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“The New Frontiers of Financial Planning”

Knowing Early and Enough Prevents Bank Runs

Presentation

By

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Good morning, distinguished guests, ladies and gentlemen.

First and foremost, I would like to thank the Financial Planning Association of Malaysia (FPAM) for inviting me to speak at this conference. It is indeed my pleasure to be here to share my thoughts on deposit insurance and the importance of public awareness and consumer education on deposit insurance in promoting financial stability.

Before I begin my presentation proper, allow me to show you our commercials on deposit insurance that some of you might have seen on television.

My presentation today, entitled “Knowing Early and Enough Prevents Bank Runs”, is partly based on an opinion piece which I wrote and was published by The Malaysian National News Agency (Bernama) in October last year. This article was written to underscore the importance of public awareness on deposit insurance in Malaysia in the light of the bank run that happened to the Northern Rock Bank in the UK in September 2007.

As the national deposit insurer, PIDM continuously works towards ensuring that the public, especially depositors, know and understand the benefits and limitations of deposit insurance. This is essential in contributing to public confidence and national financial stability.

Discussion

Today, I will first discuss the importance of public awareness and consumer education by drawing out some lessons learnt from the Northern Rock Bank incident.

I will then highlight the features of the Malaysian deposit insurance system so that you can see how the system has been designed to provide depositor protection. I would like to emphasise that deposit insurance also plays an important role in financial planning. In our various public briefings and road shows, we have helped many depositors to understand how deposit insurance works for them.

Importance of public awareness

According to a study by the Bank for International Settlements' Financial Stability Forum, a deposit insurance system can be more effective if there is adequate awareness and understanding of the benefits and limitations of the existing deposit protection. Such understanding leads to better appreciation of the deposit insurance system which enhances public confidence. And this confidence, in turn, contributes to the stability of the national financial system.

Creating awareness and understanding of deposit insurance among depositors will ultimately lead to greater financial system stability. History shows that the lack of awareness of the deposit insurance system has social and economic implications

because it will first affect public confidence. We saw how public confidence was shaken during the Northern Rock Bank crisis. Indeed, Northern Rock continues to attract media attention until today, especially in the wake of the recent decision by the British Government to nationalise Northern Rock Bank after rejecting two private takeover bids.

Northern Rock Bank, UK

In September 2007, Northern Rock, the fifth largest mortgage lender in the UK, sought emergency funding from the Bank of England after facing a liquidity crunch.

You would note that the problem faced by Northern Rock was not related to losses, which is the usual trigger for bank runs. Its problem was one of liquidity and publicity surrounding its solvency. It was reportedly a temporary financial hiccup. Northern Rock was still solvent!

Worst bank run in recent British history

Despite being solvent and having capital above the regulatory requirement, depositors still rushed to withdraw their deposits at Northern Rock, creating a bank run that captured headlines around the world. They began lining up at Northern Rock branches on Friday, 14 September. It took until late Monday, 17 September for customers to be assured that the Government would guarantee their savings, but not before deposits of about 2 billion pounds, or USD 4 billion, had been withdrawn. In total, the government has provided approximately RM 81 billion in the form of loans to Northern Rock.

News of the bank run further created unease in financial markets. Shares of Northern Rock, other mortgage banks and financial institutions fell as much as 30 per cent.

Contributing factors

Why did the bank run happen when Northern Rock was still solvent? I would like to state two reasons for this, the first being the lack of awareness and understanding.

In Britain, deposits are protected by the Financial Services Compensation Scheme (FSCS), although not many depositors were aware of this fact. The compensation limit is set at £31,700 for each depositor for the total of their deposits in a financial institution. The first £2000 is fully covered while co-insurance applies thereafter, with 90% of the next £33,000 (or £29,700) guaranteed. If an institution were to fail, depositors must file their claims to the FSCS and payment could take up to six months or longer.

Obviously, the scheme was not adequate for Northern Rock depositors. Long queues were seen outside Northern Rock branches as depositors lined up to take out their savings.

