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“Governance as a cornerstone for IADI members”

Special Address

By

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International Association of Deposit Insurers (IADI) and
Chief Executive Officer of the
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Good afternoon, Mr. Dong-II Kim, Executive Director of the Korea Deposit Insurance Corporation, distinguished guests, ladies and gentlemen.

I am deeply honoured to be invited by the Korea Deposit Insurance Corporation to be part of the International Open House and to celebrate KDIC's 10th anniversary. I thank you for giving me this opportunity to share your joy and success. As founding Chair of IADI and founding Chief Executive Officer of the Malaysia Deposit Insurance Corporation (MDIC), I have had the privilege of participating in the incorporation of several deposit insurers. This is the first time, however, that I am attending a 10th year anniversary celebration. This is a truly meaningful event for KDIC. It is a celebration of achievements and the satisfaction of having overcome difficult challenges. As Chair of IADI and on behalf of all IADI, allow me to congratulate the KDIC for its strong and decisive management throughout this period, in particular, during and after the Asian financial crisis. Its leadership during the financial crisis reflects the solid calibre of KDIC's management and its people.

2. Indeed, the success of KDIC is reflective of the overall achievement and resilience of South Korea. The “before and after” key statistics are clear. Market capitalisation of the Korea Composite Stock Price Index has now climbed to USD682.8 billion in May 2006 from USD75.2 billion¹ as at end 1997. The non-

¹ Source: Bloomberg. In Korean won, the KOSPI's market capitalization as at end 1997, 2000 and May 2006 were KRW70,787 billion, KRW186,206 billion and KRW642,424 billion respectively.

performing loans ratio had also improved from 8.9% as at end 2000 to 1.3% by April 2006². At the business level, a number of firms, notably Samsung Electronics and Hyundai Motor are among some of those which have emerged fitter and better able to compete globally. Samsung Electronics which is a leader among Asian manufacturers of memory chips is second only to Toyota in stock market capitalisation.³ Samsung Electronics' market capitalisation has improved to USD85 billion as at end 2005 from USD2 billion as at end 1997.

3. South Korea has also demonstrated nimbleness in pursuing new markets in new sectors. One of this is its emergence as a significant leader in the Asian film industry. I understand that the television miniseries *Daejanggeum* or "Jewel in the Palace" was very well received in Malaysia, Singapore, Taiwan and even Japan. This interest in South Korean films has been further tapped resulting in a minor surge in tourism with inbound tours to popular filming locations where the entire props and costumes have been retained in their entirety as popular tourist locations.

KDIC and IADI

4. KDIC is not only an important player in the domestic financial system. KDIC is a founding member of IADI and continues to be a key player. KDIC has provided immense support to IADI since its inception. An example is the recent sponsorship of a research staff to IADI's office in Basel to assist in Secretariat matters and support the activities of IADI in a number of areas for a one year period. KDIC also leads the Research and Guidance Committee's research on Funding. Since its involvement, KDIC has made significant contributions to IADI's corporate programs and activities. As Chair of the IADI, I am pleased and honoured to have KDIC involved at the Executive Council and Standing Committees.

Ladies and Gentlemen,

5. A 10 year milestone is normally an occasion for reflection so that we may learn from our experiences and face our future with greater wisdom and confidence. But I would rather be looking forward as it is far more exciting. Therefore, I will be sharing my perspective on the strategic vision of IADI over the next three years and the focus of our initiatives in fulfilling our mission of building effective deposit insurers. In the second part of this address, I shall share some observations on the optimal approach to resolution. It is a topic that we will be discussing in the next two days.

² Source: Bloomberg

³ The Economist, April 22nd 2006, page 27.

IADI's strategic focus

6. As the international face and voice of deposit insurers, IADI's vision is to share deposit insurance expertise with the world. We do this through the enhancement of deposit insurance effectiveness by promoting guidance and international cooperation. In carrying out its mandate, IADI promotes dialogue, provides training opportunities and develops guidance to improve the effectiveness of deposit protection arrangements aimed at contributing to the stability of domestic financial systems and ultimately, to global financial stability.

7. IADI is a relatively new organisation, having been established in 2002. As it celebrates its fourth anniversary, it is timely to review its strategic direction. During the initial years of its formation, our focus had been on building IADI's institutional foundations and its governance structures. During this period we have also undertaken extensive research on important areas affecting deposit insurers. Collectively, IADI is a repository of expertise and information where members may source for views and experience on operational or policy issues. As individual members, we are also available to provide assistance and advice to any member or associate on an ad hoc basis. In this area, IADI members have been actively consulting. One has to only review our newsletter to see the collaborative and cooperative approach that is being achieved under IADI's umbrella!

