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Remarks at the International Seminar on Legal and Regulatory Aspects of Financial Stability

*J.P. Sabourin**

Good morning, ladies and gentlemen. It's a pleasure to be here today and to have this opportunity to speak about the legal and regulatory aspects of financial stability from the perspective of a deposit insurer.

I would like to start with two observations—based on my twenty-five years of experience in deposit insurance, and the extensive work we have done over the years in advising a wide range of countries that were setting up or modifying their deposit insurance systems.

First, in a free marketplace, the opportunity to win comes hand-in-hand with real risks. Consequently there will always be some banks that fail, from time to time, in just about every jurisdiction in the world. To protect the depositors of those banks, there must be some form of depositor protection.

The importance of this protection, for the ordinary men and women who entrust their savings—sometimes their entire life savings—to these financial institutions cannot be overstated. We believe the best protection is offered through an explicit, limited-coverage deposit insurance system. Currently, seventy countries have explicit deposit insurance systems, and many more are considering its merits.

Without deposit insurance, a wave of bank failures—and sometimes even one—can trigger bank runs, and bring into question the stability of a financial system, if depositor confidence is shaken. As well, such failures can interfere with the payments system and in the availability of credit.

An effective deposit insurance system contributes to the stability of a country's financial system, and protects less financially sophisticated depositors from loss. But this does not mean that deposit insurance is a magic cure all. Deposit insurance systems are not intended to cope with systemic financial crises by themselves. The resolution of such crises requires broad, coordinated government action.

The Asian financial crisis of 1997—and the instability that followed—highlighted the importance of financial stability. In response, the G7 created the Financial Stability Forum. The FSF, in turn, created a number of working groups, among them the Working Group on Deposit Insurance. It was mandated to develop guidance on deposit insurance,

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through extensive consultation, that would reflect and be adaptable to a broad set of circumstances, settings, and institutional structures. Our deliverables were the Final Report, including a self-assessment methodology, 16 supporting papers on a variety of technical issues, and exchange of ideas and experiences with deposit insurance practitioners and other interested parties. Our work was fully endorsed by the Financial Stability Forum this past September.

Let me now turn to my second observation. It's a view that guided the direction the Working Group took in its consultation research and deliberations, and that frames the contents of the final report.

Simply put, that observation is that there is no one best form of deposit insurance, no set of best practices for all countries to follow.

This observation was consistently confirmed in the many discussions that took place among the members of the Working Group, as well as among the hundreds of participants at its various conferences, seminars and meetings.

While the FSF Working Group's mission has been completed, a number of countries, led by Canada, are preparing to launch a successor group—an organization that will continue the work undertaken by the Working Group, and preserve its benefits on a permanent basis. I will say a little bit more about this later in my remarks.

One of these benefits is the creation of a forum where practitioners and others interested in deposit insurance, could come together and share ideas and lessons learned. In effect, the Working Group became the first global clearinghouse for information and guidance on the practical aspects of deposit insurance.

The second major accomplishment of the Working Group is its final report—and I want to devote some time in this presentation to deal with it.¹

The report is the most comprehensive study of deposit insurance conducted to date. It puts forward almost sixty points of guidance, under a score of headings, ranging from the identification of public policy objectives all the way through to the state and structure of the banking system, the legal system, mechanisms for reimbursing depositors' claims, interventions and liquidation of assets of failed banks.²

The guidance is widely adaptable. Great care was taken to ensure that the guidance is nonprescriptive and reflects the full range of deposit insurance experiences around the world. As I observed earlier, there were no best practices to prescribe.

The report is also supported by original research on the practice of deposit insurance—work that led to the development of sixteen in-depth papers. Some of these papers capitalized on research work already done, and in other cases, original research was done to address important gaps in our understanding of certain key issues.

While some might regard the key points of guidance in the report as just common sense, it is important to note that it addresses a number of issues that have not been dealt with elsewhere. The focus was on real-world experiences—what has worked, and what has not—based on advice from practitioners.