The second reason is the lack of depositors' confidence. Besides not fully understanding how the deposit protection scheme worked, depositors felt that they had to wait too long for their deposits to be reimbursed. They also felt that the coverage limit was inadequate. This fact was also noted by the Chancellor of Exchequer Alistair Darling, who was considering to possibly increase the deposit protection limit. In fact, it was subsequently announced that the guarantee for savers in retail banks had been increased to 100% of up to £35,000, with plans for further changes in the future.

What can we learn from Northern Rock?

I have gone through more than 40 bank failures in Canada, where I previously served as the Chief Executive Officer of Canada Deposit Insurance Corporation. From my observation, knowing that your deposits are sufficiently protected by an effective deposit insurance system is critical. This is the first important lesson to note.

The second lesson to note is never say 'don't panic.' Telling people not to panic about their money as they hear about their bank going bust is akin to shouting for attention during a World Cup football match.

Deposit Insurance – a form of consumer protection

So let me spend a moment to tell you about deposit insurance – what it is, how it works and its policy objectives.

Deposit insurance is, essentially, a system established by the Government to protect depositors against the loss of their insured deposits placed with member institutions in the unlikely event of a member institution failure. If such event happens, depositors will be reimbursed promptly up to the coverage limit.

Deposit insurance is a national scheme; it is generally managed either by the central bank, a statutory body or an agency. It is not related to, or managed by general or life insurance companies. This system is funded by annual premiums received from member institutions. Depositors need not pay any premium for deposit insurance coverage.

Importance of deposit insurance

Deposit insurance contributes to the overall growth of the economy by building public confidence in the banking system. During good times, public confidence provides the environment to build a savings culture, of thrift and enterprise which is essential to economic growth. A stable financial system must be anchored strongly on public belief that the system is safe, strong and that depositors' funds will always be readily available.

As the national deposit insurer, PIDM is committed to build public awareness through implementation of public awareness programmes even at good times aimed at creating better informed depositors. History shows that public confidence in the banking system can be substantially increased by publicising the existence of deposit insurance, the benefit it provides and its limitations in good times. If people knew that their deposits were safe and guaranteed, it is less likely for depositors to panic and start withdrawing their funds en masse in bad times.

Depositors must know how deposit insurance works for them. Indeed deposit insurers must provide adequate information to depositors, so that they believe that a dollar in the bank is as safe as a dollar in their pockets! And this sense of security should be felt by the depositing public generally. Depositors also need to know how they can get access to their funds in case of a bank failure. Knowledge is important and this assurance will work when there is a bank failure, or just rumours of bank failure!

In bad times, prior knowledge of deposit insurance gives certainty and comfort to depositors in the face of rumours of bank failure that their bank deposits are safe. This assurance incentivises depositors to retain their savings in the banking system.

Deposit insurer's fundamental role

Having been a deposit insurance practitioner with more than 30 years' experience, I believe that one of a deposit insurer's fundamental roles is wealth protection. Wealth creation and management, the major role of the financial planning profession, is maintained and enhanced when complemented with wealth protection. As financial advisors, you are helping your clients to create wealth and build long-term financial security by investing in various funds and products. Depending on the client's risk appetites, most clients' investment portfolio would also include deposit products offered by banks which provide fixed returns while keeping the principal intact.

To enhance your profession

How then can knowledge of deposit insurance enhance your profession as financial planners? There is a 'snow ball' effect on financial education. Besides managing their wealth, it is essential to ensure that clients understand the investments they are making and the level of risks involved. As financial advisors, you are the primary provider of financial education to your clients and one of the important knowledge they should have is an adequate understanding of deposit insurance. By having greater understanding of deposit insurance, in the context of domestic and international financial developments such as the Northern Rock Bank incident; you will be more equipped to make proper assessment of financial risks, especially when it relates to complex financial products.

