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**Session II: “Maintaining Financial Stability through Financial
Safety Nets”**

“Guiding Principles for Crisis Management”

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Introduction

Since the Asian Financial Crisis in 1997/98, the international financial system has become more stable. Policymakers have gained a better understanding of why crises occur and how to reduce their frequency. Since then, policymakers have instilled greater resilience in the financial system with more concerted policy efforts. And banks have responded actively to increasing regulatory efforts to strengthen the soundness of banking institutions.

On the monetary front, more flexible exchange rate regimes with build-in mechanism to adjust automatically to external imbalances, and the sharp accumulation of precautionary foreign exchange reserves relative to short-term borrowings, have fortified central banks in East Asia against volatile capital swings.

The good news is that the occurrence of financial crises, going forward, may be less frequent. The bad news, however, is that future crises, if they do erupt, may be longer in duration, more widespread and disruptive in nature, due to contagion. With the increasing speed of communication and the proliferation of a wide variety of new financial instruments and services making national borders now more porous, market anxieties and herd behaviour could be transmitted much more easily and speedily. Good economies can therefore still be affected by externally transmitted shocks. In like manner, banks, no matter how efficiently supervised or regulated, could still fail. It would therefore be impossible to aim for zero tolerance. As individual banks could do very little to address external shocks, the focus of public policy have continued to emphasize prevention rather than cure.

Goals of a sound crisis management framework

Before we proceed to a discussion on guiding principles for crisis management, let me share with you some of my thoughts on what are some of the goals that safety net players should have in a crisis management framework.

As a deposit insurer with over 30 years' experience that includes hands-on experience in resolving 43 bank failures and numerous near failures, I guess that makes me a grandmaster of deposit insurance. From that vantage position, I note that the principal safety net guardians of an economy, that is, bank regulators, supervisors, deposit insurers and treasury officials, share the same goals for their economy. And the overriding principal goal of all safety net players is to promote financial stability. They are also in agreement that financial stability can only be achieved through a sound resilient banking system. Banks form the core of the financial system in most countries. In addition, their structures dictate the severity of a crisis or the ability to respond to a crisis. Hence, their soundness is of vital concern to policymakers. In fact, a strong banking system is a nation's first line of defense against the onslaught of an

externally induced financial crisis. That is why, in recent years, financial supervisors have been working towards making banks `too-good-to-fail`. They would also agree that prevention is the best approach to crisis management. We differ, however, on the tools to be used for achieving these goals.

Key elements of a sound crisis management framework

For deposit insurers, preventive crisis management has been and will always be our primary focus. This is the position advocated by IADI, the International Association of Deposit Insurers. While the first line of defense is to build a sound banking system, deposit insurers is the last line of defense for public confidence. In many countries, the severity of a bank crisis is dependent on the level of depositor confidence in the safety of their deposits in the banking system. The ability and capacity of the deposit insurer to contain the crisis has implications on the size of payouts to depositors and whether public funds would be required to sustain public confidence.

From the perspective of deposit insurers and from the practitioners' perspective, my view is that an effective crisis management framework should promote or enhance 4 key areas of discipline over banks. Within these 4 areas of discipline, I would recommend 9 specific proposals. These are not best principles of crisis management but are personal observations and views. It is possible that in future, IADI may issue principles in this area.

The proposals are as follows:

Sound internal governance discipline

- (i) Sound governance at board and management level
- (ii) Contingency capital funds
- (iii) Consumer protection

Market discipline

- (iv) Enhanced disclosures

Supervisory discipline

- (v) Enhanced audit relationship
- (vi) Prompt corrective action

Deposit insurance discipline

- (vii) Financial discipline on banks
- (viii) Legislative discipline
- (ix) Enhanced public awareness

Sound internal governance discipline.

Let me start with the first proposal which is to promote sound governance within a bank.

Sound governance at board and management level

I have observed that one of the single most important factor in ensuring the soundness of a bank is the quality of its management, supported by effective corporate governance programs. This observation was particularly true in some of the more recent crises, such as the ones in East Asia and Latin America. It was clear that fundamental weaknesses in corporate governance and risk management amongst banks had played a big part in the severity of the crises. And sound internal governance is particularly important as it directs the quality of oversight by the board of directors and senior management. The foundation of sound governance within a bank is premised on a philosophy of integrity and strong governance culture of its board of directors, senior management and all other employees. And governance is best seen when it is practised. An important part of this practice is for organizations to conduct regular reviews of their governance performance and to assess on an ongoing basis its strategic

direction, which should include putting in place sustainable and achievable business plans, contingency planning and sound capital planning.

