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“Alternative Mechanics for Intervention”

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1. Introduction

Andrew Campbell has summarized very neatly the proposals for reform contained in the consultation paper entitled “Financial Stability and Depositor Protection: Strengthening the Framework”. He has also highlighted some important areas for discussion.

I have set out some thoughts below in response to Andrew Campbell’s paper and the consultation paper mentioned above. I will focus on the proposals for the special resolution regime (SRR) and propose some design features of the deposit insurance system from the perspective of a practicing deposit insurer by sharing experience and some of the hard lessons learned from handling 43 bank failures over a working span of 32 years. These thoughts are suggestions to address what I think are some of the important issues that commonly afflict bank resolution frameworks and deposit insurance mechanisms. The suggestions here are not those of the Malaysia Deposit Insurance Corporation (MDIC) and I take full responsibility for any shortcomings.

2. Elements of effective resolution framework

An effective resolution framework may contain elements of both administrative and judicial process. The selection of which intervention tools (used interchangeably with intervention actions) to be used should be tied to the expressed objectives of bank supervision, such as to minimise bank failures and, if it does happen, to minimise the economic and financial impact of a bank failure on the country. For bank resolutions to be effective, there should be absolute clarity by the authorities on when, how and who should drive the resolution process.

The framework should contain several core elements relating to trigger mechanisms, intervention tools and accountability of safety net players. These elements and related issues are highlighted for discussion. To facilitate discussion, where relevant, I have also highlighted some questions for thought.

2.1 WHEN TO INTERVENE?

(i) The main stakeholders of a bank have competing interests. For the regulatory authorities, which must balance these competing interests, they need to be clear at which point the rights and interests of depositors, normally the largest group of creditors, should take priority over that of other creditors and shareholders. This is important since this forms the basis and objectives for intervention and for selection of intervention tools. If a bank is likened to a patient, there is a two-stage diagnostic process and corresponding treatment.

(ii) **Early stage intervention to reduce likelihood of a bank failing**

During the early stage when a bank exhibits emerging signs of distress, the supervisory authority normally takes intervention actions that are not intrusive for board of directors and bank management (such as a directive to correct an operating weakness or requiring the submission of a plan to improve capital strength). The directing minds of the bank would also be given ample opportunities to come up with private sector solutions to resolve their problems. For this purpose, regulatory authorities are normally given a battery of prompt corrective tools and mechanisms that are designed to bring troubled banks “out of the woods” so to speak. Intervention at this stage is designed to reduce the likelihood of banks failing which is one of the five key objectives of the consultation paper.

(iii) **End stage intervention to reduce the impact of a failing bank**

Where despite the prompt corrective actions taken, the troubled bank's financial position continues to deteriorate and where the directing minds of a bank are unable or assessed by the supervisory authority as unable to come up with private sector solutions, it may become necessary to intervene in a more intrusive manner. At this stage, the intervention tools should be designed to reduce the impact of a failing bank, the third key objective of the consultation paper. A subset of this objective is the protection of depositors' interests.

The difficulty is that it is not easily obvious to stakeholders or to the supervisory authority that the intervention objective has shifted towards this third objective until it is very obvious. By then, the cost of resolution will be higher than had more intrusive interventions been administered earlier. Furthermore, a poorly managed resolution may also have adverse financial impact on the banking sector and, in some worst case scenarios, on the broader economy at large.

(iv) **Appropriate trigger mechanisms**

Trigger mechanisms for early intervention to reduce the likelihood of a bank failure

The trigger mechanisms for prompt corrective actions to deal with deficiencies in sound business and financial practices including risk management are quite well known and will not be covered in this paper. In the light of recent events, it may not be adequate to base triggers solely on capital adequacy. It is suggested that regulators should place equal emphasis on a bank's liquidity as well as its capital strength.

Trigger mechanisms for end stage intervention

There are always arguments about the appropriate trigger mechanisms to an intervention to resolve a failing bank. Some regulators use a rule-based approach while others use a principle-based approach. A rule-based approach legislates regulatory action base on the occurrence of an event (for example, when a bank's capital reaches a threshold, such as 2%, or the bank is hopelessly insolvent). An example of the principle-based approach relies on the supervisors' judgment about the viability of a bank or that the bank's capital will erode to an extent that depositors' funds would be at risk. Notwithstanding the approach, the question is always whether the action was taken early enough to mitigate financial stability issues and losses.

