Subir Gokarn: Financial development and deposit insurance – some linkages

Remarks by Dr Subir Gokarn, Deputy Governor of the Reserve Bank of India and Chairperson, Deposit Insurance and Credit Guarantee Corporation (DICGC), at the 8th Asian Regional Committee and International Conference of International Associations, Goa, 18 January 2010.

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Introduction

Governor, Reserve Bank of India, Dr. D. Subbarao; Deputy Governor, Reserve Bank of India, Ms. Usha Thorat; President, IADI and Vice-Chairman, FDIC, Mr. Martin Gruenberg; Chairman, ARC and Deputy Governor, DICJ, Mr. Mutsuo Hatano; CEO of the Deposit Insurance and Credit Guarantee Corporation, Mr. H. N. Prasad; Distinguished Participants;

Let me add my own words of welcome to all the participants in this very important event. In his opening address, Governor Subbarao provided a historical perspective on the development of deposit insurance in India, highlighted its importance in sustaining confidence in the banking system as we dealt with the global financial crisis and laid out the challenges that it will have to deal with in the future. I would obviously not like to cover the same ground. Also, I must admit to being a complete novice as far as deposit insurance is concerned, having only taken on the role of Chairperson of Deposit Insurance and Credit Guarantee Corporation (DICGC) in late November 2009, when I joined the Reserve Bank of India as Deputy Governor. Consequently, I thought it would be more appropriate and useful for me to talk about a broad vision for financial sector development, which will then provide a framework within which to view the evolving role of deposit insurance.

The recent crisis is clearly a dominant factor in any current discussion on financial sector development. While this is entirely understandable and legitimate, we must resist the temptation to view the future entirely through the lens of the crisis. Crises will come and go, but the role that the financial sector as a whole plays in economic development and welfare will be fulfilled only if we allow it to find a healthy balance between multiple and sometimes potentially conflicting objectives. Taken together, these objectives provide an enduring way to view financial sector development, which combines both traditional functions and incorporates new goals that are driven by both domestic and global aspirations and compulsions.

A framework for financial development

I will now lay out a framework for financial sector development, which encompasses five critical objectives. These five objectives are: Efficiency, Stability, Transparency, Inclusion and Sustainability.

Efficiency

No one would seriously question the premise that a financial system, whatever its structure might be, will best serve development and welfare objectives by producing its services at as low a cost as possible. Like in any productive activity, achieving this objective depends on three broad factors: the cost of raising funds, the costs of due diligence and risk mitigation associated with deploying these funds and the cost of intermediation, which depends significantly on competition, organizational structure and the deployment of technology. The policy and regulatory imperatives on this front should be to ensure that financial service providers have the ability to carry out their resource mobilization and deployment activities in a competitive environment, in which individual providers have the flexibility to organize themselves in the most cost-effective manner. However, this is as far as the analogy with other productive activities goes. As we all know and was vividly demonstrated during the crisis, financial services are in many significant ways a unique specimen, which requires special consideration. This brings me to the next objective.

Stability

We could also term this objective "prudence", but I believe that stability, while fully encompassing prudence, is a somewhat broader concept. The foundation of this objective is, of course, risk. Financial services, however defined, are essentially risky in nature. There would be little value added by financial intermediaries if they did not find ways of taking on risks and earning the rewards that go with them. However, the license to take risks cannot be unbounded; the consequences of risks materializing can be severe for both direct stakeholders and, significantly, innocent bystanders. A prudential approach ensures that individual financial service providers put aside adequate resources to avoid such consequences. A wider approach to stability is based on the notion that the system as a whole has the capacity to deal with widespread pressures that emanate from the multiple linkages and inter-dependencies within the system and are beyond the prudential capacity of individual providers to handle.

The recent crisis and ones preceding it have clearly shown that the stability of the financial system is a significant contributor to macroeconomic management. It has, of course, been difficult to translate this into a widely accepted policy framework, because so many potential instruments of stability are in direct and obvious conflict with the other four objectives that I referred to. But, clearly, however efficient and dynamic it may be, an unstable financial system can seriously undermine the performance of the real economy and a viable way to resolve these conflicts needs to be found.

