

APEC – POLICY DIALOGUE ON DEPOSIT INSURANCE

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Tuesday Afternoon Session:

“Prompt Corrective Action and Intervention Trigger Mechanisms”

Presentation: “A Rule-Oriented Matrix Approach”

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Introductory Note

Why the Presentation's Title?

- “Rule-Oriented” - spectrum of options for regulators/supervisor; middle path between rigid legalism and unfettered discretion.
- “Matrix” – horizontal and vertical- part of a broader “puzzle” related to effective financial stability – all parts are inter-related and also should be complimentary.
- “Approach” – not a set, detailed road map, but a “guide”.

Outline of Presentation

A. Basic Assumptions Derived from Past Experiences

B. Preventive Prerequisites – Minimization of Bank Insolvencies

- Selective Domestic Infrastructural Aspects
- EWSs Systems
 - System-wide
 - Individual- Bank Examinations

C. A Further Prerequisite: International Standard Setting and Monitoring

- “Standard Setting” and “Standard Setters”
- Assessment
- Regional/Sub-regional Components

D. PCA- Determining the “Trigger Point”

E. Lessons to be Derived

Outline of Presentation (Continued)

F. Postscript: Note on the WB/IMF – Global Bank Insolvency Initiative (“GBII)

Appendices:

- A. Bank Insolvencies/Banking Crises – 5 Country Examples (Mexico, Thailand, Korea, Ecuador, Turkey) (derived from GBII Study)
- B. Selective Comparative Country Examples of Intervention Rules
- C. Snapshot of Asian Regional Cooperation

A. Basic Assumptions Derived From Past Experiences

- A viable Deposit Insurance System (DIS) does not exist in a vacuum.
- This System should be a component of an overall viable financial safety net.
- Purpose is to minimize system risk, while promoting financial stability. Should also support financial sector development.
- DIS is a part of a complex, interrelated matrix, includes not on DIS, but also prudential supervision, bank insolvency and liquidation, liability of financial authorities and a variety of other components *etc.*
- Need for this matrix to be addressed “globally,” regionally and domestically.
- No one model for a viable DIS. Policy Options. Needs to be country-specific.
- Special concerns as to timing and sequencing exist for Developing Countries at differing stages of their development.

B. Preventive Prerequisites (Minimization) of Bank Insolvency

1. Selective Domestic Infrastructural Aspects

- **Legal, administrative, enforcement, judicial frameworks- requires long-term commitment and strong political support.**
- **Sound private law foundations: contract, property, commercial, corporate, insolvency etc.**
- Accounting and transparency.
- Clear operating rules shaping market structure.
- Good corporate governance.
- Modern banking laws, regulations and supervisory practices.
- Viable depositor/creditor protection
- Appropriate oversight.

Example of Corporate Governance

- Area where bank regulators/supervisors can make a difference on a more immediate-medium term bases.
- Bank failures most often not so much a problem of inadequate supervision/regulation, as of poor or bad management. Improving corporate governance structures of banking institutions

Example-CG (cont'd)

- Bank regulators/supervisors can influence CG of BIs in a number of ways
 - Close scrutiny on initial entry and ongoing monitoring of integrity and financial capacity of bank ownership and quality and integrity of bank management (Board members, officers, key employees).
 - Internal control systems.
 - Sound internal audit systems, including a developed Board Audit Committee and expert independent auditors.
 - Sound credit underwriting loan policies & procedures.
 - Sound internal systems to identify other relevant risks (e.g., interest-rate & market) and to evaluate asset growth and quality, earnings and stock valuation, insider and affiliate transactions and management compensation/fees/benefit structures.
- Such CG enhancement can be achieved not simply through some form of Compliance Plan imposed as a result of PCA, but should begin on the front-end (ex ante) as an integral part of the controlling bank legislative framework and as an integral bank of the entry and ongoing prudential regulatory/supervisory practices.

2. Early Warning Systems (EWS)

In General: Another Desired Prerequisite

- Early warning systems (EWS):
 - economic variables,
 - financial ratios
 - accounting measures
- Designed to predict financial distress, a bank panic or a financial crisis situation.
- They are devised to detect financial distress at an early stage and to assist their resolution in a timely manner to prevent a loss of confidence in the financial system.