(v) **How useful are trigger mechanisms?**

History has shown that a SRR by itself would not be effective. It needs to be part of an integrated regulatory framework. Diagnostic tools and trigger mechanisms are needed to determine and justify the level and timing of an intervention to be applied. Based on experience, it is necessary for a SRR to be preceded by early supervisory interventions (prompt corrective actions) which are the best alternative mechanisms to minimise the probability of end stage bank resolution.

Trigger mechanisms under a prompt corrective action (PCA) are signposts signaling to both the supervisory authority and banks the remedial action that would follow for each stage. Depending on the supervisory framework, the supervisory authority would normally intervene at different levels. Each level, signaling deterioration in financial health, becomes the basis for increasingly intrusive levels of intervention and monitoring. These mechanisms, if correctly designed, are useful in that they tend to have a preventive effect. If implemented correctly, they become an antidote that the directing minds of a bank would want to avoid. In this way, it has the effect of encouraging those in charge to keep their bank from deteriorating towards the next stage of intervention.

To be effective, trigger mechanisms should be transparent, clearly understood by bank management and shareholders. The corresponding supervisory intervention actions should also be clearly specified for each trigger and their effect on the bank well understood. And banks must see that they are being implemented consistently and promptly. This would address to a large extent perceptions of heavy handedness over shareholders' interests or that the supervisory authority had not acted accordingly.

Trigger mechanisms must also be consistent with the mandate of the regulatory authority. For example, where the deposit insurer has a mandate to carry out least cost resolution, trigger mechanisms enable prompt and speedy intervention before the bank becomes hopelessly insolvent. Trigger mechanisms must also reflect the accountability and responsibility of the respective safety net players for intervention at each trigger point. Transparent trigger mechanisms are also useful to minimise supervisory indulgence, capture or lethargy. They also determine the degree of intrusive regulatory intervention.

Would an administrative process be more efficient than a judicial process?

It depends on whether the judicial process has a comprehensive legal framework and whether the appropriate powers, specialist skills and capacity to deal efficiently and speedily with a bank resolution are in place. In many jurisdictions, an administrative process is more efficient and effective. However, appropriate check and balance mechanisms for the administrative process should be in place. This includes, among others, clear trigger mechanisms for intervention actions and a strong ex-post judicial review process. The judiciary would play a stronger role as a watch dog for shareholders' rights and a deterrent for administrative excesses.

2.2 HOW TO INTERVENE?

(i) End-stage intervention objectives

In respect of the proposed SRR, it is important that the objectives for intervention under the SRR be clearly specified in law.

Such objective(s) is important as it then forms the mandate for resolution. The appropriate intervention powers should then be designed to enable the regulator to meet its mandate.

At the end-stage, the intervention objectives may include one or more of the following:

- Implement least cost resolution;
- Minimise loss to the deposit insurance fund;
- Minimize taxpayers' funds in a bank resolution; and
- Maintain and promote the stability of the financial system.

While the broad objective is to minimise the impact of a failing bank, such an objective is too high level to provide guidance for designing the SRR. There are subtle differences in each of the above objectives. For instance, under a least cost resolution, while the financial cost would be the primary consideration but should it be from the tripartite Authorities or the Financial Services Compensation Scheme (FSCS)'s perspective? Should the stability of the financial system take precedence over financial cost? If so, under what circumstances?

The SRR may benefit from some additional tools (set out below) which are necessary to complement the other tools already identified:

- Providing financial assistance to a third party to execute the purchase and assumption;
- Restructuring including selling part or all assets of the troubled bank; and
- Purchase some or all of the non-performing loans of the troubled bank.

(ii) **Operationalising least cost resolution**

In determining which option is a least cost resolution, a viability assessment of the bank's business and affairs should be undertaken to assess the magnitude of the problem. Until the bank's financial exposure is properly understood, the regulatory authority cannot assess the merits of different intervention resolution options. The assessment should be conducted by individuals who can value assets on a going concern basis and in a liquidation scenario for comparison purposes.