Also, too often, it is the supervisor who takes the full blame for the failure of a bank and the failed banks Board and Management are not taken to task. Directors and officers should be personally liable if they did not manage the bank's business and affairs soundly.

Contingency capital funds

Contingency planning to face unexpected liquidity shortage is necessary for banks. In an event of a temporary liquidity squeeze, banks should be able to call up funds within a short period of time to meet their obligations for a certain period of time while problems are being rectified. But in order to face more severe and permanent liquidity problems, it is sound governance on the part of a bank's board to have in place firm plans to raise contingency capital funds that can immediately be put into place when required. This could take the form of an undertaking from existing shareholders, potential shareholders or financiers, to raise or demonstrate financial capacity to raise capital funds within a short time period. A capacity to raise up to 25 % of the total issued capital base of the bank is proposed as it will support withdrawals of up to 3-4% of total deposit of the bank on average.

By forcing banks to put in place contingency capital funds, shareholders are forced to impose more explicit oversight over the board and senior management. In addition, as part of the governance process, a bank's board should be required to regularly review and inform shareholders as to the possibility of calling upon the capital fallback plan. Such review would require shareholders to seriously scrutinize the business direction, strategies and sustainability of business expansion plans.

Consumer protection

I am also of the view that governance includes treating consumers ethically and fairly. By this, I do not mean the superficial aspects of banks being pleasant and courteous to customers, although that would be helpful. A bank's board of directors should also be required to look into consumer protection as a means of aligning the safety and soundness of its consumer practices to the safety and soundness of the bank. It is expected that a bank that treats its customers as its most valuable asset would put in place sound risk management and lending practices. In this regard, banks should be educated that consumer protection is part of sound governance. Enhanced consumer protection through higher standards of consumer disclosure, the introduction of better security systems and approaches are important issues for those who manage banks. It is also good business. And some banks have begun to realise the benefits of raising shareholders' value.

Banks have a constructive role to play in consumer protection. Incentives should be given for banks to move towards a pro-consumer stance by adopting higher standards of consumer disclosure. I believe with growing consumer affluence, near instantaneous communications and heightened competition, banks have begun to appreciate the benefits of a pro-consumer stance. Based on higher ethical practices, such a stance can and does attract more customers and provide the banks with a competitive advantage. And that, in turn, boosts their earnings, strengthens their asset base and market share, and certainly, their reputation. Enlightened banks have therefore, voluntarily aligned the scales in favour of consumers. The result is a convergence of safety and soundness standards in the banks with consumer protection concerns. In this regard, I am optimistic that banks will continue to see the benefits in treating customers fairly and responsibly.

Market discipline

Let me now move on to market discipline, which should be exercised by shareholders and debt holders, as well as by certain classes of creditors and depositors. These groups must have the requisite knowledge at their disposal and through enhanced disclosures, to assess the risks banks face and have readily accessible and timely information which is generally understandable by the investing public.

Enhanced disclosures

The Asian crisis has highlighted the importance of regular, timely, comprehensive, and reliable financial and economic disclosures. Since then, government policy intentions are now more clearly communicated. Disclosure requirements on companies have also been more vigorously enforced. With more timely and adequate information, market participants are in a better position to assess and monitor risks. By rewarding good banks and punishing the weak ones, the market can deter the banking and corporate sectors from taking excessive risks. This would rightfully induce a more cautious management stance and reduce policy forbearance.

On disclosures by banks, I am of the view that banks should, wherever possible, be required to comply with disclosure requirements imposed on listed companies, and also disclosures with regard to regulatory breaches. Disclosures could either be transmitted through annual report or press release. This could help shareholders, investors and depositors to play a more active role in ensuring board and management discipline.

Disclosure requirements are often placed only on banking activities. Banks, however, are increasingly evolving towards the universal bank model where investment banks merged with commercial banks, resulting, in some cases, the investment banks driving the overall business. And some investment banks do

have significant private equity business, including proprietary trading, which could potentially drag the banks down, if their dealings in private equity turn bad. Therefore, the imposition of disclosure requirements on non-banking activities is just as necessary as it is on banking activities.

Naturally, there are concerns that full and prompt disclosures may cause depositors to over-react in situations where the problems are temporary and rectifiable, which otherwise could have been corrected by appropriate remedial action.

Nevertheless, the market can act as agents for enforcing good regulation as it is against market excess and damaging policies. Public listed companies would be more inclined to pursue responsible policies if they know that the market could punish them by unloading their shares, if they pursue damaging policies or undertake excessive risk taking.