1. *Guidance For Developing Effective Deposit Insurance Systems*, Financial Stability Forum (Sept. 7, 2001), available at <http://www.fsforum.org/Reports/DepositInsuranceFinal.html> (last visited Sept. 15, 2002).

2. *Id.*

The report starts with a discussion of the contextual issues for deposit insurance. In particular, it stresses that an explicit deposit insurance system is preferable to the implicit coverage that exists, where no formal system is in place.

By its nature, implicit protection creates uncertainty about how depositors, creditors, and others will be treated when bank failures occur. Thus, explicit deposit insurance clarifies the obligations of the insurer, and limits the scope for discretionary decisions that may result in arbitrary actions. An explicit system also sets out the rules for depositor compensation, it builds public confidence in the financial system, and provides an orderly process for dealing with depositor claims when banks fail.

The report also goes on to address the issue of moral hazard, and issues relating to countries transitioning from blanket guarantees to a deposit insurance system. As to moral hazard, this refers to the incentives for excessive risk-taking by banks, or those receiving the benefits of insurance protection. As the report points out, such behavior may arise where depositors or other creditors are protected—or believe they are—from loss, or where they believe a bank will not be allowed to fail.

A number of factors can mitigate moral hazard, and the report lists four of them:

- Incentives for good corporate governance and management at individual banks.
- Market discipline, with sufficient and timely information to adequately assess the risks involved.
- Prudential regulatory and supervisory discipline.
- The inclusion of certain features in a deposit insurance function, such as restrictions on coverage, differential or risk-adjusted premiums, early closure of troubled banks, and a willingness to take legal action against bank management and directors, where warranted.

Importantly, the report noted that certain local conditions must be in place for specific mitigants to operate effectively. For example, emerging or transitioning economies may find it difficult to implement differential premiums.

There can be no doubt, as well, that the mitigation of moral hazard involves country-specific solutions. No two countries share the same government structures, political cultures, or legal systems—and laws relating to bankruptcy in particular are a profound influence in this matter.

Let me spend a few moments on legal provisions, as they are highly important in the effective operation of a deposit insurance system.

One issue we identified, was the importance of statutory indemnification for employees of safety-net participants. The lack of legal protection can reduce incentives to be vigilant in carrying out responsibilities, particularly in cases where mandates emphasize early detection, intervention and closure of troubled banks.

Our report also drew attention to the need for the enforcement of effective laws as a means to support strong prudential regulation and supervision, and to contribute to the effectiveness of a deposit insurance system. Clearly, if it is not possible to close a bank before it is insolvent, costs to the deposit insurance system will rise. Indeed, in our report we say: “The determination and recognition of when a bank is in serious financial difficulty, should be made on the basis of well-defined and transparent criteria by a safety-net participant with authority to act.”³

3. *Id.* at 49.

Property rights, the ranking of depositor claims in a liquidation process, the effects of collateralization and set-off arrangements, in particular, can influence the priority of claims in a bank failure. Our report identifies these issues.

I would note, that in a recent article that according to an index of economic freedom for 2002, only forty-five out of the 161 countries graded in the index, offer very high to high protection of property rights. The other 116 countries offer weak protection, which prompted the author to suggest that, relatively speaking, economic activity can sustain itself in less than one-third of the world.

Let me say a few words about depositor priority, collateralization and set-off arrangements.

The potential effects of existing depositor priority laws or statutes, on failure-resolution costs, can influence the incentive for depositors, the deposit insurer, and other creditors to exert market discipline.

In some countries, depositor claims have priority over other claimants, while in others they rank equally. In some jurisdictions, deposit insurer claims rank in priority while in others, they rank equally with other depositor claims, because of subrogation.

Similarly, policymakers need to be aware of the effects of collateralization. In some countries, depositors, the deposit insurer, and other unsecured claimants share only in the unencumbered assets of the failed bank, and their recoveries are reduced by the collateralization of other parties' claims.