A valuation methodology, based on generally accepted accounting principles, should be developed that can withstand public scrutiny. These would include determining the ranges of values for assets (tangible and non-tangible), amount of secured debts, insured and uninsured deposits as well as valuation of all liabilities (both on and off-balance sheet) should be determined.

Once this is completed and validated, the assumptions used will then be substantiated using the different resolution methods and the optimal resolution method can then be selected.

If a sale to a third party is being considered, a formal bidding process must also be established to ensure that all interested parties have an opportunity to bid on the business of the troubled bank and so that the best price can be extracted.

Specialist knowledge and experience are necessary tools for efficient bank resolutions. Outsourcing is one option. However, the benefits of building institutional experience and capacity within one of the safety net players who has the financial incentive to do so has much merit, especially since these skills are specialized and contingency planning for interventions is critical.

(iii) **Appeal mechanism**

It should be expected that creditors and shareholders would demand an equitable appeal process if their rights and interests are removed by a SRR approach. A useful appeal mechanism is to provide for a special assessor or committee to review the reasonableness of the SRR and the transacted price, if any, executed under the SRR. The assessor or committee should have the power to direct the relevant regulatory authority to make good the difference between a reasonable market price (had a market transaction been undertaken) and the SRR transacted price. The assessor or committee should be established within the SRR framework and aimed at providing a review and speedy compensation process to aggrieved shareholders who should not have to wait for the normal judicial process (for example, Canada Deposit Insurance Corporation's Financial Institutions Restructuring Program). To ensure that there is no unjust enrichment to shareholders, the assessor or committee would have established criteria under which they would evaluate the SRR. Examples could include:

- the ongoing viability and value of the bank at the time of resolution;
- the prevailing market conditions for sale or disposal of similar assets or business under a receivership or liquidation; and
- whether any special financial assistance had been provided by the authorities and if the bank would have had a reasonable chance of survival without continued support.

2.3 WHO TO INTERVENE?

- (i) It is important to be clear as to who should lead a bank failure resolution and at which point. The consultation paper states that the tripartite Authorities would be responsible for activating the SRR. It is possibly envisaged that the Financial Services Authority (FSA) would have responsibility for overseeing the implementation of the SRR at all levels

including liquidation. This sole supervisory authority approach is deemed justifiable since the responsibility and accountability for financial system viability are placed solely on it.

The basis for assigning responsibility and accountability should be based on who has the burden for bearing the financial losses. Unless this is clear, the issue of accountability may simply be a case of moving the deck chairs on the Titanic.

(ii) **Accountability for troubled bank**

It is very important that all safety net players understand their role in the process so that they may be given appropriate powers to carry out their roles effectively. If one single authority is given responsibility and able to be fully accountable to all stakeholders (including being the directing mind of the restructuring officer), and it should have in place clear and transparent conflict of interest rules and be accountable for the losses incurred. If the resolution of that bank is part of the deposit insurer's mandate to find a least cost option, it is appropriate to shift this responsibility to the deposit insurer. It should be noted that segregation of roles and duties of the safety net players should aim to provide a strong accountability regime and disclosure while eliminating unproductive overlaps, inconsistencies in approaches, and duplication of efforts.

<p>What is the system of checks and balances that should be put in place between the safety net players to ensure that the public policy objectives of bank resolution are achieved in the most effective and efficient manner?</p>

<p>Is there a risk of regulatory indulgence through supervisory forbearance which result in higher cost to the deposit insurer and ultimately to taxpayers?</p>

(iii) **Perception and moral hazard**

Where the supervisory authority has all the responsibility and accountability, it increases the moral hazard challenges for the system. It creates a perception that the supervisory authority stands ready to guarantee the cost of the resolution or even that the resolution is a result of supervisory ineptitude. Experience has shown that such perceptions are often sticky and could pose difficulties especially when the resolution involves financial support from taxpayers. The decoupling of the supervisory authority from end stage bank resolution responsibilities will minimise such perceptions. Having a separate agency that is operationally independent and accountable publicly for its actions has been shown to be a better option.