Transparency

An important lesson from the crisis was "what cannot be measured cannot be managed". Diagnoses of the causes of the crisis generally suggest that neither regulators nor top managements of large, global financial institutions had a complete picture of the product offerings and portfolio choices that ultimately led to the catastrophe. Of course, transparency has always been a central pillar of financial regulation, but clearly, the conventional notion simply did not address many new developments in financial activity. Global initiatives to achieve some degree of regulatory co-ordination in the wake of the crisis emphasize the need for a greater degree of harmonization of disclosure standards across countries to keep pace with the geographic spread and diversification of financial service providers. The need for strengthening this attribute of the global financial system may have been highlighted by the crisis, but there is little question that it would have manifested itself sooner rather than later.

Inclusion

This objective is particularly significant in the current Indian context. It is a central theme of the RBI's observance of the institution's Platinum Jubilee (or 75th Anniversary). But, I would argue that inclusion is an important component of any financial system and its pursuit is a legitimate objective for policymakers and regulators under any circumstances. The specific strategies will, of course, depend on the context and state of development of each country. In its early stages, as exemplified by the Indian situation, the challenge is simply to give millions of people their first access to very basic financial services at extremely low thresholds of activity.

Sustainability

As global attention on climate change intensifies, it is quite clear that every component of the economic system will be subject to scrutiny with regard to what it can contribute to adaptation and mitigation. From a broader perspective, while climate change is for the moment the most salient of issues relating to sustainability, there are a host of other factors on the radar screen, which will sooner or later engage the attention of national and global regulators. On all these fronts, the financial system will be expected to play a role, whether it is in the form of channelizing resources to firms that have good sustainability practices, or financing innovation in and development of "green" technologies or even contributing to insurance and safety-net mechanisms for people who are likely to be adversely impacted by the changes.

In this segment of my remarks, I have articulated the view that effective financial sector development must simultaneously pursue five objectives; some are defined by tradition, while others reflect changing global and domestic priorities. I have hinted at possible conflicts between some of these objectives. Finding the right balance between them is clearly the goal of financial sector policy and regulation, but this is not the place to go into that set of issues. I shall now try and provide a brief description of how both the idea of deposit insurance itself and the way in which it is provided relate to the five broad objectives of financial sector development.

The role of deposit insurance

Deposit insurance has clearly been around for a long time and its utility as an instrument of trust and confidence in the financial (or perhaps more narrowly in the banking) system has rarely been in question. Rather, the question that now faces us is whether it can be expanded and re-structured to address a greater variety of requirements that the financial system now has. These are issues that will obviously be discussed during the technical sessions of this conference and I look forward to being informed of the significant points that emerge from them, both for my own education and as inputs into the shaping of strategies for DICGC. Here, I will confine myself to a few illustrations of how deposit insurance fits into the broader financial development framework.

With regard to efficiency, the existence of insurance is perhaps less important than the way in which it is structured. Deposit-taking financial institutions, particularly those servicing a large number of relatively small accounts can obviously be mandated to buy insurance. But, this will impact their operating costs, which depositors will bear to some extent. One way of encouraging overall efficiency is to differentiate insurance premiums between institutions based on some objective measure of the riskiness of their loan and asset portfolios. This will help to bring about a better alignment between the cost of funds and the portfolio risks across the deposit-taking financial sector.

Stability is clearly the objective with the most direct connection with deposit insurance. By providing depositors with the assurance that at least some of their money is safe no matter what happens to the institution, it provides a huge incentive for people to use the system, with consequent benefits for the economy as a whole. But, the viability of any insurance scheme is based essentially on the premise that claims will originate from only a small proportion of the insured population at any given time. A crisis is a situation in which virtually the entire population will make claims at the same time. From a welfare perspective, the core objective of protecting depositors' interests becomes even more paramount in such a situation. However, from the perspective of resources, the cost providing full insurance against catastrophic failure can be very high for individual institutions, coming into conflict with efficiency considerations. Where, then, the resources needed to continue to inspire confidence in the system are going to come from is a critical question. Strategic management of the insurance corpus and conditional state support will, presumably, both have a role.

One important consideration that is on our own strategic agenda is the role of the deposit insurer in the resolution process itself. When individual institutions fail, rather than let the depositor be rescued solely by the insurance cover, which in any case, is not comprehensive for larger depositors, it may be more effective to involve the insurer in the process right from the beginning. This will give depositors as a stakeholder group a voice in the process, allowing them to better protect their interests, while at the same time increasing the capacity of the insurance scheme. Of course, in this expanded role, the organizational design and skill requirements of the insurance provider need to be kept in mind.

