

**1st IADI Inter Regional Conference (Europe, Eurasia, MENA)
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**The Role of the Deposit insurance Systems in Enhancing Financial Stability
in Different Countries**

Opening Remarks

By

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“Challenges for Deposit Insurance in Promoting Financial Stability”

Good Morning, distinguished guests, ladies and gentlemen. First, I would like to say how honoured I am to be invited to speak at this conference. I want to thank the organisers for putting in so much effort to make this first IADI Inter Regional Conference a resounding success. Congratulations to Mr. Ahmet Erturk, for hosting this Conference and Mr. Al Jafari, for taking on the role of Conference Coordinator. This Conference is an excellent initiative by IADI's Regional Committees of Europe, Eurasia and MENA. And this cross country cooperation between 14 countries, across 3 continents, strongly underpins the excellent working relationship between the Regional Committees of IADI as well as its members!!

To provide a setting along the theme of this conference, I would like to share my thoughts on some of the challenges for deposit insurers in promoting financial stability.

Ladies and gentlemen,

We all know that deposit insurance is one of the policy tools used by governments to build public confidence. By preventing bank runs and protecting the payments system, deposit insurance reinforces the foundation necessary for a robust banking system. And by reducing the vulnerability of the banking system to panics, a deposit insurance system promotes financial stability.

However today, despite much progress, it is unfortunate that the role of deposit insurance is still under appreciated, misunderstood and not fully recognised by small segment of our stakeholders. Those stakeholders often associate deposit insurance with moral hazard. Ultimately, they argued that deposit insurance should stay at the peripherals and tinker only at the margins.

A country without a deposit insurance system would normally have a system of implicit deposit insurance or blanket guarantees to prevent bank runs. Under blanket guarantees, the incentives for increased risk taking are greater, in fact far greater. Also, in a full blown crisis, blanket guarantees, sometimes, cannot prevent bank runs.

Under blanket guarantees, the wrong party is made to bear the full brunt of a financial payout. Taxpayers are innocent bystanders. It appears more justifiable that financial institutions and their clients, and not the taxpayers, should pay for the benefits they receive from financial stability. This should include paying premiums to fund the operations and losses borne by a deposit insurance system. A deposit insurance system, therefore, redistributes the burden of stabilising the financial sector from taxpayers to financial institutions. Justifying this shift is a view of fairness based on simple economic equality – those that get the direct benefit should pay the cost!

The reality is that, moral hazard is everywhere, affecting many facets of the economy, many government programs and initiatives. In the banking system, whether with deposit insurance or not, moral hazard is always present. The very act of policy forbearance and a central bank's lender of last resort function elicit moral hazard. Not to mention the public's expectation that the government will make them whole if a bank fails.

The good news is that, moral hazard can be mitigated if an effective deposit insurance system is in place. However, such a system needs to be well designed. In this context, it is critical that all deposit insurers be given appropriate powers, sufficient legal authority, independence and legal indemnity, and adequate resources to act and fulfill the great expectations placed upon them to promote and contribute to stability of the financial system. Second, a deposit insurance system should offer an explicit and limited deposit insurance coverage. Thirdly, ensuring prompt corrective actions and early intervention are taken, making banks responsible for a share of the costs and allowing bad banks to fail would reduce moral hazard. Fourthly, to be effective, a well designed deposit insurance system needs to be supported by good corporate governance, strong market discipline, a strong regulatory and supervisory environment, and sound legal regime, including good accounting and auditing standards. Early interventions and resolutions by deposit insurers are vital to contain the disruption that a bank failure might provide, possibility of contagion and the overall costs to the financial system. Leaving insolvent banks to continue operating would increase moral hazard incentives, introduce competitive distortions and would eventually inflict much greater harm on the economy.

Ladies and Gentlemen,

I will now highlight two key challenges facing a deposit insurer. The first challenge is independence. By this I mean the operational independence to carry out our mandate objectively and in the best interest of the financial system. There are three aspects to this issue. The first aspect is the ability to act independently from political influence and pressure or what I would call, political capture. Because of the strong links between business and politics, political interference in dealing with troubled banks has in the past posed problems in many countries.