Objective of EWS

- The objective of analyzing EWSs is to grasp what indicators are available and to what extent regulators can cite them to trigger regulatory action. By aggregating experts' opinion, guidelines on the threshold can be devised.

Prevention (cont'd)

EWS-Financial System-Wide

- Financial system-wide EWS endeavors to detect the fragility of the overall financial system.
- Financial system-wide EWS include:
 - *macroeconomic* approach (focusing on macroeconomic variables that reflect banking sector fragility and predicts a banking crisis),
 - the *bottom-up approach* (compiling financial performance ratios of individual banks into a macro ratio) and
 - an *aggregate model* (looking into aggregate statistics for a macroeconomic view).

EWS-Bank Specific

Individual Bank Examinations

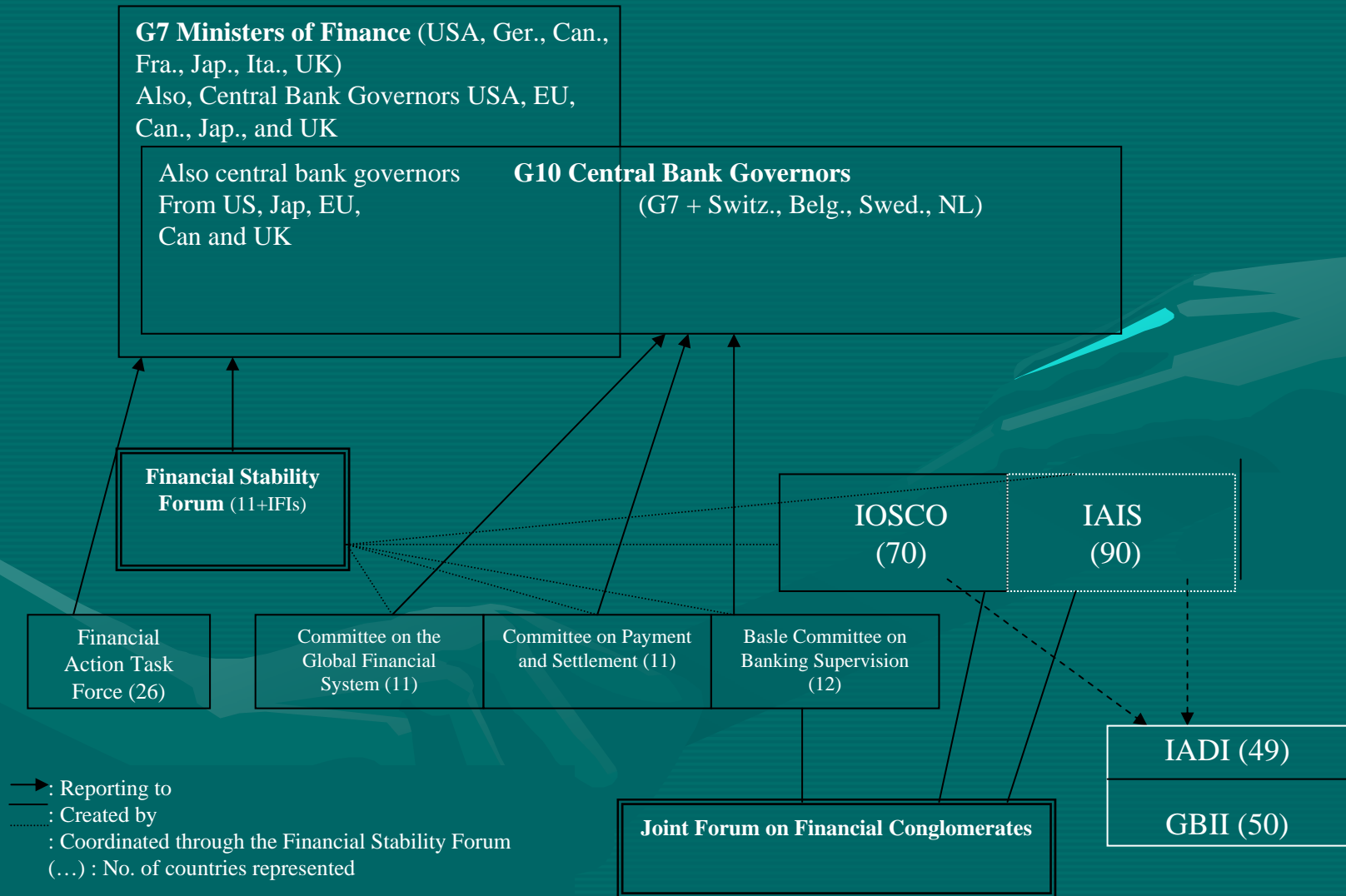
- examining the business and the performance of each individual bank. Through:
 - on-site examination: when a regulator enters the premise of a bank to conduct an examination (requires well trained, sufficient in number and sufficient in pay examiners)
 - off-site examination of banks: when a regulator either calls for financial reports from banks on a periodic basis or monitors the banks' market activities.
- Its aim is to evaluate the financial condition of each individual bank and not the financial system as a whole.
- When the regulator spots a problem in a bank through the bank specific EWS, it will take regulatory action against that specific bank. The EWS helps provide an objective threshold for this to take place.

