Zeti Akhtar Aziz: Deposit insurance and consumer protection

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the "Deposit Insurance and Consumer Protection" 6th International Association of Deposit Insurers (IADI) Annual Conference, Kuala Lumpur, 31 October 2007.

* * *

Introduction

As the international and domestic financial landscape continues to transform, the quest to secure financial stability has become increasingly challenging. Regardless of the stage of development, financial systems have continued to be vulnerable to crisis that have resulted in financial disruptions that have had severe economic repercussions. In these circumstances regulators and financial safety net frameworks have been tested to the limit.

While the rapid pace of globalisation, the rising internationalisation of the financial system and the advances in technology have brought benefits in terms of increased access to new markets, encouraging financial innovation and increasing consumer choice, it has also brought new risks to the financial system. The intensification of cross-border financing, and the growing complexity of financial structures has resulted in new international inter-linkages which has increased the international interdependence. The transmission of negative shocks in one country to others via the international financial system has demonstrated the potential for financial crises and economic disruptions to spread on a global scale. These concerns have been brought into the forefront recently with the developments in the sub-prime mortgage market in the United States and its contagion effect on financial systems in other parts of the world. Indeed, it has shown that in today's globalised and increasingly internationally integrated financial markets, seemingly isolated events in a small segment in one market can have far reaching and vastly magnified implications in other financial markets across the world.

This recent episode of financial turmoil has shown that even the more sophisticated and informed investors are pre-disposed to over-react to uncertainties in financial institutions. It also needs to be recognised that the changes in the international environment has also increased the challenges to understanding and managing risks, even for financial institutions and the authorities. These developments have also brought issues of the effectiveness of financial safety nets as well as institutional arrangements for the regulation and supervision of banks, to the forefront.

Elements of financial safety net

It is in this context that the components of the financial safety net, the prudential regulation and supervision, deposit insurance, liquidity support arrangements, crisis management approaches and the consumer protection framework – have continued to evolve over the recent decade. My remarks this morning will consider some of the developments and challenges that are shaping the calibration of the financial safety net in the current environment.

Prudential regulation and supervision

Sound risk management by banking institutions, which is reinforced by prudential regulation and supervision, remains the first line of defence against financial crisis. This recent decade has seen important strides being achieved at both the international and national levels towards strengthening the prudential regulatory and supervisory frameworks in response to the changing nature and scope of banking activities.

While lending and deposit-taking remain the mainstay of commercial banking, the profile of credit markets has changed significantly. Today, conventional credit products are being offered alongside the growing significance of asset securitisation and credit derivative activities. This has had a profound impact on the nature of banking. The rapid development of these synthetic credit markets, coupled with an extended period of ample liquidity in the global financial system, has expanded the avenues for banks to engage in more aggressive lending practices that are funded by borrowing from the wholesale money markets, and by repackaging and selling loans to other investors in the form of asset-backed securities. This represents a significant shift from the more traditional banking models where loans are predominantly funded by deposits.

The increasing complexity in the way that debt is created and distributed in the financial system raises important implications for financial stability. The “originate and distribute” strategy that has been adopted by some institutions warrants addressing more comprehensively the full range of risks to which the banks are exposed. This includes the liquidity, foreign exchange and moral hazard risks in banking institutions. Credit risk exposures have also taken on more complicated forms, including counterparty risks on derivatives and foreign exchange transactions. The valuation of such financial transactions and instruments are also often difficult to measure particularly under distressed market conditions. In addition, the correlations between credit and market risk, both within and across national borders, have become more complex. Of concern has also been lack of adequate information on debt concentrations in the system partly due to the increasingly elaborate ways in which debt is passed on from originating institutions to different investors. The propensity to under-price credit risk, especially under conditions of excess liquidity, has also increased concerns over underwriting standards. The consequent sharp pricing corrections would in turn have the potential to result in broader economic disruptions.

Recent developments in the prudential regulatory and supervisory framework have, and will continue to play an important role in promoting sound risk management practices in the light of these changes. These of course, include the modification of capital standards that are more granular in addressing different types of risk. Supervisory approaches globally have also evolved to place a greater emphasis on sound risk management and early interventions to address emerging risks before they become major problems. There is also more emphasis being placed on the expectations of financial institutions to play a greater role in ensuring that financial products offered to customers and investors are suitable given their needs and financial circumstances, and that they have a good understanding of risks assumed with the products.

Bank Negara Malaysia's approach to the financial regulation and supervision has similarly evolved to achieve a more robust regime that emphasises three key dimensions: first, creating a strong risk management culture that overlays the operations of banking institutions; second, facilitating market-led adjustments that will allow the industry to evolve in response to market and technological; and third, ensuring mutually consistent prudential policies across the financial sector.