Transparency is a two-way street. Depositors need to be fully aware of the extent of protection, what it is costing the institution and the limitations on protection in the event of a systemic failure. The insurer needs to know precisely who each depositor is and the size of his/her exposure. This will enable speedy resolution of claims, which is a critical requirement for an effective insurance programme.

With regard to inclusion, deposit insurance is clearly very relevant in a situation such as India's. A large number of people interfacing with the organized financial system for the first time will naturally be very concerned about the safety of their funds. At the same time, there is a welfare imperative of protecting this category of depositors from both strategic errors by management and wider systemic shocks. Of course, this consideration brings into focus the potential conflict between the inclusion objective and the efficiency objective; if relatively more vulnerable institutions also happen to be more effective in pursuing an inclusion agenda, some degree of cross-subsidization may be necessary.

Finally, on the issue of sustainability, while a direct link with deposit insurance is difficult to make, the wider requirement for insurance in a scenario of long-term environmental change and the vulnerabilities of several production systems to it – for example, agriculture, fisheries and tourism – is well recognized. Such risks will also have to be borne by financial service providers who are exposed to these sectors, which may have implications for, among other things, deposit insurance.

Conclusion

I would like to conclude by re-emphasizing the point that the future trajectory of deposit insurance programmes is best viewed in the context of an explicit vision and framework for the financial sector as a whole. I have attempted to offer one way of doing this, which, I hope, will be useful to you as you get into the agenda items of the conference. My best wishes to all of you for a substantial and meaningful event. Thank you all for being here and special thanks to Mr. Prasad and his team for their efforts in arranging this event.

José Manuel González-Páramo: The regulatory and supervisory reform in Europe

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the presentation of the Report "Observatorio sobre la reforma de los mercados financieros 2009, realizado por la Fundación de Estudios Financieros", Madrid, 22 January 2010.

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Introduction

Ladies and Gentlemen,[1]

I am very glad to participate this morning in the presentation of the latest "Observatorio" from the Fundación de Estudios Financieros (FEF).[2] This year's report is dedicated to the very important issue of the Reform of the European Financial Markets. The current financial crisis has revealed a number of deficiencies in the European and international regulatory framework, which need to be addressed in order to place our financial systems and economies on a more solid footing.

As a result, a number of initiatives have been undertaken in the relevant European and international fora. The number and breadth of these initiatives is impressive and very promising. The report from FEF provides a very comprehensive survey of all the current initiatives, identifying the various strands of work and summarising the main implications for the financial sector and markets. I congratulate the authors on this exhaustive report, which represents a very useful reference for whoever is interested in understanding the ongoing developments in the regulatory and supervisory field.

Of course, the reader may not necessarily agree with all conclusions of the report. In particular, the report identifies a major risk of over-regulation and instead stresses the virtues from industry self-regulation. I beg to disagree. In my view, the main risk right now is not to do too much, but rather that we do too little.

There is a serious risk that the gradual improvement of conditions in the financial markets and the banking industry may diminish the sense of urgency and necessity of implementing reforms identified as essential to prevent the occurrence of similar crises in the future. Albert Hirschman, the American economist, noted that in many of the debates that precede social and political reforms of historical magnitude, the proposed changes are typically met with three arguments: (1) that they would produce perverse effects, (2) that they would be ineffectual, and (3) that they would jeopardise previous achievements.[3] I am afraid that we are now increasingly hearing the same arguments in the context of the debate on financial reform.

The crisis which began in the summer of 2007 has developed over time into one of the most disruptive and costly crises for our economies and societies that the world has experienced in many decades. Therefore, both public authorities and the financial market participants have a collective responsibility to do whatever is needed to address weaknesses in the regulatory and supervisory framework in order to provide sounder foundations to our financial systems.

Let me now stress some of the areas in which substantial work has been achieved to design and implement reforms.

Three key areas of reform: credit rating agencies, hedge funds and compensation practices

As I mentioned earlier, substantive progress has been made in the regulatory and supervisory reform as a response to the financial crisis. A remarkable amount of technical

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[1] I am very grateful to Katri Mikkonen for valuable inputs and to Fátima Pires, Fabio Recine and Panagiotis Strouzas for useful comments.

[2] Fundación de Estudios Financieros (2009), Observatorio sobre la Reforma de los Mercados Financieros Europeos, Papeles de la Fundación N. 34.