As well, where set off is available or imposed, creditors who are also debtors of the failed bank, may increase their recoveries, while other creditors' recoveries are diminished. We know that these issues generally involve trade-offs, and require country-specific solutions built around the legal framework of a country respecting, of course, its very important traditions and court processes.

Given these differences, there can be—as I mentioned earlier—no set of best practices that can apply to the provision of deposit insurance in all situations. That being said, three steps are essential when designing and setting up a deposit insurance system:

- The public policy objectives must be explicitly specified.
- A comprehensive situational analysis of local conditions must be performed, including attention to the legal framework, and the enforcement of effective laws.
- And the mandate, powers, and structures for the insurer must be clearly defined and understood.

It is critical that strong cooperative links be forged between the deposit insurance function, and the other safety net functions, with the responsibilities of all parties explicitly set out—especially for dealing with troubled banks—along with clear mechanisms for information sharing and exchange.

In performing these steps, of course, countries should not ignore reality. Local conditions may often be less than ideal. Policymakers should identify the gaps between what exists, and what's necessary, and to close those gaps wherever possible.

Indeed, the operation of any deposit insurance system should never be a question of comfortable *status quo*. The world—and the global financial marketplace in particular—presents too many new and pressing challenges for decision makers to ignore.

For every deposit insurer, there should be a process for and commitment to continuous improvement.

Now, let me turn to the role that a deposit insurer can play in the closure of a problem bank, from a legal point of view, in the context of what other members of the Canadian financial safety net are able to do. In the session this afternoon, perhaps we can get more into the specifics of the existing authorities, and the persons or agencies that have those powers.

The financial safety net participants play many roles in the system of intervention in Canada. A system of intervention is most effective when those it affects clearly, and readily, understand it. Let me turn specifically to the role that the Canada Deposit Insurance Corporation plays in the system of intervention as a risk-minimizer. A risk-minimizer acts proactively to assess its risks, and takes the necessary actions to minimize its exposure to loss. To achieve its mandate, a risk minimizing deposit insurer needs powers to control entry, and exit from the deposit insurance system.

I will illustrate what CDIC does during the contingency planning, staging and early intervention phase, and then later I will focus on the failure resolution and exit stage. I must caution that I am speaking from the vantage point of CDIC, and we should recognize that not all of the powers that I will be talking about are available to all deposit insurers, even these that have risk minimization mandates.

As a starting point, it is important to know what the legislative basis is for prudential regulation, supervision, and deposit insurance, and its relationship to bank closure. Clear statements of mandates, authority and accountability of the financial safety-net participants is very important. In Canada we have been using a "Guide to Intervention for Federal Financial Institutions" since 1995, which helps to promote awareness and transparency of the system of intervention.⁴ The four stages are as follows—One, early warning. Two, risk to financial viability or solvency. Three, future financial viability in serious doubt. Four, insolvency imminent.

At the same time, it is very important to know which statutes will be in effect when the closure occurs, and it is helpful to have the courts experienced in such matters. In many countries, including Canada, the Winding Up Act provisions are used, but other statutes play a role in the closure of a financial institution.

Let me now turn to the issues relevant to early intervention, and the framework for supervision. For me, the cornerstones of an effective system are transparency, accountability, predictability, and coordination. Let me explain with some examples.

Transparency allows for orderly planning and a better ability to predict outcomes. As an example, in situations where differential premium rates are used, it is important for institutions to understand the mechanics of how it works. An institution that is unhappy with its rating, needs to know what it has to do to move into a more favorable category. Another example I have already mentioned, is transparency regarding the system of intervention.

