving international dialogue and contributions from those who are not members of the various groups is encouraged.

Conclusion

The working group has taken steps to be inclusive – not “top-down” approach with input from G-10 players only. The sub-group looking at transitional considerations is co-ordinated by Mexico, for example.

The working group invites input from all sides: countries with experience in introducing deposit insurance systems, participants in financial industry, public policy advocates, academics.

(12/10/02)

****Outline for Review****

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