

Visioning on Deposit Insurance*

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Today marks the 10th anniversary of KDIC. 10 years may not be seen as a sufficiently long time to gather great wisdom and experiences. But, it is not the number of years that matter. The real test of an organisation is how it conducts itself during times of turbulence. KDIC, which was established just ahead of the eruption of the Asian financial crisis, has successfully weathered one of the most challenging decades in recent times. Indeed, it has come out stronger from that experience. This is only possible when an organisation has in place, sound infrastructure which includes robust governance processes and good work values. KDIC and the people of South Korea have all these and more.

Hence, today is a very significant event for KDIC. It is a celebration of KDIC's achievements and the achievements of the people of South Korea, which has weathered the financial crisis. As Chair of IADI and on behalf of IADI, I congratulate the KDIC for its strong and decisive management throughout this period, in particular, during and after the Asian financial crisis. Its leadership during the financial crisis reflects the solid calibre of KDIC's management and its people.

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Differential premium system

As Chair of the International Association of Deposit Insurers or IADI, in short, I am very pleased to note that KDIC is working towards structuring an appropriate differential premium system and building a target reserve fund. This initiative is aligned with the recommendations of the Financial Stability Forum (“FSF”) as embodied in its Report on “Guidance for Developing Effective Deposit Insurance Systems”. The establishment of a target reserve fund builds public confidence and credibility in the deposit insurer’s readiness in fulfilling its mandate. In this regard, the FSF Report recommends that risk-adjusted differential premium systems (DPS) be adopted to encourage more prudent risk management practices at member banks as premiums assessed on each member bank are directly correlated to the risks that the member bank pose to the deposit insurer.

Development of a risk adjusted DPS is one of the more important initiatives for IADI members as we constantly seek to improve processes and management tools to meet our respective mandates in an efficient and effective manner. A well-designed DPS will provide incentives for banks to avoid excessive risk taking and introduce more fairness into the premium assessment process. Differential Premium Systems are most effective in achieving these objectives when they provide good incentives for banks to manage their risks and when they are accompanied by effective early warning systems and prompt corrective supervisory action to deal with problem banks.

To my knowledge, globally only 15 deposit insurers have DPS and these include the Canada Deposit Insurance Corporation, the Federal Deposit Insurance

Corporation and the Central Deposit Insurance Corporation of Taiwan. Given the importance of an effective DPS in contributing to a stronger financial system, IADI issued a research paper to provide general guidance to our members. The paper entitled “General Guidance for Developing Differential Premium Systems” was issued in February 2005. KDIC was a member of the Subcommittee for the research work leading to the publication of this paper. As a pro-active deposit insurer dedicated to high governance standards, KDIC is moving in the right direction and providing leadership to the rest of the region.

MDIC’s vision

As the Chief Executive Officer of the Malaysia Deposit Insurance Corporation, allow me to share MDIC’s vision for the near future. MDIC will also be implementing a DPS in the near future. Although MDIC was established only in late 2005, we have committed to our stakeholders to implement a DPS in 2008 as this is one of several initiatives to promote incentives for sound risk management of banks. In designing the system, MIDC will be adopting a consultative approach where we will set up a Task Force that will comprise representatives from the Central Bank, member institutions and MDIC. We have already started the public awareness process on the DPS. We are on track with its development and we look forward to share our thoughts and experiences with the KDIC on this very important matter.

Domestic vision

On the domestic front, MDIC has, since its incorporation, been busy putting in place its organizational and governance structure. Our focus is to build a world-

class deposit insurer over the next few years. To achieve this, MIDC will be implementing several initiatives aimed at further strengthening our governance infrastructure. In this regard, we have implemented several very high level policies. At the board level, we have implemented a board governance policy and job descriptions of the Board of Directors, individual directors, the Chairman of the board of directors and that of the Chief Executive Officer. We shall be developing a job profile, which identifies the desired skills set for our board of directors. This desired profile will be used to benchmark future board appointments and also succession planning at the board level.

International vision

On the international front, MDIC will be working closely with IADI to establish a Standing Committee for researching Islamic deposit insurance issues. Islamic banking is one of the youngest and fastest growing branches of the world's financial services. I should note that Islamic banking is not that young as is generally perceived. The first Islamic bank was established in 1975 and over the last decade, Islamic banking has enjoyed significant growth and gained a significant niche in many countries. According to the IMF, there are more than 300 Islamic financial institutions in 75 countries around the world. The Islamic banks and Islamic window banks managed more than USD400 billion assets with annual growth of 15% per annum.