C. A Further Prerequisite: Role of International Standard Setting and Ongoing Monitoring/Oversight

1. “Standard Setting” and “Standard Setters”

- FSF – International Standards Setting
- Basel Committee – Core Principles and Assessment Methodology
- IFIs – SAP, TA, FSAP and ROSC
- Peer Review – Regional and Sub regional- Critical but to date under-emphasized and under-appreciated

International System of Standard Setting



International Standard Setting for Banking Institutions

FSF - Standard Setters/Standards (Evolving or Set or Consolidating)

- IMF } transparency code in monetary & financial policies
} Code of good practices in fiscal transparency
SDS/GDDS
- WB Insolvency
- OECD Corporate Governance Principles
- IASB IAS
- IPAC ISA
- CPSS Core principles for payment and settlement
- *FATF 40 + 8 Recommendations – anti-money laundering and anti-terrorism
- BCBS Core Principles for effective banking supervision
- IOSCO Objectives and Principles of securities regulation
- IAIS Insurance Core Principles

Other Related Standard Setters/Standards

- IADI Guidance on Deposit Insurance Schemes
- WB/IMF Global Bank Insolvency Initiative (GBII)
- Should these become international standards/guidances; should they become consolidated (*e.g.*, under BCPs; or should they be treated as helpful international reports?).
- How should they fit into future assessment mechanisms (*e.g.*, FSAP and ROSC): directly or indirectly/informally?

2. Assessment

Financial Sector Assessment Program (FSAP)-

“Comprehensive health check-up of a country’s financial sector.”

- Origin: the 1990’s Crises
- The Geographic Scope of the Program
- The Beneficial Effects of the Program
 - To the Country
 - To the Bank and the Fund.

The Subject Matter of Assessment

- Financial Soundness Indicators
- Observance of Standards and Codes
- Broader Policy Framework Including Financial Safety Nets

ROSCs

- The Role of Standardization in Regulatory and Legal Reform.
- The Origin of the Bank/Fund Initiative
- The Relationship between the FSAP and ROSCs
- The Scope of the Initiative
- Implications for Depositors Protection.

3. Regional/Sub-Regional Components

- Basel “Satellite” Groupings of Bank Supervisors
“Liaison Group”
- EU Initiatives and its “Acquis” Programme
- Western Hemispheric Initiatives
- Asian Region (see Appendix C).

D. PCA: Determining the “Trigger Point”

Weak Bank (“moral suasion”)

Weak Bank (formal intervention)

Insolvent Bank (insolvency proceedings)

- A weak bank is one which “liquidity or solvency is or will be
- impaired unless there is a major improvement in its financial
- resources, risk profile, strategic business direction, risk management capabilities and/or quality of management

- - “Banking authorities may use “moral suasion” – “Jawboning” to persuade informally the bank’s management to take measures to correct its situation – Cooperative Phase.

- - If the management is unable or unwilling to solve the bank’s problems, the authorities may need to become more directly involved. In these cases, the actions of the authorities will normally be taken in the context of the various forms of insolvency proceedings. But, again, at which point?

“Trigger Point” (cont’d)

- Varies among countries (see Appendix B).
- Should be linked to EWSs.
- Might be several point and/or “sliding” points of formal intervention.
- Should not be strictly legalistic nor be based on unfettered discretion- a flexible “rule-oriented approach” (*e.g.*, Canadian Model of “viability”).
- Last and Final Stage (*i.e.*, “insolvency”)- ? how objective, ? About relation to bank regulators’ potential liability.
- Overall, should be “rule-oriented,” rooted within a transparent, “rule of law–based” administrative and judicial environment (with judicial review).