Financial literacy promotes market discipline

I can't emphasise enough the importance of financial literacy and understanding as an important channel in promoting market discipline. A well-informed public would be less susceptible to unsubstantiated rumours, hence preventing such rumours from creating consumer panic. With better financial literacy, consumers would be able to make informed decisions pertaining to the financial products they subscribe to. Financial literacy also aims to educate consumers on the means to access information and the ability to compare information. One would expect that most of your clients are probably high-net-worth individuals who have the capacity and ability to scrutinise the conduct of banking institutions and ensure that the institutions are adhering to sound business and risk management practices. This can, therefore, contribute to greater market discipline.

Value of the deposit insurance system

Another important channel in promoting market discipline is building up the value of the deposit insurance system. I strongly believe that a well-designed deposit insurance system contributes effectively towards financial system stability. The establishment of an effective deposit insurance system can also mitigate the problem of moral hazard, the existence of which often undermines the value of deposit insurance systems.

Implemented worldwide since 1934

As you are probably aware, the deposit insurance system began in 1934 following the Great Depression banking crisis in the United States of America. Since then, we have seen, throughout history, how deposit insurance has proven its effectiveness in restoring public confidence in crisis situations while the banking system recovers.

Today, deposit insurance systems have been introduced in almost 100 countries in the world, among which includes Canada (1967), Brazil (1974) and France (1980). In the Asian region, a number of countries have implemented deposit insurance systems including India (1961), the Philippines (1963), Japan (1971), Taiwan (1985), Korea (1996) and Vietnam (2000). More recently, it has been introduced in Malaysia (2005), Indonesia (also 2005), Singapore (2006) and Thailand (2008).

Deposit Insurance is internationally recognised as an integral part of a comprehensive financial safety net since it promotes and contributes to the stability of a country's financial system. The IMF and World Bank recommend the establishment of a deposit insurance system for all countries.

In Malaysia

In 2001, the Financial Sector Master Plan (FSMP) issued by Bank Negara Malaysia (BNM) recommended the establishment of a deposit insurance system in Malaysia. The

setting up of an explicit deposit insurance system was one of the key elements in building the foundation for an effective consumer protection as outlined in the FSMP. An explicit deposit insurance system was to reduce moral hazard by providing limited deposit guarantee tailored to cover a large population with low deposit value.

The establishment of PIDM further strengthened the consumer protection framework in Malaysia and represented a major step forward in the ongoing development of the Malaysian financial system. This was done through enhanced discipline and strengthening risk management practices of member institutions.

A special task force was set up to carefully design a deposit insurance system to meet the needs of Malaysians. The Task Force studied, analysed and compared the best practices of established deposit insurance systems in other countries.

The *Akta Perbadanan Insurans Deposit Malaysia 2005* (PIDM Act) came into force in July 2005. Perbadanan Insurans Deposit Malaysia (PIDM) was established under the PIDM Act to administer the deposit insurance system which was launched on 1 September 2005.

PIDM is an operationally independent statutory body, accountable to the Parliament through the Minister of Finance. Its mandate, role and responsibilities are defined in its statute.

PIDM's responsibilities

Our statutory mandate is to:

- a. administer a deposit insurance system under the PIDM Act;
- b. provide insurance against the loss of part or all deposits of a member institution;
- c. provide incentives for sound risk management in the financial system; and
- d. promote or contribute to the stability of the financial system.

In achieving its objects under (b) and (d), PIDM is required to minimise costs to the financial system.

Functionally, the role of PIDM is to:

- a. Assess and collect premiums from member institutions;
- b. Manage two Deposit Insurance Funds;
- c. Undertake resolution of non-viable banks;
- d. Reimburse depositors in the unlikely event of a member institution failure; and
- e. Create and enhance public awareness on the deposit insurance system by delivering comprehensive and on-going public awareness programmes aimed at increasing financial literacy and creating better informed depositors.

Role of PIDM in the financial system

BNM is and remains the primary supervisor and regulator of the financial system. It continues to be responsible for maintaining the stability of the financial system as well as responsible for the safety and soundness of the financial system.