Accountability is also important in the discharge of a public trust. In Canada, the deposit insurer reports to Parliament through the Minister of Finance. In this regard, the Executive Officers of the Corporation have to be prepared to answer questions about the performance and actions of the deposit insurer, from committees of the two houses

4. *Guide to Intervention for Federal Financial Institution*, Office of the Superintendent of Financial Institutions, available at <http://www.osfi-bsif.gc.ca/eng/documents/practices/pages/index.asp?id=1995> (last visited Sept. 15, 2002).

of Parliament. Believe me, when there is a failure or failures, there are plenty of questions for CDIC and the supervisor!

Another cornerstone is predictability. With respect to the four stages of intervention I mentioned earlier, it is important for an institution to know how it is being rated. Is it at Stage One, Two, Three, or Four, and what are the likely regulatory and deposit insurer responses going to be at each stage? The ability to predict behavior and outcomes allows for orderly planning, which in turn contributes to stability. When the world unfolds as expected, situations can remain calmer.

Lastly, coordination is important, of course, because the deposit insurer is not the only safety net player involved in dealing with financial institutions. The lender of last resort in Canada is the central bank, but CDIC can also act in that capacity. Although CDIC can undertake special examinations of members, it is not the supervisor. It does rely extensively on examinations, and the information provided by the supervisor to assess its risks. That is why coordination is so important at all critical events in the life cycle of an institution. As well, CDIC can cancel a member's deposit insurance when, in its opinion, the member is, or is about to become insolvent. Upon a cancellation, CDIC is deemed to be a creditor of the institution for the purpose of petitioning for a formal winding up and liquidation. This is subject to the right of veto by the Minister on the grounds of public interest.

Since it can be difficult to prove insolvency at the beginning of a winding up, CDIC usually acts in concert with the supervisor. Let me illustrate how.

In the case of a federal member, our legislation provides complementary roles for CDIC, and the supervisor in the following way. CDIC can start the process leading to termination of deposit insurance when, in its opinion, the member is not following CDIC regulations under its applicable business and financial standards; is in breach of any of the CDIC by-laws, or is in breach of a condition of its policy of deposit insurance. The member has a right to respond and, the Minister has the right to veto CDIC's decision, if he/she decides it is not in the public interest for the policy of deposit insurance to be terminated.

The Canadian Bank Act, Trust and Loan Companies Act and the Office of the Superintendent of Financial Institutions Act provide various grounds on which the supervisor may take control of a bank or its assets including, for example, that CDIC has terminated the bank's deposit insurance.⁵ Once in control the supervisor may ask the Attorney-General of Canada to petition the courts for a formal winding up and liquidation.

While CDIC as a deemed creditor can only petition on the ground of insolvency, the Attorney-General of Canada can petition on the ground that the supervisor has taken control, or that it is just and equitable, among others.

I have provided a perspective on our system to show what we do in Canada. Our system is based on experience and lessons learned. It has built in tension among the players to ensure performance. It is not necessarily workable for other countries.

Let me know turn to international issues. I would note that David Clementi of the Bank of England, in a recent speech, drew attention to the work being done internationally on insolvency, and credit issues that is aimed at greater international cooperation

5. Bank Act, ch. 28, S.C. 1999 (Can.).

among the main players. That cooperation needs to be backed up by greater coordination in cross-border insolvencies, but this task is complicated by the approaches adopted in different countries reflected in different legal traditions and different policy choices.

Mr. Clementi went on to say that, as of yet, there has been little in-depth exploration of the linkages between corporate and financial sector restructurings, and I would add that the growing cross-border nature of banking means that international discussions surrounding deposit protection arrangements are also timely. Given the need to treat similar classes of depositors and creditors equitably.

Before I close let me pose the question: How does deposit insurance fit in the prudential regulatory framework? To answer that question let me refer back to the Final Report of the Working Group.⁶

As noted in the Key Points of Guidance, starting on page thirty nine, policymakers will need to make choices about the kind of deposit insurance system they want, and how it will fit in as part of the safety net.⁷

A deposit insurance system will be country specific, and must evolve over time. In Canada, the deposit insurer started as a pay box, it provided limited coverage deposit insurance, and it has evolved to a role of a risk minimizer. Deposit insurance should be subject to continuous improvement, respond or grow to meet the situation, be congruent with a country's legal system and supported by the enforcement of effective laws.