E. Lessons to be Derived

- Law and Legal Infrastructure are key components for an effective financial safety net and for underpinning financial stability.
- Before adopting an explicit deposit insurance scheme Government needs to begin seriously to address: serious weaknesses in such matters as transparency, accountability and deterrence.
- No one model fits all: policy and structural options. But, in all events, a sound DIS needs to be constructed in a manner to minimize the dangers of “moral hazard” and not become the functional equivalent of a blanket government guarantee or bailout.

Lessons to be Derived (cont'd)

- Specific Focus: banking regulation and supervision protection of property rights; enforceability of contracts; quality of accounting and disclosure; sound corporate governance; modern corporate insolvency (corporate and bank), and commercial laws; developed and open administration processes (with judicial review); and effective enforcement mechanisms; and well-trained and non-corrupt judiciary and “rule of law”-based judicial processes.
- Role of International Standard Setters/Standards essential; but role of Regional/sub-regional Arrangements (peer pressure & review) perhaps even more desirable in terms of long-term implementation and efficacy
- Neither an approach based on strict legalistic or unfettered discretion; but a “rule-oriented” matrix approach within a “rule of law” (non-politicized) environment.

Lessons Derived cont'd

- ⌋ In jurisdictions with a weak legal infrastructure environment, a poorly constructed deposit insurance scheme will tend to increase the probability of future banking crises.
- Special considerations exist as to timing of adoption of particular approach to be taken by a Developing Country – Question of staging/sequencing. Will vary according to a country's particular stage of development

F. Postscript: Note on the WB/IMF

Global Bank Insolvency Initiative (GBII)

(Presented in absence of scheduled speaker, Dr Ernesto Aguirre of World Bank. Based on June 2002 presentation of Dr Aguirre: see

http://www1.worldbank.org/finance/assets/images/Aguirre_global_bk_insolv_inet_ppt.pdf . Since then, in January 2004, the GBII was approved by WB and IMF Boards. Will be subject to further refinement over next 12-18 months)

1. Objectives and Scope of the Global Bank Insolvency Initiative
2. Work Program
3. Key legal, regulatory and institutional framework
4. Beyond the legal framework.

Global Bank Insolvency Initiative

Objectives:

1. To determine the appropriate institutional, legal and regulatory framework to deal with bank insolvency including in the context of systemic crises. (“the framework”).
2. To, progressively, create an international consensus regarding the framework including best practices and alternatives to deal with bank insolvency.
3. To design a methodology for the assessment of the countries’ institutional, legal and regulatory framework to deal with bank insolvency, and
4. To facilitate the provision of technical assistance to countries for the improvement of their “framework”.

Scope of the World Bank

IMF Initiative:

- Official action involving the removal of management and/or imposition of limits on, or suspension of, the rights of shareholders and the assumption of direct control by a banking authority or other officially-appointed person over a bank.

Participating Institutions

Coordination

- WB (leading institution)
 - IMF (main partner)
-

Participants (Countries)

- All countries through:
- Bank Supervisory Agency
 - Central Bank
 - Deposit Insurance Agency
-

Participants (International Institutions)

- BIS, FSI, BCBS
 - Regional Development Banks
-

Work Program

(2002-2003)

- 2 Global seminars (Basel, Washington)
- 5 Regional seminars (Uruguay, Poland, Malaysia, South Africa, Tunisia)
- Questionnaire and global data-base
- Internet web-site
- Core Consultative Group
- Final Report and supporting documents

Key Framework

Institutional aspects

- Who decides
 - Who implements
 - Need to avoid gaps and duplications of responsibilities
 - Eliminate uncertainty as to which authority is in charge
-

Legal protection and accountability

- Bank regulator/bank restructuring authority
 - Accountability to whom?
-

Principles and mechanisms for the use of public funds

- Least-cost solutions
- Transparency
- Fairness

Key Framework (cont'd)

Bank Intervention

- Clear rules for bank intervention
- Flexibility to carry out an intervention whenever the bank authority deems it necessary.