Underpinning this approach has been a more pronounced shift towards principle-based regulations. Increasingly, regulations have focused less on prescriptive rules, and more on establishing broad parameters for sound financial and business practices that leave substantial flexibility for banks to apply the principles in the manner most appropriate to their specific circumstances. Of importance, has been the creation of appropriate incentives within the system to counteract potential market distortions that could undermine financial stability. The differentiated regulatory framework under which stronger banking institutions would have substantially greater operating flexibility and a lower level of supervisory intervention, for example, provides a powerful competitive incentive for the adoption of sound risk management practices.

While enhanced bank regulatory and supervisory functions have had a direct and significant impact on improved risk management by banking institutions, the primary responsibility for sound institutional risk management will continue to rest with the boards and senior management of banks. It is the boards, and not supervisors, that are principally responsible for the performance of banks and for their financial strength. Boards set the tone for their institutions' risk taking activities, and provide effective oversight to ensure that their decisions are followed. Of paramount importance is the need for boards to ensure that risks are estimated in a consistent and timely manner, and escalated to the board with attention being focussed on the management of the emerging risks.

Today, boards face additional challenges of discharging these responsibilities in an environment that is rapidly changing and highly competitive. Achieving effective boards and strengthening the foundations of sound corporate governance have therefore become a priority in the reform agenda for many countries in the recent period. The implementation of Basel II, new financial reporting standards and principles-based regulatory approaches have also significantly increased the importance of, and reliance on sound judgement, integrity and competence by the board and senior management. This, in turn has been a key driver in galvanising efforts to strengthen market discipline as a countervailing influence that will rein in high risk behaviour by banking institutions.

Achieving a framework with the right mix of regulatory and market-based incentives, however, continues to remain a significant challenge. Transitioning to market-based discipline can be particularly challenging in emerging markets where regulation has tended to be more prescriptive. In these markets, safety nets are also more prevalent and the tolerance for institutional failures is lower given its far reaching implications on consumer confidence. For the most part, the liabilities of banks are not traded in the market, so debtholders generally lack the opportunity to exercise market discipline. Moreover, the market preoccupation with short-term stock price, rather than long-term creditworthiness also presents potential risks to financial stability.

Notwithstanding these challenges, several recent positive developments in emerging economies have augured well for market discipline to have a more effective role in reinforcing sound governance. In particular, the development of financial markets have resulted in more efficient markets with wide options for investors to exert discipline. The adoption of international financial reporting standards, efforts to strengthen auditor independence as well as financial capability initiatives will also reinforce market-based discipline going forward.

All of these initiatives will improve the prospects for financial stability by preventing problems from occurring at the level of individual institutions. However, the recent events in the international financial environment have demonstrated the increasing complexity of banking activities which has raised the broader challenges for financial regulation and the design of safety nets in the context of managing systemic risk. Regulators have begun to carefully consider the need to re-calibrate current regulatory approaches to appropriately address risks to the financial system stemming from large and complex institutions that are increasingly engaged in non-traditional activities. This has, in turn, placed new demands on financial regulators as well as for institutions to develop a deeper understanding of the inter-linkages between the financial system and the economy, and in particular, the macro-economic transmission of financial risk. Going forward, a more optimal balance of micro (that is, at the institution level) and macro (that is, affecting broader economy) responses will become increasingly important in the management of such systemic risks.

An important dimension to effectively manage the increasing inter-linkages between the financial system and the economy involves the strengthening of cooperative arrangements between Central Banks and other regulatory authorities, within and across borders. Indeed, cooperation, coordination and goodwill have become essential in the increasingly integrated system. Such arrangements could include the more formal institutional arrangements for cooperation in surveillance efforts and crisis management, as well as the home-host arrangements for the supervision of international financial institutions, in supporting the early identification of risks and the pre-emptive interventions that need to be made. Cross border surveillance in the Asian region in particular has now been enhanced to ensure that information gaps are identified and that the mechanisms to facilitate information sharing are put in place.

Achieving effective inter-agency coordination between financial safety net participants also needs to be considered carefully in the context of crisis management. Inevitably, the task of managing a financial crisis particularly in the areas of timely decision making, coordination and communication become much more complex when the functions of lender of last resort, bank supervision and deposit insurance are allocated to separate agencies, as each respective agency is accountable for discharging its own mandate having regard to its own inherent priorities. Consequently, issues relating to information sharing, allocation of powers, responsibilities, accountability and coordination among the various agencies must be clearly and explicitly addressed at the outset. The legislative mandates would need to provide clear roles and responsibilities for each relevant authority. This will form the foundation for the adoption of an integrated and coordinated approach. The need for such coordinated action becomes particularly important in conditions of an imminent financial crisis. Having in place a crisis management framework would allow for its prompt and effective implementation. The issues relating to the effective management of the inter-relationships between the safety net participants were brought to the forefront recently in the United Kingdom, testing the framework in which the functions of lender of the last resort and the supervisory function are placed in separate entities.