[3] Albert O. Hirschman (1991), *The Rethoric of Reaction: Perversity, Futility, Jeopardy*, Cambridge MA; Harvard University Press.

work has been undertaken in a demanding timeframe. All relevant initiatives have been coordinated globally, and the European Union has been a frontrunner in a number key areas. Three areas in which much progress has been made are: *credit rating agencies, hedge funds and compensation practices*.

- As regards *credit rating agencies*, a new EU regulation subjecting such agencies to mandatory registration and oversight in order to increase transparency and reduce conflicts of interest in the rating process has already entered into force in December 2009.
- As for *hedge funds*, the European Commission has proposed a Directive on alternative investment fund managers. This proposal, which is currently under debate, provides that alternative investment fund managers be subject to authorisation and harmonised regulatory standards, including minimum capital as well as disclosure requirements.
- On *compensation practices*, the European Commission was among the first to incorporate in a Directive proposal the Principles developed by the Financial Stability Board (FSB) for sound compensation practices, with a projected implementation date of end-2010. In this context, the EU was leading the international agenda in developing further guidance to align compensation practices with long-term value creation and discourage excessive risk-taking in the short-term. To recall, the G20 leaders in Pittsburgh in September endorsed the FSB implementation standards that aim to defer bonus payments, disallow guaranteed bonuses, and introduce a claw-back clause.

Recent proposals on how to strengthen the prudential framework

In addition, agreement has been reached globally on a comprehensive set of measures to strengthen the prudential framework in response to the crisis. In the EU, the Commission's proposal for an amendment of the Capital Requirements Directive of July 2009 includes the internationally agreed stricter requirements for *trading book* and *re-securitisations*.

Moreover, the recently issued proposals of the *Basel Committee* aim at improving the quality, consistency and transparency of *capital* for credit institutions as well as developing a framework for *liquidity risk*. As a consequence, the quality of capital, especially the so called Tier-1 capital which is of utmost importance for loss-absorption on going concern and crisis situations, will significantly improve.

- The risk coverage of capital requirements will be further strengthened for the counterparty risk related to *derivatives, repos and securities financing activities*, and incentives will be increased to move OTC derivative exposures to central counterparties and exchanges.
- A *leverage ratio* will be introduced as a supplementary measure to the Basel II risk control framework to curb excessive balance sheet growth and to safeguard against model risk and measurement error.
- *Capital buffers and forward-looking provisioning* will be introduced to mitigate the inherent procyclical nature of financial activities.
- Finally, a *global minimum liquidity risk standard* for internationally active banks will be put in place, requiring banks to hold sufficient high-quality liquid assets to withstand financial stress.

These proposed measures have the support of the Group of Central Bank Governors and Heads of Supervision, who requested the Committee to deliver a fully calibrated and finalised package of reforms by the end of 2010. The Commission envisages the timely incorporation of the aforementioned upcoming regulatory changes in the EU framework.

Recent developments in European prudential framework

Finally, international cooperation has been strongly reinforced and supervisory colleges for large complex financial groups have been established. At EU level, the setting up and functioning of colleges is provided for in the EU regulatory framework and is well advanced.

Looking ahead, legislative proposals should fully reflect the ongoing work at international and EU level aiming at enhancing the resilience of the financial system and protect consumers and investors against the impact of excessive risk taking and irresponsible market practices. Main priorities include: *(1) finalising the reform of the prudential framework; (2) addressing the risks posed by systemically important institutions; and (3) setting a framework for macro-prudential supervision*.

- *First*, the *strengthened prudential framework* currently being developed needs to be properly and timely finalised. The agreed measures, when implemented, will address many of the shortcoming highlighted by the financial crisis, and will increase the ability of financial institutions to withstand shocks and thus the resilience of the financial system. In this context, let me highlight the importance of a thorough impact assessment, to be carried out in the course of this year, before the final calibration of the framework can be made. The exact timing of implementation has, equally, to be carefully considered, so that the economic and financial recovery will not be endangered. In this context, adequate transition and grandfathering arrangements should be ensured.

- *Second*, legislative reform also needs to address the *moral hazard stemming from systemically important financial institutions*. In a resilient financial system it cannot and should not be taken for granted that authorities will always come to the rescue. The focus of the ongoing work by the FSB in this regard is threefold:

    1. It seeks to ensure that financial institutions, whatever their size and interconnectedness, should not cause undue distress to the functioning of the financial system and to the economy as a whole, if and when mismanagement drive them to bankruptcy. Possible tools include introducing capital and liquidity surcharges, or constraining size or the range of activities, to reduce the externalities of systemically important institutions to the society.