8. IADI's focus on building a cadre of efficient and effective deposit insurers is part of a high level vision of protecting the public interest. In the longer term, we hope to increase our efforts on enhancing our guidance-setting processes, set minimal benchmarks and, ultimately, the development of global standards and best practices for our members. Given the youthfulness of IADI, much of our efforts, thus far, have centred on providing training programmes, and developing guidance and research materials for our members and other deposit insurers around the world. While these have been successful in meeting specific gaps in deposit insurance issues, there is a need to further enhance institutional arrangements among our members aimed at building organisational effectiveness. Hence, in the near to medium term, the key areas of our focus will be in two areas - building good governance and enhancing the risk management capacity of our members.

Building good governance

9. During the last decade, it has been increasingly recognised, in both the private and public sectors, that good corporate governance is a major factor in corporate success. Events in the last three years, such as the debacle of Enron and Parmalat, have reinforced this perspective.

10. On the flip side of the coin, there are still some who remain unconvinced that good governance is an asset to be actively acquired. The issue of whether governance can be a positive contributor to corporate performance is not new. This dilemma was pointed out in early 1998 by a former Managing Director of the IMF. He observed and I quote that *“Indeed, as recently as a few years ago, there was little support among our members for the IMF, or for any other international financial institution, to become more actively involved in governance issues. Today, however, not only have governance issues moved to the forefront of discussion, but in many cases government reform has moved to the top of the policy agenda.”*⁴ What brought about this change? One important factor highlighted by the IMF was the increasing amount of evidence that had surfaced which supported the perception that good governance builds public confidence in governments. This in turn had generated an enabling climate for “high quality” and sustainable economic growth.

Can governance improve performance?

11. While there is consensus as to the importance of governance as a general management framework, there is less agreement that governance can contribute to improved performance. Let me present some evidence in support of a strong correlation between good governance and corporate performance. The World Economic Forum’s Global Competitiveness Report 2001 – 2002⁵ showed that efficient control mechanisms at the firm level and national competitiveness - defined as a country’s ability to achieve sustained economic growth over the medium-and long-term, are relatively closely correlated as evidenced by a correlation coefficient of 0.65. According to the Forum’s Competitiveness Survey of that period, to which more than 4,600 senior executives from 75 countries responded, the ten most competitive nations include six top-ranked countries in terms of the efficiency of corporate boards. Conversely, countries at the bottom of the Forum’s competitiveness ranking appear to be suffering especially from poor corporate control mechanism.

⁴ “The IMF and Good Governance” Address by Michel Camdessus, Managing Director of the International Monetary Fund at Transparency International (France), Paris, France, January 21, 1998

⁵ 2002 Report on the Corporate Performance Project.

Please refer to Appendix B on “Governance, Performance and Competitiveness” and Appendix C on “2001 Survey on the Performance Dimension of Corporate Governance”. The Corporate Performance Project was launched by The World Economic Forum and Deloitte Touche Tohmatsu in early 2000 as a joint effort that would be a continuing focus of the World Economic Forum agenda. Published in partnership by World Economic Forum and Harvard University.

12. For deposit insurers, governance is important from two perspectives. First, it is to build good governance within the internal fabric of the deposit insurer so as to build its credibility and, second, to provide the high moral grounds for deposit insurers to build good governance amongst the banks that they insure. Viewed from a broad perspective, good governance in deposit insurers contributes to the establishment of an enabling climate for national economic performance. A number of my colleagues at IADI share my view that good governance in regulatory organisations can contribute effectively to economic performance with strong implications for the soundness of financial safety net systems. There is a causal link between governance and economic performance. Good governance builds institutional credibility. Credibility builds depositor confidence. Confidence builds stability in the financial system which in turn promotes economic growth. In this regard, the demand for good governance is more intensified in view of the financial stewardship role of deposit insurers over large sums of premiums collected.