However, there is a general distrust that the market can be a qualified disciplinarian all the time. The problem is the market, driven mainly by profits and greed, do commit big judgmental mistakes. Sometimes it is slow to punish. This allows companies to drift a long way down an unsustainable path before being subject to large and devastating corrections. And at times, the punishment handed out may be far more severe than the mistakes committed. Despite periods of overshooting and irrational exuberance, in the long run, rational expectations do eventually prevail in the market. On balance, with market discipline not always reliable, more weight has to be placed on supervisory oversight to enforce discipline over banks.

Supervisory and regulatory discipline

To function efficiently, safety net players need clear legislated mandates, the requirement to put in place early warning systems, deal with problem banks through prompt corrective actions, clear and well understood triggers to intervention not based on solvency, and rules that are transparent and disclosed. Here, I have identified the role of external auditors and prompt corrective actions as key proposals.

Enhanced audit relationships

A strong supervisory framework, which reduces excessive risk-taking, is a key aspect of crisis prevention. While banks, through internal auditors, are responsible for performing due diligence with robust self discipline on their transactions and business activities, the tasks of supervisors are to ensure that banks comply with existing laws and adhere to sound banking practices, and to implement appropriate corrective actions to deal with any financial weaknesses.

As you would be aware, a strong supervisory framework should have the following characteristics:

- 1) powers to issue prudential regulations,
- 2) powers of examination of banks, and
- 3) powers to deal promptly with breaches including taking prompt corrective actions.

I would like to highlight that while the powers of examination are highly important and crucial, bank supervisors lack the resources to audit and examine all banks on an annual basis. This power is crucial to identify the excesses of bank management and to provide a critical check and balance on the overtures and posturing of bank management with respect to their risk profile and their risk

management practices. How then can this aspect be improved given the resource constraints?

To improve the mechanism to detect incipient signs of financial distress within banks, I would suggest that bank supervisors rely on other components of the financial infrastructure. One way is to put in place a tri-partite mechanism involving the supervisors, internal and external auditors. Under this mechanism, incentives could be given to the internal and external auditors to jointly report to the supervisor on any material weakness in a bank without delay.

In addition, the role of an internal auditor could be made more independent by recasting the reporting structure to the board, through an audit committee which will have direct responsibility for the audit function instead of bank management.

With respect to external auditors, supervisors should, as a matter of practice, meet annually to discuss their audit findings. Where an external auditor has been replaced, the supervisors should be aware of the reasons for the change and where necessary, meet with the outgoing external auditors on their perspective. Supervisors should also be aware of the scope of the annual audit and the board of directors' level of satisfaction with such scope.

Prompt corrective action

The most critical tool for crisis management resides with the supervisors. While auditors may uncover sloppy lending practices, poor credit controls and weakening capital adequacy, bank managements are unlikely to take firm remedial actions unless the supervisors are ready and able to take action. Although bank supervisors have an arsenal of regulatory actions, there are many cases where they have provided funding to insolvent banks to recapitalize them or in the hope that a rescue could be mounted, or to mask the problem or to delay the imminent failure. This is another form of regulatory forbearance.

At this juncture, a key guiding principle is for bank supervisors to put in place a clear prompt corrective action timetable for various regulatory breaches. More

importantly, prompt corrective actions or PCAs should be implemented at an early stage before a bank's regulatory capital is eroded. Let me expand on this idea by discussing first the definition of non-viability for a bank.

The assessment of bank viability is normally centred on the definition of insolvency, that is, the inability of the bank to operate as a going concern. In the past, bank supervisors have used this definition to justify assumption of control and finally termination of bank licence. Often it is too late except to close the bank and make depositor payments. More recently, bank supervisors have taken more severe PCA action over banks which display signs of continuing inability to meet minimum regulatory capital requirements, deterioration in the quality or value of assets, liquidity problems, or severe declines in earnings. This is a positive move. I am also of the view that PCA should be implemented when a bank is unable to meet its regulatory capital of 8%. In many countries, the intervention and resolution mechanisms kick in only when a bank is nearly or already insolvent. This is a form of regulatory indulgence which undermines the supervisory and regulatory discipline. For supervisory discipline to be effective, a timely and effective strategy for handling problem or failed banks will help to substantially reduce costs and avoid adverse effects on other safety-net participants, the government, the public, the banking industry and the economy.

Crisis management from the perspective of deposit insurers

Let me move on to the role of deposit insurers in advocating the proposals on financial discipline that I have highlighted earlier.

Deposit insurers complement bank supervisors throughout the supervisory processes in mitigating risks by providing incentives for banks to manage their business prudently with sound corporate governance and risk management procedures. We do this through three approaches, namely:

- i) by exerting financial and market discipline,
- ii) through legislation, and
- iii) through public awareness and financial literacy.