The second aspect is independence from our member banks or regulatory and supervisory capture. In many countries, for reasons of economic development, and/or reducing the political disruption caused by a bank failure, regulators and supervisors have, in many instances, provided undue regulatory indulgence for national banks. In the hope of growing national champions, regulators have given special privileges or even exemption from compliance with regulatory and supervisory standards. In some

instances, banks are perceived to be not only too big to fail, they are considered too iconic to fail.

The third aspect is independence from other safety-net players or safety net capture. This challenge is unique to deposit insurers!! This is due largely to the historical and birth links since the central bank was often the creator of the deposit insurer!! There is a psychological barrier which makes it inconceivable in many minds that the offspring could ever become independent of its creator.

Many good reasons exist to justify why deposit insurers should be established as independent entities with true operational independence. The stability of the financial system is one good reason. Let us not forget that deposit insurance is a tool to build confidence in the system. It is a means to achieve a common objective!! Therefore, the deposit insurer must be credible in the eyes of public. Independence builds credibility. An independent deposit insurer is definitely more credible than one that is perceived to be captured by supervisors or supervisees, one that cannot act to minimise losses or act before it is far too late. And credibility speaks to the integrity and stability of the whole financial system.

Based on my experience, I find that an optimal independent deposit insurer can create healthy competition amongst safety net players for the betterment of the financial system as a whole!! This creates a natural system of checks and balance, especially if the deposit insurer is empowered to operate under a least cost or risk minimisation mandate. Such deposit insurers are able to improve their effectiveness and efficiency at great savings to the financial system. Ultimately, independence is about sustaining integrity and public trust!! Unless deposit insurers can demonstrate that their decisions are based on sound judgement, stand up to public scrutiny and are not dictated by any hidden political, regulatory or agency agenda, their role in financial system stability would not be maximised, and their mandate to promote and contribute to the stability of the financial system would not be realised!!

Ladies and Gentlemen,

The second challenge that a deposit insurer faces is the misalignment and/or inadequacy of powers. In some countries, despite the eagerness in establishing a

deposit insurance system, policymakers and regulators are reluctant to give adequate powers for the deposit insurer to function effectively and efficiently!! The fallacy of having a paybox deposit insurer not being responsible for the optimisation recoveries of their claims and leaving it to disinterested third parties, substantially increases the costs to the deposit insurer and the financial system. In the case of CDIC Canada, when it implemented the least cost resolution mandate, it was able to recover 85 cents for every dollar of claims paid compared with 54 cents previously. This translates into billion of dollars in savings to the financial system, not to mention banking system stability by being able to deal with bank failures pro-actively.

Perhaps, the failure of our key stakeholders to fully appreciate our contributions to financial stability may partly reflect the failure of our education programs in reaching out to them to explain the benefits that an effective deposit insurer can provide to a financial system. All our hard work would not mean much if the public and our stakeholders do not fully understand our integral role within the financial architecture in the promotion of financial stability. We should now work equally hard to make certain that every single stakeholder fully understands the functions, features, benefits and limitations of a deposit insurance system to the point that the skeptics do not have any more excuse for caution!! Indeed, well developed deposit insurance systems are a pre-requisite to ensuring a sound and robust financial system in any country.

Conclusion

Ladies and gentlemen,

From my short opening remarks, one can see that we still have a lot of hard work to meet the challenges that are before us. Let us all work closely and pull our collective resources together, in order that we can be more effective in meeting these challenges and in convincing our various stakeholders of our integral role in the safety net in safeguarding the stability of the financial system. An effective deposit insurance system is not an option but a necessity.

Lastly, allow me to express my sincere appreciation to our host for their excellent hospitality and for holding our meetings in Istanbul, a city so rich with history and culture.

Thank you very much for your attention and I look forward to your active participation and deliberations in this conference.

Malaysia Deposit Insurance Corporation
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