13. Being publicly accountable bodies, deposit insurers face these same challenges and more. We not only need to be good, we also need to be seen and to demonstrate that we are good corporate citizens. This philosophy recognises the bigger stewardship role deposit insurers have as one of the anchors of the financial safety net. In Deloitte Touche Tohmatsu's 2001 survey of CEOs on the Performance Dimension of Corporate Governance⁶, CEOs of portfolio investors indicated a scale of 5.97 on a scale from 1 (lowest importance) to 7 (maximum importance) as regards the importance of corporate governance as contributing to attracting investment funds.

Initiatives for good governance

14. In articulating my perspective on good governance, I suggested a roadmap of 10 initiatives⁷ to enhance internal governance practices. I had first proposed these initiatives in my paper presented at the IADI-Asia Regional Committee Meeting and International Seminar held in February this year in Manila. I suggested a pragmatic approach to governance premised upon five key components of sound corporate governance - independence, accountability, transparency, integrity⁸ and stewardship. I hope that such an approach would provide IADI members and other deposit insurers around the world with guidance for immediate implementation.

⁶ 2002 Report on the Corporate Performance Project.

Please refer to Appendix C: 2001 survey of CEOs on the Performance Dimension of Corporate Governance. The Corporate Performance Project was launched by The World Economic Forum and Deloitte Touche Tohmatsu in early 2000 as a joint effort that would be a continuing focus of the World Economic Forum agenda.

⁷ "Corporate Governance Initiatives for Deposit Insurers" Speech, Jean Pierre Sabourin at IADI-Asia Regional Committee Meeting and International Seminar, Manila, February 16-17, 2006.

⁸ The first four key components were identified by Stefan Ingves of the International Monetary Fund in his paper presented during the APEC Policy Dialogue held in Kuala Lumpur in 2003.

15. Moving forward, I will be proposing to my IADI colleagues to consider the merits of establishing a core set of governance practices to guide deposit insurers in managing their corporations. This is consistent with IADI's values that as far as possible, we should adopt the same governance standards that we would wish to impose on the banks that we insure. Towards this end, IADI will consider the merits of a principles-based approach to governance.

Enhancing risk management capacity

16. There are clear indications that regional markets in Asia will transition to higher interest rates. High oil prices and inflation are some of the more immediate concerns affecting our economies. These will have immediate and long term impact for the world with implications for our financial markets. Geopolitical tensions, threats of global epidemics and dampened global economic growth continue to exert pressure on the global financial system. In addition, the conjunction of powerful forces such as globalization, technological innovation, market deregulation and product innovation in the financial services industry has resulted in newer forms of risks. Looking ahead, there is much for IADI members to do to remain vigilant in meeting the challenges ahead.

17. A key challenge is the management of significant risks in an increasingly volatile climate. Risk management is also a key element of sound corporate governance. An effective governance framework assists an organisation in identifying and managing risks in a systematic and effective manner. As the Turnbull Report in the United Kingdom has convincingly argued, risk management and internal controls have to be an integral part of management. As such, they have to be moved firmly onto the boardroom agenda of our members. It is interesting to note that in Deloitte Touche's 2001 survey of CEOs⁹, CEOs of portfolio investors share this view. Among the factors that were relevant to sustainable performance of individual entities, "management of significant business risks" was given a scale of 5.94 in order of importance.

Ladies and Gentlemen,

Risks and Enterprise Risk Management

18. I will be recommending to my IADI colleagues to put in place training programmes that will enable our members to proactively manage risks in an integrated and comprehensive manner, under a process commonly known as Enterprise Risk Management or ERM in short.

⁹ 2002 Report on the Corporate Performance Project, Appendix B: "2001 survey of CEOs on the Performance Dimension of Corporate Governance"

19. ERM represents a comprehensive approach to the way an organisation approaches risk. ERM's underlying premise is that every organisation faces risks in its business environment and the challenge is to determine the degree of risk to accept. For deposit insurers, they will benefit from the ERM program by being able to identify, quantify and prioritise significant insurance and other business risks, through a process which uses strategy setting to identify potential events that will affect the organisation and also incorporates risk strategies consistent with the mandate of the deposit insurer.

20. In designing any ERM, IADI will be mindful that it has to be flexible, responds to change and can be tailored to the deposit insurer's corporate strategies, investment activities and operating environment within the domestic and global context. As a start, I plan to organise a session in conjunction with the meeting of the Executive Council of IADI to be held in Kuala Lumpur in September and you will be hearing more about our ERM initiatives.

