

**The 1st IADI Inter-Regional Conference
Europe, Eurasia, Middle East and North Africa**

**"The Role of the Deposit Insurance Systems in Enhancing Financial Stability in
Different Countries"
Istanbul, 27th June 2007**

**Session V: Cooperation Among Safety Net Members in Bank Resolution:
Practical Considerations**

Presentation

By

**Mr. Jean Pierre Sabourin
Chair of the Executive Council and President of
the International Association of Deposit Insurers (IADI) and
Chief Executive Officer of the Malaysia Deposit Insurance Corporation**

Good morning, Mr Ahmet Erturk, Chair of the Savings Deposit Insurance Funds of Turkey, Mr Durmush Yilmaz, Governor of the Central Bank of the Republic of Turkey, Mr Tevfik Bilgin, Chair of the Banking Regulation and Supervision Agency, and Mr Turan Erol, Chair of the Capital Markets Board of Turkey which celebrated its silver jubilee this year.

Distinguished guests, Ladies and Gentlemen,

Rationale for organisational effectiveness

Over the last 12 months I have been thinking a lot about organisational effectiveness and its implication on the effectiveness of the financial safety net. As you would be aware, I now lead a young and dynamic deposit insurer that is barely 22 months old. Maybe because it is young, it therefore has the audacity to set for itself a lofty goal to be the most effective deposit insurer in Asia by 2008 and one of the best in the world by 2010. Sheer bravado one might say and certainly, the people at the Malaysia Deposit Insurance Corporation, MDIC in short, have been recruited for their attitude, passion to excel and the determination to achieve our lofty vision. And importantly, it has the unwavering support of the Central Bank of Malaysia, which is the supervisor of our banking system.

The underlying philosophy for this goal is simple, that is, a deposit insurer cannot be an effective policy tool for building and sustaining public confidence if it is not effective. And effectiveness has to be seen to be believed. During the last 22 months, we at MDIC, have put in place a series of strategic objectives and initiatives that will form the organization's structural framework. We have developed and are implementing a business plan that drives performance! Our foundation is set upon sound governance policies for the Board and Management, a risk and insurance assessment framework as well as best practice accounting standards and policies and sound regulations based on a comprehensive public consultation approach. And as many of you know, we are already about to implement a differential premium system, and are currently developing IT systems to support our core business.

From experience, I find that organisational effectiveness by itself is not enough although it is an important attribute or value that characterizes successful organizations. Possession of this value does not automatically transform the deposit insurer into an effective financial safety net player. In order for a deposit insurer to be truly effective, it must ensure that it is able to operationalise the requirements of its mandate and play its safety net role effectively. This can only be achieved when the combined effect of the role of the deposit insurer and the other safety net players is bigger than the sum of their individual contributions. Unlike other organisations, the role, contribution and effectiveness of the deposit insurer must be assessed together with those of the other safety net players since their roles are indeed linked and intertwined!

It is from this perspective that I will offer some suggestions on the practical considerations for cooperation among safety net players in bank failure resolution. Cooperation among safety net players is important in all aspects of the management of financial system stability. More so, in problem banks as the franchise value of a failing bank deteriorates rapidly with every hour of delay in structuring and implementing a bank resolution! It is a perishable good!

I shall discuss this topic in three parts. The first part will cover briefly the stages of bank failure resolution, the second on the challenges and practical considerations and the third, areas for cooperation.

Part I: The three stages of bank failure resolution

Like a person, a bank also goes through the normal life cycle – birth, life and death. In theory and practise, its life cycle as it enters the sick stage is not so different to the rehabilitation and management of sick individuals. A bank at the sick stage is equivalent to the bank failure resolution stage. A sick bank goes through three stages as well. They are **Pre-closure, Closure and Post-closure**.

During the **Pre-Closure stage**, symptoms of early distress are diagnosed for cause, followed by the appropriate prescriptive solutions which are dependent on the seriousness of the problems.

In the **Closure Stage**, the bank is allowed to fail. This would normally involve cancellation of the banking licence and preparation for settling the estate of the failed bank.

Immediately after this, is the **Post-Closure stage** where depositors and creditors look to having their claims paid. For depositors, the deposit insurer would make payments based on the coverage limits. Post payment to depositors, the deposit insurer would then file its claim against the estate of the failed bank. During this stage, the assets of the failed bank would be valued, collections and claims made against debtors and after the assets are liquidated, the proceeds would be distributed to depositors and creditors.

Part II: Challenges and practical considerations

I shall now discuss two practical challenges that we need to address as deposit insurers and some of the areas for cooperation.