In the wake of its growing importance, many regulatory issues are being reviewed, including the compatibility of regulatory approaches between Islamic and conventional banking. Concrete steps are already taken to streamline initiatives

in this area. Of key importance was the establishment of the Islamic Financial Services Board (IFSB) in 2002 in Kuala Lumpur. The IFSB plays a role similar to other international regulatory agencies, such as the BIS. The IFSB is the international standard setting body for regulatory and supervisory Islamic agencies. IFSB's mandate is to develop prudential, regulatory and disclosure standards for Islamic finance, and promote uniformity in best practices on the governance of Islamic financial institutions worldwide. Recently, IFSB issued two prudential standards on risk management and capital adequacy for institutions offering Islamic financial services, which are recommended for implementation in 2007. The IFSB is currently developing three other standards. These are on corporate governance, supervisory review and transparency, and market discipline to be released in due course.

In Malaysia, the Islamic financial system today has emerged as an important component of the overall Malaysian financial system that contributes to the growth and development of the Malaysia economy. The assets of the Islamic banking industry have been growing at an average of 18% per annum. As at 31 March 2006, Islamic banking assets accounted for a market share of 11.2% of total banking assets, while total Islamic deposits and financing accounted for 11.5% and 12.0% respectively.

In MDIC, we have a unique feature in that MDIC provides deposit insurance coverage for both conventional and Islamic deposits - side by side and equitably for depositors of both systems. MDIC manages 2 deposit insurance funds. We are able to do this as the Islamic premiums collected are kept separate and distinct

from the conventional premiums. In relation to the Islamic deposit insurance fund, all investments and payouts in respect of Islamic premiums are managed according to Shariah principles.

With the rising prominence of the Islamic banking sector, there is growing awareness on the need to provide deposit coverage for the Islamic banking sector. Globally, other deposit insurers with Islamic banking systems are already looking at developing Islamic deposit insurance so as to provide equitable treatment for Islamic depositors and to provide financial stability for Islamic depositors. The challenges for Islamic deposit coverage are different from the conventional norm. For example, where conventional deposit-taking is subject to a debtor-creditor relationship, Islamic deposit-taking is premised on various Shariah concepts, such as “mudharabah”. Under mudharabah, deposits are accepted on a joint risk-taking basis where the bank and depositor agree to share profits and loss that may arise from investment of the deposits.

Committee on Islamic deposit insurance

In the light of global developments and the complexities of Islamic banking, IADI has approved in principle, the establishment of a Standing Committee on Islamic Deposit Insurance. This committee will identify issues and challenges affecting Islamic deposits with the objective to develop guidance materials for deposit insurers providing or looking to provide deposit coverage for Islamic deposits. With the establishment of the Islamic Deposit Committee, the IADI will join the ranks of other international agencies, such as the IFSB and the IMF that have undertaken initiatives regarding the Islamic financial industry.

As the President of IADI, let me share my perspective on the initiatives that IADI will address in the near future. IADI's mandate is to share deposit insurance expertise with the world. We do this through the enhancement of deposit insurance effectiveness and efficiency by promoting guidance and international cooperation. This is achieved through global dialogue, training and development of guidance materials to improve the effectiveness of deposit insurers.

IADI's focus over the last few years in building a cadre of efficient and effective deposit insurers is part of a high level vision of protecting the public interest. In the near to medium term, the key areas of our focus will be in two areas - building good governance and enhancing risk management capacity of our members.

For deposit insurers, governance is important from two perspectives. First, it is to build good governance within the internal fabric of deposit insurers so as to build their credibility and, second, to provide the high moral grounds for deposit insurers to build good governance amongst the banks they insure. Viewed from a broad perspective, good governance in deposit insurers contributes to the establishment of an enabling climate for national economic performance. There is a causal link between governance and economic performance. Good governance builds institutional credibility. Credibility builds depositor confidence. Confidence builds stability in the financial system, which in turn promotes economic growth. Therefore, good governance is important more for deposit insurers in view of the financial stewardship role of deposit insurers over large sums of premiums collected.

Risk management is also a key element of corporate governance. Moving forward, I will be proposing to my IADI colleagues to put in place training programmes that will enable our members to proactively manage risks in an integrated and comprehensive manner, under a process commonly known as Enterprise Risk Management or ERM in short. ERM represents a comprehensive approach to the way an organisation approaches risk. ERM's underlying premise is that every organisation faces risks in its business environment and the challenge is to determine the degree of risk to accept. For deposit insurers, they will benefit from the ERM program by being able to identify, quantify and prioritise significant insurance and other business risks, through a process, which uses strategy setting to identify potential events that will affect the organisation and also incorporates risk strategies consistent with the mandate of the deposit insurer.