Entry Rules

- New foreign and domestic investors
- “Fit and proper” rules

Mechanisms for bank restructuring and resolution

- Mergers and acquisitions
 - “Purchase and assumption” transactions
 - Bridge banks
 - Good bank-bad bank
 - Other
-

Key Framework (cont'd)

Liquidation

- Deposit payoff
 - Asset resolution
 - Debt restructuring and recovery
-

Deposit insurance

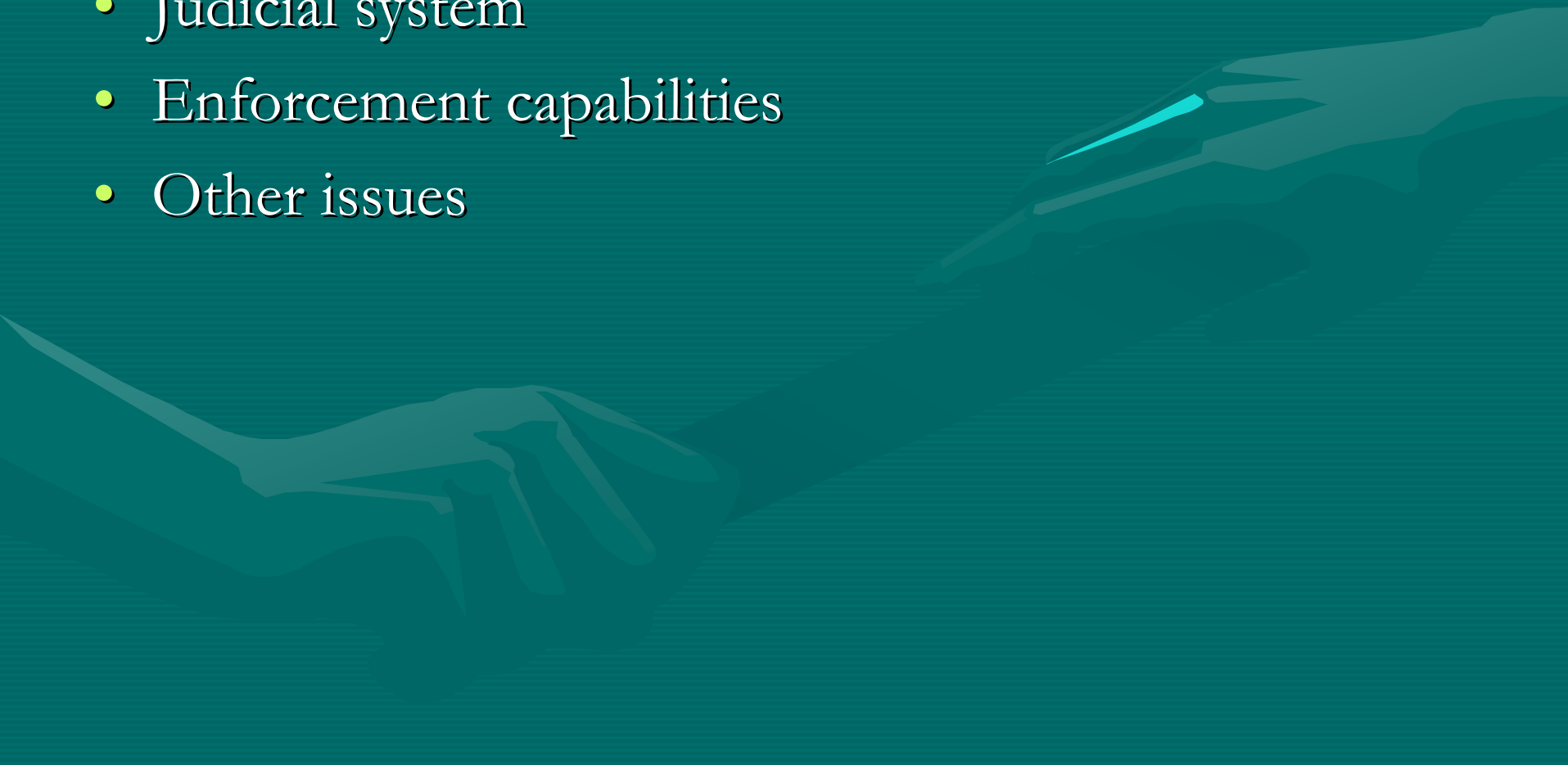
- Limited deposit insurance
 - Schemes to assist troubled institutions
 - Other
-

Systemic Crises

- A separate regime?
 - Regulatory forbearance
-

Beyond the Legal Framework

- Crises type 4
- Judicial system
- Enforcement capabilities
- Other issues



Appendix A

Bank Insolvencies/Banking Crises – 5 Country Examples

(derived from Dr. E Aguirre's GBII Study)

Country Examples-Mexico 1994

Was the intervention and resolution regime too weak?