With regard to our role in the financial system, PIDM complements BNM's role and contributes to stability of the system by managing the deposit insurance system in a manner that encourages prudent risk management in member institutions. There is no unproductive duplication of functions, which leads to minimal regulatory costs.

PIDM works closely with BNM and we collaborate and co-ordinate our efforts as required under a Strategic Alliance Agreement. This partnership with BNM ensures timely exchange of information on member institutions and collaboration in all significant aspects of our functions and activities, including the areas of public awareness and consumer education. PIDM is empowered to undertake resolution on member institutions upon notification of non-viability of the member institution by BNM.

Features of deposit insurance system

A distinctive feature of the Malaysian deposit insurance system is its application to both the conventional banking system and Islamic banking system. PIDM runs a dual deposit insurance system and administers two separate and distinct deposit insurance systems under a single organisation. This is also in line with Malaysia's dual banking system.

Who are our members?

Member institutions of PIDM are all commercial banks licensed under the Banking and Financial Institutions Act 1989 and all Islamic banks licensed under the Islamic Banking Act 1983. Membership is mandatory under the PIDM Act; no commercial bank or Islamic bank can opt out of this system. PIDM has 34 member institutions, which are 22 commercial banks and 12 Islamic banks.

Membership decal

Membership is denoted by a membership decal. It should be prominently displayed at all branch offices of our member institutions. You should see this sign at your bank branch. All our decals are displayed in four languages - Bahasa Malaysia, English, Chinese and Tamil for Peninsular Malaysia and we use Kadazandusun as one of the four languages in Sabah and Iban as one of the four languages in Sarawak.

Coverage

Deposit insurance is provided automatically for all depositors with Ringgit Malaysia deposits placed in member institutions. Depositors include resident and non-resident individuals, business enterprises, companies, societies and associations. You need not apply for deposit insurance coverage as it is automatic. You also need not pay any premium to enjoy deposit insurance coverage as the member institution pays annual premiums to PIDM.

All insured deposits must be denominated in Ringgit Malaysia and payable in Malaysia. Eligible deposits include Ringgit-denominated savings and current accounts and fixed deposits. In determining the types of deposits that would be covered under the deposit insurance system, consideration was given to the relative importance of the different types of deposits in the banking system, nature and purpose of the deposits and the ease of determining ownership of the deposits.

The coverage limit is RM60,000 per depositor per member institution. The RM60,000 limit was set based on statistics showing that at this limit, approximately 95% of depositors will already be protected in full, or about 35% in terms of value of deposits covered. This coverage limit is in line with international practices as most deposit insurance systems around the world cover about 80% to more than 90% of depositors or accounts in full.

Separate coverage is based on legal ownership of deposit, for example conventional deposits, Islamic deposits, joint accounts, trust accounts and accounts held by sole proprietorship, partnership or professional practice.

Funding

The Malaysian deposit insurance system is funded by premiums paid by member institutions. PIDM administers two separate funds which are the Islamic Deposit Insurance Fund, which is from premiums collected on Islamic deposits; and the Conventional Deposit Insurance Fund, which is from premiums collected on conventional deposits. To ensure compliance with Shariah principles, the Islamic Deposit Insurance Fund is managed separately and invested in accordance with Shariah principles.

In previous years, member institutions paid annual premiums based on a flat rate. Such policy requires that all institutions – high risk and low risk alike – pay the same premium rate.

I emphasised earlier that part of PIDM's mandate is to promote sound risk management practices amongst banks so as to promote and contribute to the stability of the financial system. As such, with effect from this year, we are implementing the differential

premium systems (DPS). The systems are primarily designed to provide financial incentives for banks to improve their risk management.

Under the DPS, higher risk banks will be charged with higher premium rates while lower risk banks pay lower premium rates. The DPS removes the moral hazard issues associated with the flat premium system. If you are interested in knowing more about our DPS, you can download a copy of the consultation paper and the responses from our website.

Payment to Depositors

An important requisite to maintaining deposit confidence is how quickly deposit insurance payouts can be made. Should a member institution fail, PIDM will promptly reimburse depositors on their insured deposits based on the records of the member institution.