Ladies and Gentlemen,

Bank Resolution

21. Allow me to spend a bit of time on the topic of bank resolution. IADI advocates Prevention over Resolution. But the reality is that banks can and will fail. Hence, an efficient ERM program requires deposit insurers to adopt a proactive role in risk management. A robust ERM program will include mechanisms for prompt detection and resolution of problem institutions in the early stage. Early and timely intervention helps to reduce social costs of failures, contributing to stability and lessening the potential of future crisis. Thorsten Beck and Luc Laeven¹⁰ have found that banks are more stable in countries where deposit insurers can intervene in banks and or revoke membership in deposit insurance. As a significant partner in an increasingly complex financial system, the effectiveness of deposit insurers will be judged by our ability to reduce uncertainty, promote economic efficiency, and provide fair and equitable treatment to depositors.

22. I spoke on this issue in Taiwan last year and proposed the OPTIMAL approach¹¹ to bank resolution. OPTIMAL is the acronym which highlights the key areas to be addressed. These include, setting clear **O**bjectives and mandates, robust **P**rocesses, right **T**iming, early **I**ntervention, **M**arket Discipline, on-going **A**ssessment and a conducive **L**egal Framework in which one can operate.

¹⁰ Beck, Thorsten, Laeven, Luc (2006), Resolution of Failed Banks by Deposit Insurers: Cross-Country Evidence, World Bank Policy Research Working Paper 3920.

Beck is at the World Bank and Laeven is at the IMF Bank and CEPR.

¹¹ "An Optimal Approach to Bank Resolution" Speech, Jean Pierre Sabourin at IADI 4th Annual Conference in Taipei, Taiwan, September 28-29, 2005.

23. Within IADI, our collective experience both from outside and within Asia is extensive and varied. Drawing from my experience at Canada Deposit Insurance Corporation which has dealt with a total of 43 bank failures, allow me to share the following observations:

- **Where prevention fails, then the next best solution is prompt resolution.** The quicker the recognition and resolution of banking distress, the more efficient and less costly will be the resolution. The faster the problems come to light and the quicker these are tackled, the more options there are available to the authorities and the lower the cost of resolution. The faster the authorities move, the lower will be the resolution costs and the faster the reestablishment of banking sector stability.
- **Legal and insolvency regimes that permit early bank resolution framework is one of the most crucial element within the OPTIMAL approach to a successful failure resolution.** Deposit insurance systems that are supported by an effective and equitable bank insolvency regime can reduce moral hazard and improve economic efficiency. An effective insolvency system is one that comprises three major elements – capacity to enforce contracts and collateral foreclosure, provide for clear criteria for initiating insolvency proceedings of banks and has a transparent process for making refunds to depositors quickly. A deposit insurer who is unable to or cannot fulfill the promise of payment within a reasonable timeframe will further destabilise the financial system as depositor confidence ebbs.

Among IADI members, many have made great strides in implementing these elements in their national insolvency systems. However with increased globalisation of banks, national and international insolvency rules must converge to address cross-border insolvencies. This would be another area that IADI will do further research in the future.

- **Equity and fair treatment principles should be applied and applied consistently.** In this regard, restructuring policies should be applied equitably across all banks according to a transparent process. The first loss principle should apply to existing shareholders and debt holders, while depositors' funds should receive priority of payment. Repayment to depositors should follow clear and transparent deposit insurance coverage rules that are simple and clearly communicated to avoid destabilizing depositors and the banking public, at large.
- **There is no winner in a bank resolution.** This is the sad truth. The best that can be done in such a situation is to complete the resolution as quickly as possible. The goal is to minimize cost to the deposit insurer and the

overall financial system and to contain the resulting economic and social costs.

Ladies and Gentlemen,

Concluding Remarks

24. In conclusion, allow me to draw an analogy between KDIC and gold. It is said that the quality of gold is only known after it has been tested by fire. Similarly, the real test of an organisation is not how it performs during good times but how it conducts itself during times of turbulence. KDIC, which was established just ahead of the eruption of the Asian financial crisis, has successfully weathered one of the most challenging decades in recent times. Indeed, it has come out stronger from that experience. This is only possible when an organisation has in place, sound infrastructure which includes robust governance processes and good work values. KDIC and the people of South Korea have all these and more.

In respect of IADI's vision to build effective and efficient deposit insurers, my view is that in building strong governance we are also building the strength and the backbone of our members. That, Ladies and Gentlemen, shall be the cornerstone upon which we will build the house of IADI.

25. On this note, I wish you fruitful discussions.