Financial and market discipline

Deposit insurers exert financial discipline on banks by imposing higher premium payments from riskier banks. As part of the formula for incentivising banks, deposit insurers are increasingly imposing risk differential premium framework in assessing premiums due from banks. Part of the formula could include a penalty on weaknesses in corporate governance practices, the quality of management and market discipline mechanisms put in place by banks. In extreme cases, deposit insurers can also enforce licensing discipline through the termination and cancellation of membership. In the case of MDIC, it is also empowered to impose premium surcharge on banks that fail to comply with regulations issued by the central bank and by MDIC.

A well designed deposit insurance system also promotes market discipline on depositors. A properly crafted coverage limit has two functions. It promotes public confidence by protecting unsophisticated depositors. In addition, it instills market discipline among high net worth individuals who holds deposits over the coverage limit. Such depositors have an incentive to monitor banks by moving funds from poor to good quality banks.

Legislative discipline

Many deposit insurers often have mandates to promote sound risk management as part of their financial stability mandate. MDIC's statutory mandate also requires it to provide incentives for sound risk management. In this regard, MDIC is considering the use of subsidiary legislation to drive higher standards of governance in member banks as part of the plans to improve the philosophy and integrity of bank management. In addition, legislation would be considered to improve consumer protection by requiring banks to deal fairly and ethically with

consumers. This could be done by way of the issuance of guidance or directives to banks to improve the quality and timeliness of information, and regulation of disclosure requirements in respect of information provided by banks to the public as well as customers on deposit products.

Enhance awareness and financial literacy

For deposit insurers, public awareness of the soundness of the financial system is a critical element of financial stability as it is synonymous to depositor confidence. Depositors who are aware and confident of the safety of their deposits are the main stabilising blocks to a stable banking system. In MDIC's case, our aim, therefore, is to promote a clear understanding of what deposit insurance does, its benefits and limitations. Our efforts in building awareness include that of a toll-free line and a Call Centre to handle public enquiries in the various languages of choice. Currently, MDIC provides information in Bahasa Malaysia, English, Tamil and Mandarin. MDIC's website has comprehensive information on deposit insurance, also in the four languages. We have also formed partnerships with our member institutions for the dissemination of information and to train employees of member institutions. Information brochures are issued in 5 languages. Our focus has been on operation and front line employees, who are most likely to be involved in advising their customers about deposit insurance. Next year, we shall be rolling out a comprehensive public awareness campaign which will include various media channels and approaches. Our aim is to educate the public so that they can make informed financial decisions.

Critical success factors

In order for preventive crisis management to succeed, all the safety net players should have clear legislated mandates with respect to their roles and responsibilities. A clear set of responsibilities and accountabilities is particularly important to ensure timely action is taken by the relevant safety net players when

banks face emerging problems or during a failure of one or more banks. Such arrangements make the institutional and legal framework governing surveillance, early warning, prompt corrective actions and intervention and resolution more effective.

Equally important is a functioning information sharing arrangement between the safety net players, particularly between the deposit insurer and other safety net players. The need for information will vary depending on the mandate of the deposit insurer and its roles and responsibilities. For example, in the case of a pay-box system, the deposit insurer should have access to depositor information to calculate insurance premiums and to reimburse depositors in a timely and efficient manner when required to do so. In the case of least cost deposit insurers, it is important that they have access to relevant information on non-performing loans and other sensitive information, if the deposit insurer is to participate actively with other safety net players to prevent a crisis. Adequate and accurate relevant information is the basis for any action that will be taken to manage problems that could potentially escalate into a crisis management. Withholding such information amongst relevant safety net players will only curtail the effectiveness of any crisis management program.

Concluding remarks

It should be recognized that, no banks, no matter how well supervised and regulated, is too-good-to-fail as individual banks could do very little to address external shocks. For this reason, the focus of public policy has rightly continued to emphasize prevention rather than cure. Formulating a sound crisis management framework with key elements such as deposit insurance discipline, sound internal governance discipline, market discipline and supervisory discipline, although not the whole solution, would be critical in minimizing bank failures.

On the other hand, while regulators are seeking to create an environment conducive to robust market disciplines, they should also be mindful that policies should not be unnecessarily burdensome or be so restrictive and too rigid that they disrupt the efficiency of the banking system.

Lastly, I would like to congratulate Bank Indonesia and the other co-sponsors for organizing this workshop. Indeed, this workshop presents to us a brilliant opportunity to look into the rearview mirror and take stock of what we have learned and achieved thus far. It also provides a platform to generate good and practical ideas that would help us build on our strengths, enabling us to move forward, broaden our endeavors and improve our capacity to deal with future crises. And we at MDIC continue to look forward to work closely with the other IADI members to build a more solid crisis management framework that could reduce the number of bank failures over time.

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