Whatever the role of the deposit insurer, it is important for the safety net to be well defined. And it is important to walk the talk. As our Final Report noted, "whatever the mandate selected, it is critical that there be consistency between the stated objects and the powers, and responsibilities given to the deposit insurer."⁸ As the Report further notes, "Clarity of the mandate reinforces the stability of the financial system, and contributes to sound governance and greater accountability."⁹

I would like to say a few words about the leadership role that we are taking in forming an international association of deposit insurers.

Following on from the progress that was made by the WG on deposit insurance, we are creating an international association of deposit insurers.

What kind of work could an association do? I've reiterated the point that there are no best practices in a world where local conditions for the provision of deposit insurance or depositor protection vary greatly.

But I don't believe that means we cannot work towards development of good practices, or effective organizational policies that can guide deposit insurance practitioners: a menu of practices that are tried and true, that have been used by practitioners in various settings around the world. Sound guidance that can help make deposit insurers do an effective job. Indeed, the guidance in the Final Report is a good start in this direction. But more needs to be done. The timeframe and resources of the Working Group were limited, and in many areas, its efforts have only scratched the surface.

The soon to be formed International Association of Deposit Insurers will hold its inaugural meeting in Basel on May 6, 2002. The Statutes have been drafted and have been circulated to all interested parties.

6. Financial Stability Forum, *supra* note 1.

7. *Id.* at 39.

8. *Id.* at 17.

9. *Id.*

Its objects are:

- To enhance the understanding of common interests and issues related to deposit insurance.
- To set out guidance to enhance the effectiveness of deposit insurance systems.
- To facilitate the sharing and exchange of expertise on deposit insurance issues through training, development and educational programs, and provide advice on the establishment or enhancement of effective deposit insurance systems.
- To undertake research on deposit insurance issues.
- To take such other action as may be necessary, or useful, for the furtherance of its Objects and activities.

I believe that the IADI should have as one of its objects, the ability to set out guidance to enhance the effectiveness of deposit insurance systems. I should note that most countries are supportive of this approach, but there remain a few countries that are opposed. Why? At this time, I am not sure. In my view it would be rather peculiar if an international body didn't have setting out guidance as part of its object. Clearly, if the International Association of Deposit Insurers does not do it, then I would have to ask, who would?

Should this important work be left to others who have little practical experience? That would seem to be an odd approach.

If I allow myself to speculate, it may be that certain countries are concerned about the number of standard setters already established, and the number of standards already in place. In other words, perhaps they are suffering from the application and requirement to follow a growing number of standards. Or quite simply stated, they suffer from standards overload.

That is why we purposely used the term guidance in our Objects. Guidance that is adaptable to different sets of circumstances and situations.

All countries stand to benefit if we can identify good and effective guidance in the form of practices, processes, procedures and policies, among others. Guidance that have proven their worth in areas such as funding, differential premium systems, access to information, operational policies and procedures on claims and recoveries, arrangements to manage working relationships among deposit insurers, and other safety net participants. This would even apply to a variety of techniques already in place that can help us do our job better and more effectively.

The guidance developed by the IADI need not conflict with frameworks developed by countries, or even those implemented by regional groupings. Indeed, the surest way that I can think to take into consideration such factors, is to have countries included in those regions, is to have them join with us in the establishment of the IADI.

Currently, we have close to fifty organizations that have expressed an interest in participating in the IADI. This is an excellent beginning.

It is my strong hope that the Final Report of the Working Group, and the questions left for future research and discussion, catch your interest, the interest of many others involved in the provision of deposit insurance, and that many of you will become active participants in the IADI. I look forward to your questions and comments.

Thank you.



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