(iv) Minimising cost

It is important to be clear as to who bears the cost of a resolution. Since resolution costs can escalate with delays in taking supervisory action, the mandate for undertaking bank resolution should be made clear in statutes. From the governance perspective, the safety net player with the financial exposure for the cost of resolution has the greatest interest in containing losses and hence should have the responsibility.

History has given us many examples of supervisory forbearance and delays in dealing with problem banks and some of these are due to supervisory reluctance to act which may be due to regulatory capture, supervisory indulgence or political pressure. For these reasons, more jurisdictions have or are establishing operationally independent deposit insurers with strong governance and wider mandates.

(v) Asset management

The safety net player responsible for reimbursing depositors should also have the responsibility to maximize recoveries on claims paid. The management for this important function has serious financial consequences on resolution costs. Again, the player with the financial exposure should take responsibility. Experience has shown that deposit insurers (since they have a direct interest in preserving their funds) have been more efficient and effective in ensuring effective recoveries.

(vi) Funding

The issue of who funds the cost of a troubled bank resolution has a bearing on allocation of responsibility and accountability for bank resolution. If the insured members of the banking sector contribute towards a deposit insurance fund for this purpose, the deposit insurer has a responsibility to its insured members to minimise bank resolution costs.

Where the supervisory authority has sole authority for undertaking resolutions, the deposit insurer has no control over costs or losses.

Is it good governance for the deposit insurer to “compensate” the supervisory authority for all or part of the resolution cost of a troubled bank, seeing that the deposit insurer has all of the risk but none of the tools to manage this risk?

Should the supervisory authority keep the deposit insurer informed of supervisory actions taken and progress of such actions? If so, at which trigger point?
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Should the deposit insurer have a say in determining the resolution options at the early/end stage bank resolution or not at all?

Should the deposit insurance fund be available at the supervisory authority's discretion or should the deposit insurer be given a significant role in minimizing the cost of a bank resolution?

(vii) **Legal immunity for employees**

To ensure that the authorities assigned to handle bank resolution do not engage in regulatory forbearance, it is important that they be given legal immunity against lawsuits if their actions are carried out in good faith and in the best interest of the organisation they represent. This would give them the incentive to carry out their job promptly and properly.

3. The Deposit Insurance Scheme Proposals

There are several key elements in any deposit insurance scheme. These include the public policy objectives for establishing the deposit insurance scheme, who should be covered, the size of coverage, the funding mechanism, the premium system and rates and the payout mechanism (under what circumstances and how payment should be made as well as the time frame for making payment).

3.1 Public policy objectives

There should be well defined public policy objectives supporting the deposit insurance system. When these are clearly articulated, the design of its key features is a matter of cutting the cloth to suit the objectives. Presently, Chapter 7, on effective coordination, states that the FSCS would be consulted in certain circumstances although no details are provided. Further deliberation on the role of the FSCS within the SRR framework would be beneficial especially for insured member banks who pay the freight.

3.2 Coverage

While the 35,000 sterling pounds appear to satisfy depositors, a more detailed assessment may need to be conducted as it would have cost implication to the industry. In the case of Malaysia, I had advised that a quantitative assessment be made where banking institutions were requested to quantify the number of depositors according to the size of their deposits. A rule of thumb is to insure about 90% of depositors while insuring a range of between 25 to 45% of the value of deposits. An understanding of depositor distribution according to deposit amount is helpful as a basis or tool:

- To justify the policy for setting the final coverage limit;
- For assessing the amount of premiums to be charged; and

- For the deposit insurer to maximise the number of depositors covered while minimising the value of deposits insured.

The consultation paper provides depositor information but it is only limited to two large banks. To ensure the information is consistent throughout the banking industry, a wider study should be undertaken.