The first challenge is to decide ***which safety net player should be involved and at which point***. In many jurisdictions, only the supervisor or the central bank is vested with the power to review the causes of distress or prescribe the remedy or intervene at the treatment stage. This sole supervisor approach is deemed justifiable since the responsibility and accountability for financial system stability are placed solely on the shoulders of the supervisor or central bank. This perception is particularly strong in the case of deposit insurers with paybox mandates! Due to such perception, paybox deposit insurers normally

do not participate in bank failure resolution. Simply put, their role is to reimburse depositors, or, as one of my colleagues aptly called it, to send a cheque to the widow.

My personal assessment is that a deposit insurer should be involved at each of the three stages. It may not be immediately apparent as to why deposit insurers, especially those with paybox mandates, should be involved in the treatment stage.

In many jurisdictions, the deposit insurer is not the gatekeeper for new bank entrants. Still, it bears the financial and inherent risk of providing insurance to all entrants to the banking system. It also bears the risk of the supervisor's inability and/or reluctance to resolve troubled institutions efficiently. As a result, the deposit insurer should stand as the watchdog since it is the last line of defence against the use of its funds and the potential that public funds may also be used to reduce its risks or pay out depositors.

In today's corporate world, the honest accountant who pays upon the instruction of the managing director has long been replaced by the chief financial officer who participates in the decision-making process to ensure that the financial decisions are the result of an effective least cost production process and in the best interest of the organisation. Following the aftermath of the Enron and Parmalat debacles, corporate governance of listed entities has been given even greater emphasis. In contrast, deposit insurers with accountability for large sums of money are often passive by-standers who watch the costs mounting during the treatment stage.

My personal view is that governance is equally, if not more important, in the public sector. I am of the view that our financial stewardship role creates an inherent accountability to ensure the correct and effective usage of the deposit insurance funds. And governance exerts a responsibility on the deposit insurer to be aware of the first signs of distress in its member institutions and its response to treatment.

Good governance requires pro-activeness on the part of the deposit insurer. It must be able to mitigate its risks by making appropriate contingency plans before the bank slides into the closure stage and I stress again that payboxes are no different in that they require time to

prepare for payouts, to strategise and plan. Therefore, earlier participation is of paramount importance!

In the case of MDIC, we take over the resolution of ailing banks when notified by the supervisor that a bank has ceased or likely to cease to be viable. Before this, we are kept fully informed by the supervisor of signs of distress among its member institutions. In fact, we are involved the moment signs of distress are detected. We work closely with the supervisor on the treatment and the progress of the bank throughout the rehabilitation process. And, MDIC is required and expected by the supervisor to conduct its own independent on-going assessment on the health of its member banks.

A second challenge is to determine **who should lead the bank failure resolution process**. In my judgment, I would say that it depends on who has responsibility for the troubled bank. If the supervisor is responsible and is fully accountable to all stakeholders, it should lead throughout the resolution process. But when the resolution of a bank is part of the deposit insurer's mandate (least-cost or risk minimising), there should be a corresponding change in leadership when it is clear that the bank is unlikely to rehabilitate into viability and that the supervisor has exhausted all of its power to find an effective solution.

Let me share Malaysia's approach in this area. The Central Bank of Malaysia, which is the supervisor, notifies MDIC when the troubled institution ceases or is likely to cease to be viable. At this point, MDIC accepts responsibility and accountability for the final resolution of the member. I should point out and I stress that this does not mean an abdication of responsibility by the supervisor. It continues to remain as the supervisor until the bank is closed. It is only not responsible for the bank failure resolution process or how depositors are finally protected or the bank resolved. Simply put, the person with the gold makes the rule!

There are substantial benefits to clear accountability for each player that is involved in a bank failure resolution. This is not one area where constructive authority has a role to play! Among others, it enables each player to be clear as to its role within the safety net system and the powers that it would need to operationalise this role effectively. In some

jurisdictions, the supervisor has a mandate which includes the power to rehabilitate a troubled bank. This would require that the supervisor has powers to sell part or all assets of the bank, set up a bridge bank, assume control of the business of the bank and possibly, the power to appoint the deposit insurer as receiver. Such an arrangement is not effective for the financial system. It increases the moral hazard challenges for the system by creating a perception that the supervisor stands ready to guarantee the rehabilitation and to perhaps hide past supervisory mistakes. In addition, the inability to resolve troubled banks expeditiously by the supervisor creates more losses to the deposit insurer.