- Long time required to intervene (resolve) large insolvent banks

Inadequate framework for the use of public funds

- Difficulties to allocate resources to recapitalize banks.

Deficient bankruptcy regime

- Problems to force defaulted debtors to repay their loans.
-

Country Examples-Thailand 1997

Lack of legal protection for bank authorities

- Authorities afraid of intervening banks or take prompt corrective measures to prevent problems from growing.
-

Lack of explicit deposit insurance

- Were they a factor to decide the adoption of a blanket guarantee covering all deposits in the system? Was the above decision timely? Relation between the adoption of the blanket guarantee and the costs associated with the crisis resolution.
-

Weak legal regime for the intervention /resolution of financial institutions.

Deficient bankruptcy regime

- Problems to force debtors to repay or renegotiate their loans.
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Appendix A (cont'd)

Country Examples-Korea 1997

Excessive constraints to entry of foreign investors

- Delays to sell large intervened banks

Fragmented financial sector legislation

- Authorities dealt rapidly with banks' problems, but failed to recognize and rapidly solve problems of other non-bank financial institutions.

Deficient bankruptcy regime

- Problems to force defaulted debtors to repay their loans.
-

Country Examples-Ecuador 1998

Lack of legal protection to bank authorities

- Authorities afraid to intervene banks or take appropriate corrective measures before a bank collapses.

Weak institutional arrangements

- High Turnover of senior government officials.
- Main decisions revoked by courts or the legislative.

Deficient bankruptcy regime

- Problems to force defaulted debtors to repay their loans or restructure their debts..
-

Turkey 1999

Adequate legal framework but not sufficient

1999

New Banking Law

- Allowed rapid intervention of small and medium insolvent banks

But fiscal problems prevented

- Rapid resolution of insolvent banks.

Once the funding was resolved

- Resolution of insolvent banks proceeded adequately.
-

Appendix B

Comparative Country Examples Of Intervention Rules

- **Australia:** Under Article 11 C A of the Banking Act, if the Australian Prudential Regulation Authority (APRA) finds that a bank has become, or is likely to become unable to meet its obligations or suspend payments, APRA **may** investigate the affairs of a bank, appoint a person to do so, take control of the bank's business, or appoint a "statutory manager" or administrator who exercises complete control over the bank's business.
- **Brazil:** Under Decree-Law 2321, the central bank, as the supervisory authority, **may decide** to impose temporary administration of financial institutions in case of repeated violations of the law, insolvency ("existence of uncovered liabilities"), non-compliance with the mandatory reserve requirements, negligent or fraudulent management, insolvency when rehabilitation may still be possible, or when losses are suffered as a result of bad management. Temporary administration shall immediately cancel the powers of the existing management. However under Law 6024, Article 2, financial institutions **will be intervened** when according to the Central Bank bad management has led to losses, exposing the creditors to risk, when repeated infractions of the law and regulations have occurred, and when there is scope for the rehabilitation of an insolvent institution.
- **Bulgaria:** Under Article 65 of the Banking Law, the supervisory agency (central bank) **may appoint a conservator** .
- **Canada:** Under Article 39 (1) of the Canadian Deposit Insurance Corporation Act, if the superintendent of banks **is of the opinion** that a bank has ceased or is about to cease to be **viable and viability cannot be restored**, the superintendent **reports** to the CDIC, which **may request** to vest the bank's shares with the CDIC or place the bank under receivership.

Appendix B (cont'd)

•**Chile:** In case of repeated infractions and any serious indication of financial instability, the supervisor **has the right to appoint a delegate inspector** who has the power to suspend decisions of the Board of Directors. He also has the **option to appoint a provisional administrator with prior consent of the Central Bank**. If the bank ceases payment of an obligation, the supervisor **shall determine** whether the institution is still solvent and if not **shall take the measures provided for in the law**. Solvency problems are presumed by law when basic capital is less than 2 percent of total net assets.

•**Czech Republic:** If measures are not taken by a bank to correct specific deficiencies, including undercapitalization, **one of a range of actions shall be applied**, which **may include** imposition of **conservatorship**. Action is mandatory when capital falls below $\frac{2}{3}$ of the required minimum, although the law does not specify which type of action should be taken.