    2. The *core financial infrastructures and markets* need to be strengthened, for example via the promotion of central counterparty clearing and revision of supervisory standards on financial market infrastructures.

    3. We also need to review *resolution regimes* and bankruptcy laws to ensure an orderly winding-down of systemic cross-border financial institutions. In this respect, the European Commission has already launched a public consultation on measures for a new EU framework for crisis management in the banking sector, in which policy options as regards early intervention, bank resolution and harmonised insolvency procedures are considered. In addition, it will be relevant to enhance the framework for coordination among the relevant authorities for financial stability in case of crisis.

- The *third and final area* relates to *macro-prudential supervision*. One of the key lessons stemming from the financial crisis relates to the importance of understanding and assessing the degree of “interconnectedness” between market participants. In particular, the crisis demonstrated that the nature and magnitude of the systemic risk in the financial sector is related not only to the potential illiquidity or insolvency of large banks or other major regulated financial institutions, but it also depends on the close intertwining between financial institutions, markets and infrastructures. The financial stability framework needs to be able to identify and assess systemic risks corresponding to the degree of “interconnectedness” I just mentioned. In this context, macro-prudential oversight would focus on factors and risks that can affect the stability of the financial system as a whole and therefore would complement micro-prudential supervision, which looks at the stability of individual financial institutions.

Macroprudential supervision in the euro area: The European Systemic Risk Board

Macroprudential oversight will be the key task of the European Systemic Risk Board (ESRB), which is built on the proposals of the High Level Group chaired by Jacques de Larosière. The European Commission's legislative proposals for the establishment and functioning of the ESRB have received the support by the ECOFIN and the EU Council. The European Parliament is currently considering the proposals in its turn. Let me also mention that the ECB/Eurosystem expressed its stance in the opinion adopted on 26 October. 2009 It welcomed the broad agreement reached by ECOFIN on the draft legal texts regarding the establishment of the ESRB and the involvement of the ECB in supporting the ESRB. As stated in its Opinion, the ECB has decided that it stands ready to provide the analytical, statistical, administrative and logistical support to the ESRB, including the Secretariat of the ESRB.

What will be the activities of the ESRB and what is its value added? The ESRB will be expected to actively monitor the various sources of risk to financial stability in the EU – across countries and across financial sectors, and also taking into account global developments. As a result of this monitoring, the ESRB can identify the risks and analyse in-depth how they could impact the financial system. Stress-testing and other methodologies could assist the risk prioritisation exercise.

The value-added to be provided by the ESRB is to link, in particular, macro-economic conditions, structural developments, and key vulnerabilities of financial institutions. This will permit to identify system-wide risks for the benefit of regulatory and supervisory policies. The monitoring, assessment and collection of information on sources of risk to be conducted by the ESRB, at the level of the entire EU, is of the essence, given the advanced financial integration of the internal market. In addition, the risks for Europe stemming from global sources will also need to be considered, also in coordination with the IMF and the FSB.

The financial stability monitoring in the EU as a whole will provide significant analytical and informational challenges. A large part of the effectiveness of the ESRB will rely on the quality and solidity of the analysis and information underlying its financial stability assessments. It will be important to set-up efficient arrangements between the ESRB and the new European Supervisory Authorities for the mutual cooperation and exchange of information, as foreseen in the Commission's legislative proposals. This would allow avoiding multiple reporting from financial institutions.

In order to support the new European macro-prudential function, as decided by the Ecofin, the ECB will provide analytical, statistical, administrative and logistical support, also drawing on the technical advice of the 27 national central banks and supervisors of the Member States. Accordingly, we will optimise our present capabilities and infrastructure in the areas of financial stability monitoring, macro-economic analysis, and collection of statistical information, to the benefit of the ESRB. This aims at reaping the maximum synergies in terms of expertise, resources and infrastructures with the existing central bank activities in the EU. To this aim, preparatory work is already under way.

Let me now conclude by saying that although much has been achieved to improve the European regulatory and supervisory framework, a lot still remains to be done. This is no time for complacency. We still need to make further progress to create a supervisory and regulatory framework, both micro and macroprudential, in which a strong and competitive financial system can enjoy sustainable growth. Europe should play a leading role in these developments.

Thank you for your attention.