So what is so different in Malaysia's approach? The answer is in the supervisor-deposit insurer partnership approach to bank resolution. When the supervisor leads, the deposit insurer works alongside the supervisor and vice-versa. In creating MDIC, the supervisor gave MDIC the same bank resolution powers that it had. Then, the supervisor gave it special asset management provisions which the supervisor did not even have. The rationale, which is enshrined in the MDIC Act, is that such provisions are in the public interest for MDIC to implement promptly resolution actions at a minimum cost to the financial system.

Part III: Areas of cooperation

Let me now turn to areas of cooperation for supervisors and deposit insurers.

An important area for cooperation is the sharing of knowledge and analysis of early warning signals. The correct diagnosis and therefore the prescriptive remedy are dependent on the quality of early signals and the willingness to act. Many deposit insurers already implement some form of early warning system as part of their internal risk assessment systems. An early warning system is not specific to deposit insurers. Private fund managers, international financial institutions and supervisors have their own early warning systems. Only the sophistication and their effectiveness differ. Since both the supervisor and the deposit insurer are involved in monitoring individual banks, it would be a logical process for both deposit insurer and supervisor to cooperate and compare notes on their assessment of the financial system and on individual banks. The benefits of a dual monitoring system are increasingly being appreciated. Not only does a dual filter system ensure all the early signals are captured, it provides checks and balance between the views of the supervisor

and that of the deposit insurer. Two sets of eyes are better than one, especially when our mandates are separate and distinct!

Another area of cooperation is the sharing of knowledge on the financial condition of banks under surveillance, those undergoing treatment and their progress. A number of jurisdictions have cooperated in the above areas. Malaysia is one such example. It has taken the approach that the deposit insurer is an integral component of the financial safety net. MDIC does not have examination powers but has the right to information and must independently assess the risks of individual banks and the financial system as a whole so that it can administer the deposit insurance fund prudently, be in a position to form its own opinions from that of the supervisors and contribute to and fulfil its safety net role effectively. As such, the supervisor and MDIC exchange all relevant information, such as the exchange of timely and up-to-date information on the condition of the financial system, including –

- emerging issues and threats affecting the financial system, in particular, assessment of the risks of specific banks that may affect the position of MDIC as the insurer, and the monitoring of regulatory and supervisory action plans set out to deal with troubled banks;
- Development and implementation of an early warning system with a view to reduce or avert a risk to the financial system and to banks;
- Development and implementation of prompt corrective measures for dealing with potentially troubled or high-risk banks including the criteria for defining non-viability; and
- Development and implementation of a framework for intervention of banks that have been determined as non-viable.

Collaboration of actions can be legislated, formal or informal. At MDIC, we have legislated the exchange of information and collaboration, and we have executed a Strategic Alliance Agreement (SAA) with the Central Bank that sets out the roles and responsibilities of both agencies, arrangements for sharing of information¹ and resources as well as the

¹ The SAA covers the sharing of up-to-date information on emerging threats to the banking system, cooperation and consultation on new regulations and other policy initiatives, the development of early

coordination of actions. The SAA recognises that although MDIC and the Central Bank have distinct and separate mandates and responsibilities, both of them are integral regulatory agencies that have a common primary objective of promoting the stability of the Malaysian financial system.

An example of the collaboration of actions between MDIC and the supervisor can be seen in the Terms and Conditions of Membership which we have issued for public consultation last week. Among others, the Terms and Conditions of Membership set out the obligation of banks to provide accurate information on deposit insurance, adhere to prudential and regulatory requirements set by the supervisor including bank commitments given in letters of undertaking to the supervisor. Failure to comply may result in the imposition of premium surcharge on banks. As can be seen, MDIC directly supports the supervisor through financial incentives on our members.

Concluding remarks

I should like to conclude with an observation on organisational effectiveness. How do we measure the effectiveness of a deposit insurer or each safety net player? From my experience, a deposit insurer must strive for organisational effectiveness as well as synergistic effectiveness with the other safety net players. The actions of the supervisors have strong risk impact on deposit insurers and vice versa. Therefore, we need to be informed of each others' plans and actions. It is about what we can achieve together. I see the bank failure resolution process as a team effort. The combined strength of each safety net player is needed to steer financial stability and each has a role to play. The real measure of our individual effectiveness is when acting together, our contribution to total financial system effectiveness is far greater than the sum of our individual contributions.

Thank you for your attention.

Malaysia Deposit Insurance Corporation
27 June 2007
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warning system, development and implementation of prompt corrective measures, intervention framework and incentives to promote sound risk management.