•**Germany:** if managers of the bank have been suspended, the supervisor **may request** the Court to appoint persons to manage the bank.

Indonesia: Under Article 2/11/PBI/2000, the supervisor **shall place a bank under special surveillance** if the capital of the bank falls below the required minimum, non-performing loans rise above 35 percent of total credit, loans in excess of the lending limit have not been brought back to compliance, or mandatory reserves stand at less than 5 percent, and have been on a rapid decline.

The Netherlands: If a bank shows signs of a dangerous development and no improvement of that development is to be expected, the supervisor **may petition the Court** to declare that special measures are required in the interests of creditors and depositors. When granting the petition, the Court shall appoint one or more receivers who shall exercise all powers of the governance bodies of the bank.

Appendix B (cont'd)

- Peru:** Under Articles 95, 103, 104-113 of the Banking Law, the superintendent **shall subject banks to the surveillance** procedure when (i.e.) the bank is insufficiently capitalized. The bank is then obliged to submit a recovery plan. If the recovery plan is not complied with, or the bank has suspended payment of its obligations, has incurred credit risk exceeding 25 x its own funds, or has lost 50 percent of its equity, it **shall be intervened**.
- Philippines:** Under Article 29 of the Central Bank Act, when the supervisor finds that a bank is in state of continuing inability or unwillingness to maintain the liquidity deemed adequate to protect the interests of depositors and creditors, it **may appoint a conservator**, who shall have such powers as considered necessary, and who reports to the Monetary Board.
- Slovenia:** Under Articles 131 and 132 of the Banking Law, the supervisor shall issue an order if a bank becomes undercapitalized or is in violation in other ways. The supervisors **shall impose special administration** if a bank has not started to implement a corrective order.
- South Africa:** When the supervisor is of the opinion that a bank will be unable to, or probably will be unable to repay deposits or meet any other obligation, **the Minister may**, if desirable in the public interest, and with the written consent of the CEO of the bank, **appoint a curator** to manage the bank subject to the supervisor's instructions.
- Uruguay:** Under Article 20 of the Financial Intermediation Act, **administrative control may be imposed**, for instance in cases of poor performance of management duties.
- USA:** Article 38 of the Federal Deposit Insurance Act requires banks that have capital lower than the minimum to submit an “acceptable” recapitalization plan. When Tier 1 capital sinks below 3 percent, the FDIC **must take action, out of a broad range of possible actions**. If the bank is “critically undercapitalized (equal to or less than 2 percent), the bank shall cease payment of principal or interest on subordinated debt, be placed under receivership, or be restricted in other activities.

Appendix C – Snapshot of Asian Regional Cooperation

Historical background of Asian Regional Cooperation

- Little regional integration efforts taking place prior to 1997
- Historical suspicion towards Japan and China
- Japanese economic growth & Asian economic growth
- 1997 Asian Financial Crises: demand for a regional solution to financial instability.

Institutionalisation in Asia

- Asian Development Bank
- APEC (Asia-Pacific Economic Cooperation)
- ASEAN (Association of South East Asian Nations)
- EMEAP (Executives' Meeting of East Asian and Pacific Central Banks)
- Bank for International Settlements Asia
- Proposal for a “Regional Stability Fund”
- Liason Groups with EU, Latin America, Western Hemisphere etc.

Appendix C (Cont'd)

Significant Regional Integration Efforts Since 1998

- Political economy considerations
- Chiang Mai Initiative (ASEAN economic integration and financial services)
- An expanded ASEAN swap arrangement that would include all ASEAN countries and a network of bilateral swap and repurchases agreement facilities among ASEAN countries, China, Japan and Korea.
- Use of the ASEAN+3 framework to promote the exchange of consistent and timely data and information on capital flows.
- Establishment of a regional financing arrangement to supplement existing international facilities.
- Establishment of an appropriate mechanism (early warning system) that could enhance the ability to provide sufficient and timely financial stability in the East Asian region.

Appendix C (Cont'd)

Some Considerations Towards Future Asian Regional Cooperation

- Asian Bond Fund
- Institutional Competition as the Seat of a Regional Financial Institution
- ASEAN protocols to implement financial services integration commitments under Chiang Mai Institute.