The PIDM Act legislates that PIDM must reimburse depositors within three (3) months from the date of the institution's winding-up order. This is a statutory imposed deadline but we are planning to make reimbursement of depositors claims within days of a failure and not months. PIDM has a number of methods at its disposal to reimburse the depositors without undue delay. It also must be noted that PIDM does not require depositors to file any claim forms.

In this regard, we are enhancing our operational readiness through the development of appropriate payout systems, policies and procedures that will substantially streamline this important process. This includes promulgating regulations to ensure the quality of depositor records at member institutions. Thus, we are confident that we can achieve or even pay out faster than the statutory imposed deadline.

As PIDM will reimburse depositors holding insured deposits up to RM60,000, what happens to amounts above that limit? Depositors can file a claim with the bank's liquidator for any uninsured amount and would receive distributions as the assets are liquidated.

Reaching out to the public

How are we reaching out to the public? Our Integrated Communications Plan 2007-2011 outlines a number of initiatives to create awareness on deposit insurance and build confidence in PIDM as the national deposit insurer. Under this plan, PIDM undertakes various programmes and activities to reach out to various target audiences. These programmes include print and broadcast advertising, training for member institutions, media relations, briefings and road shows, website, publications and an information video.

In carrying out our public awareness and consumer education initiatives, PIDM also collaborates with Bank Negara Malaysia (BNM) and other partner agencies including the Financial Planning Association of Malaysia (FPAM), Institut Bank-Bank Malaysia, the Credit Counselling and Debt Management Agency and the Financial Mediation Bureau.

As an example, PIDM participated in the BNM-FPAM Financial Education Roadshow last year which was held in five cities across Malaysia. Through this road show, we were able to raise awareness on deposit insurance among the general public especially the financial planners. We were pleased to note their feedback during the road show that by being able to understand deposit insurance better, they were able to explain it more clearly to their clients. I encourage you to visit our booth during the conference, ask questions, get copies of our publications and tell your business associates, family and friends about deposit insurance.

Moving forward

As I mentioned earlier, PIDM is currently putting in place regulations to ensure that member institutions provide relevant deposit insurance information to their customers including the disclosure of the insurability of each deposit product offered through a Register of Insured Deposits. This Register must be maintained by the member institutions and made available to any customer upon request.

Moving forward, we are focusing on building greater financial literacy through the development and implementation of an educational programme for schools, colleges and universities.

Conclusion

It is incumbent on depositors to become informed on the benefits and limitations of a deposit insurance system so that they can manage their funds in a manner that suits their risk appetite. If depositors are adverse to any risk, they should manage their financial affairs accordingly and therefore, education is crucial.

But again, all the good work put into creating an effective and relevant deposit insurance system will not meet its objectives if we do not engage the people for whom the system is created in the first place. It is a responsibility between the deposit insurer, depositors and all other stakeholders, including financial planners. The deposit insurer must be committed in building public awareness while others must actively seek knowledge about how deposit insurance works for them.

PIDM believes that this results in a 'win-win' situation for all concerned. Creating awareness will not only spur the public to become informed consumers, it will also steer the path towards greater financial stability and economic growth. In this regard, I believe

that financial planners like yourself can play a significant role by advising your clients on the role of deposit insurance and its contribution to financial system stability.

We have an excellent deposit protection system in place in Malaysia and we will continue to improve this system in line with developments in the financial landscape to remain current and relevant to the depositors we serve. PIDM takes its role of acting for the benefit of depositors seriously. It is imperative that everyone with a bank account knows about our system.

I know that I have given you much information on our deposit insurance system – maybe too much to “digest” at this presentation. So allow me to run our Information Video which will reinforce the design features of our Malaysian deposit insurance system.

Contact

For more information, you can contact our Customer Service Call Centre at toll free 1-800-88-1266 from 8.30 a.m. to 5.30 p.m., Mondays to Fridays except public holidays. You can visit our website at www.pidm.gov.my or email to us at info@pidm.gov.my

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