In comparison, when a single agent such as the central bank is entrusted with these respective functions, the interrelationship issue, as well as potential conflicts and trade-offs become internal and would be resolved across the organisation. It would nevertheless still need to rely on an adequate accountability regime among the respective departments or divisions that are responsible for each mandate.

Malaysia's own experience during the Asian financial crisis exactly ten years ago allowed the Central Bank as a single regulator, to promptly respond to the liquidity and solvency issues that were confronting the financial system. The preemptive action that was supported by a comprehensive resolution programme significantly reduced the cost of the crisis on the financial system and the overall economy.

More recently, the Central banks in the East Asian region have come together to put in place a comprehensive regional surveillance system that is supported by a comprehensive integrated crisis management framework that would deal with any imminent financial crisis in the region. These initiatives are aimed at effectively preventing or containing developments that could trigger destabilising consequences, thereby promoting regional financial stability.

Deposit insurance system

Ladies and Gentlemen:

Following the restructuring and reform of our financial system, Malaysia has two years ago implemented the deposit insurance system as part of our efforts to build a cohesive and mutually reinforcing financial safety net system. The deposit insurance system has an important role not just in promoting confidence with explicit coverage of deposits, but also in reinforcing sound risk management practices. It therefore has embed features that complements the supervisory process in promoting sound risk management practices in the financial institutions. In addition, the deposit insurance corporation in Malaysia is also mandated with the responsibility for the “least-cost” resolution of problem financial institutions.

A comprehensive approach was thus adopted in establishing the Malaysia Deposit Insurance Corporation (MDIC). To promote depositors confidence, the deposit insurance scheme was designed to ensure that there was optimum coverage with sufficient reach to retail depositors. In designing the deposit insurance scheme, about 95% of all depositors are covered in full while in value terms about 35% of total deposits is covered. An important element in the framework is the strong collaboration between the supervisor and deposit insurer in promoting discipline in the banking system. As the supervisor, recognition is given to sound risk management practices demonstrated by banking institutions to have greater business flexibility, while the deposit insurer, through a differential premium system, provides incentives for financial institutions to adopt sound financial and business practices.

In adopting this framework, clear accountabilities have been critical in ensuring that there is no duplication in efforts so that the banks would not be over burdened by overlapping regulation and submission requirements. There was also a need to ensure close co-operation and collaboration between the supervisor and the deposit insurer to ensure the intervention and resolution actions instituted by the deposit insurer, would not be to the detriment of the system as a whole. These resolution powers would be invoked by the deposit insurer following notification by the Central Bank that a member institution was likely to cease to be viable.

It is in this context, the strategic alliance between the Central Bank and the deposit insurer was formed as a basis for cooperation to ensure the safety and soundness of the financial system. In Malaysia, Bank Negara Malaysia is mandated with the responsibility of safeguarding and ensuring the stability of the financial system. The overall supervision of the financial institutions remains within the functions of Bank Negara Malaysia. The Strategic Alliance Agreement with the Deposit Insurer provides for a structured collaboration between the Bank and MDIC to share information on key issues and developments to facilitate the operations of MDIC.

Both formal and informal information exchange mechanisms have been put in place to facilitate timely data and information exchange that can be leveraged upon to support and enable MDIC to fulfil its mandated role. This has proven to be effective in minimising duplication of efforts. These information exchanges include cooperation and consultations on supervisory and prudential regulations where both agencies are involved from the early planning stage, particularly in circumstances in which the initiatives impact the functions of the respective institutions.

Consumer protection framework

To complement the deposit insurance system, Bank Negara Malaysia has also put in place a comprehensive consumer protection framework that covers financial education, fair treatment of consumers, avenues for redress, distress management and rehabilitation as well as advisory services. These include having in place the Financial Mediation Bureau to ensure that consumers of financial services that are under the purview of the Central Bank have recourse to a fair and impartial dispute resolution mechanism. The establishment of the Credit Counselling and Debt Management Agency provides individuals with credit counselling and assistance in restructuring of debts; and the establishment of the Bank Negara Malaysia LINK and BNMTELELINK forms an integrated customer service centre for members of the public and small and medium sized enterprise on matters relating to services provided in the financial sector. This has evolved a high rate of participation in the financial system with deposits now accounting for 160% of GDP. This has allowed for the efficient functioning of the intermediation process to effectively mobilise and channel savings to productive activity thereby supporting the overall growth and development process.

Conclusion

Ladies and gentlemen

Essential to a progressive financial system is prudential safety and soundness, competition and consumer protection which needs to co-exist to effectively serve the interests of various stakeholders. As regulators we need to adopt the right balance between providing adequate protection for consumers while promoting competition and financial innovation in the financial system. But it is the combined efforts of regulators, the industry, and consumers that ultimately maintain market confidence and ensures the effective and efficient functioning of the financial system. The recognition of, and commitment to this shared responsibility will not only contribute to the evolution of the financial landscape and preserving financial stability, but will enhance its overall contribution to the overall functioning of the economy and securing its full potential.