3.3 Funding mechanism and premium rates

A deposit insurer should have available all the funding mechanisms to meet its obligations at all times. Many deposit insurers assess premiums on an ex-ante basis where insured banks pay an annual premium which is tax deductible as a business expense. In such cases, the deposit insurance system is funded by both the banking industry and the government. Most deposit insurers assess premiums based on a flat rate premium system. However, more effective deposit insurers apply differential rate premium systems with a view to promote sound risk management in banks. The use of differential premium systems is being adapted in more systems today since it provides for well managed banks to pay lower premiums commensurate with their risk profile. Weaker banks are thus financially encouraged to improve in order to avoid paying punitive premium rates. This provides a direct incentive for banks to have better risk management systems. The differential premium system can also provide support to the authorities in ensuring that banks take appropriate and timely action to rectify identified regulatory deficiencies.

3.4 Payment mechanisms

The FSCS is envisaged to be a paybox mechanism which will only be activated when a bank is liquidated and depositors need to be repaid. While the consultation paper provides that where there are monies readily available in the insolvency, these may be used to fund the repayment of deposits which would otherwise be paid by the FSCS. Experience has shown that it is more likely that funds would not be adequate in the insolvency to pay depositors. Therefore, if the FSCS is to be effective, it would need the authority to borrow or raise funds to meet payments to depositors. It should also be given ample notice of the size of its deposit insurance exposure in the event of such liquidation.

Consideration should also be given to provide for ex-ante funding to build its deposit insurance fund (DIF) over time. However, the FSCS will require liquidity funding when its obligations to reimburse depositors are larger than its DIF.

The consultation paper rightly points out that the FSCS should be legislatively subrogated to all the rights and interests of depositors to the extent of the amount of payments made and claim forms should be eliminated. The FSCS should also be able to maintain an action in respect of those rights and interests in the names of the depositors against the estate of the bank. The paper also rightly suggests that many administrative impediments be removed so that quick and accurate payouts can be accomplished. However, undertaking a payout in a week is at best

dreaming in colours unless the FSCS has the power to undertake preparatory examinations and has in place appropriate payout systems, policies, procedures and resources.

3.5 Public awareness

Public awareness programmes by deposit insurers contribute to financial stability through consumer education and through a good crisis communications strategy. However, it should be noted that conducting public awareness requires substantial resources and can form a significant part of a deposit insurer's operating budget. But recent events have showed that it would be even more costly not communicating with depositors. Public awareness outreach, whether mandated or not, are necessary programmes for all deposit insurers, to be effective.

It is important that public awareness initiatives be a joint effort between insured banks and the deposit insurer since depositors should have accurate and timely information about what is and what is not insured when they make investment decisions (at point of sale). A number of deposit insurers have implemented comprehensive multi-year public awareness programmes to increase the awareness levels with success.

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About the author

Jean Pierre Sabourin or **JP** (as he is more fondly known among deposit insurers) is the Chief Executive Officer of the Malaysia Deposit Insurance Corporation (MDIC) which was established in August 2005. He was also the Advisor to the Central Bank of Malaysia Task Force on Deposit Insurance. The Task Force was established as one of the initiatives of the Central Bank to enhance depositor protection. JP was appointed to his present post after his retirement as the President and Chief Executive Officer of the Canada Deposit Insurance Corporation (CDIC), a position that he held for 15 years. During his 29 years at CDIC, he was involved with 43 bank failures.

JP has been involved with providing consultancy and advice to governments on the establishment of new deposit insurance systems and improvements to existing systems. Some of these include the Jamaica Deposit Insurance System, the Central Deposit Insurance Corporation of Taiwan, the Ukraine and Hungary deposit insurance systems and the Philippine Deposit Insurance Corporation. He chaired both the FSF Study Group and the Working Group on Deposit Insurance which developed guidance for establishing effective deposit insurance systems (1999-2001). He was the founding chairman of the International Association of Deposit Insurers (IADI), a position he held for 6 years until late 2007. IADI

membership currently includes more than 75 organizations and it has recently issued core principles for effective deposit insurance systems. He is passionate about governance for deposit insurers and is an advocate for sound safety net systems with clear accountabilities with appropriate checks and balances. He has shared his practical experience in numerous presentations and speeches around the globe. His more recent speeches may be accessed from the MDIC website at www.pidm.gov.my