Re-enforcing “Just-in-case” with “What if”: Navigating financial crises for a better tomorrow

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*In the previous Part 1 of the “Insights into PIDM” series (“series”), titled “’*Just-in-case’ protection systems for financial consumers*”, we shared PIDM’s role as a financial consumer protection authority and our protection systems for financial consumers. In this Part 2 of the series, we will share PIDM’s role and mandate as the resolution authority for its member institutions, and how PIDM ensures a member institution could be resolved in a prompt and orderly manner with the least disruption and cost to the financial system, should it fail.*

In Part 1, I quoted William Blake, the famous English poet. He once said, “*hindsight is a wonderful thing but foresight is better, especially when it comes to saving life, or some pain*”. While foresight is better than hindsight when it comes to crisis preparedness, it is nevertheless difficult to predict with great certainty when calamities such as earthquakes, typhoons, floods or landslides; or even a bank failure or financial crisis, might take place. But while these events can happen at any time, effective crisis response measures would contribute significantly to minimise financial stability issues and losses.

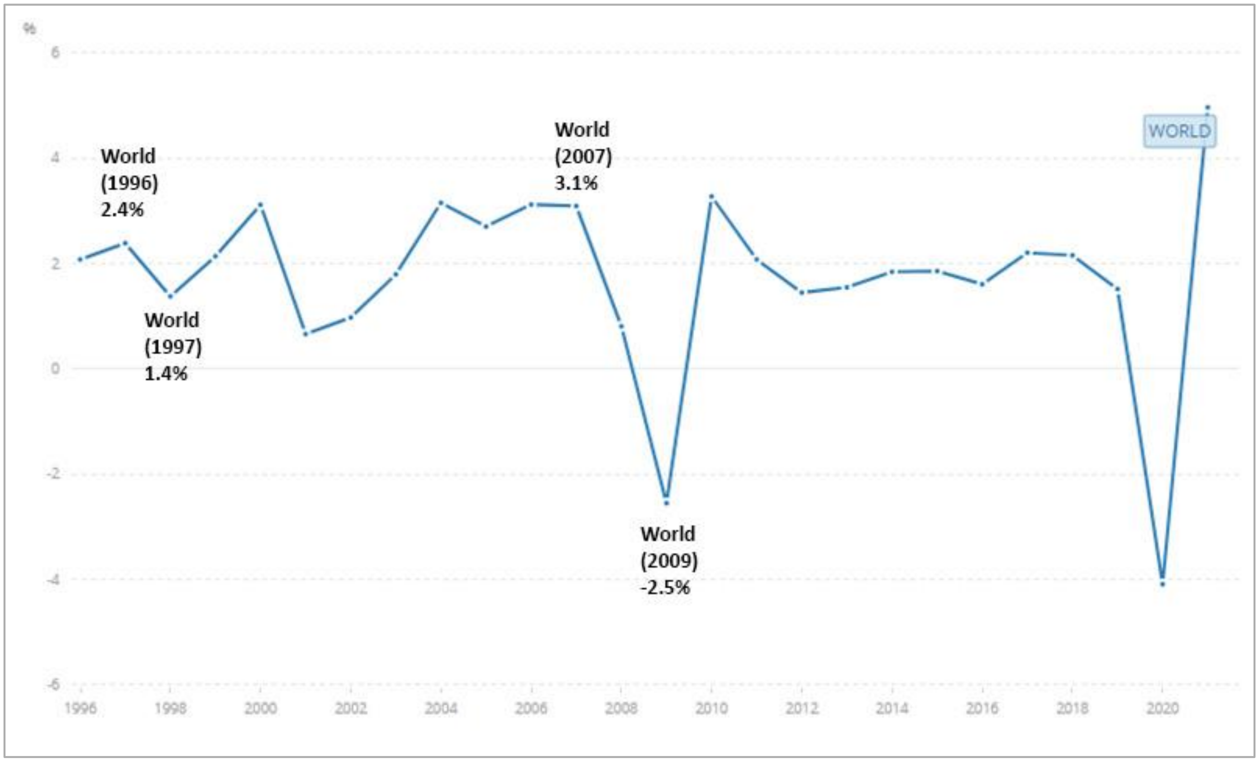
The recent failure of Silicon Valley Bank (“SVB”) in the USA is a good example. Regardless of the causes of SVB failure, and why SVB encountered the problems it did, measures taken by the authorities managed to calm the markets and avoided a full-blown financial crisis (for now). The SVB case has also demonstrated that while deposit insurance is an important mechanism to instil confidence and provide insured deposit protection, there may be exigent “what-if” cases where the interest and stability of the overall financial system may be at stake. When this happens, the authorities may resort to extraordinary measures that extend beyond the scope and limits of deposits protection. In this regard, early planning and preparedness to cater for “what-if” cases are pivotal.

Lessons from the crises

Financial crises do not just affect people in the financial industry. From the experiences of the Asian Financial Crisis (AFC) in 1998 or the Global Financial Crisis (GFC) in 2008, we saw how they affected the broader economy due to spill-over effects.

These spill-over effects can stem from stock market crash, loss of jobs and savings and destruction of wealth and assets value due to multiple failures of companies that typically follow a financial crisis. Recovery from a financial crisis requires considerable efforts and resources, and the hardship experienced by people can be real. Statistics show that during the AFC, the world GDP per capita growth rate slowed from 2.4% in 1996 to 1.4% in 1997. As for the GFC, the world GDP per capita growth rate declined from 3.1% in 2007 to a contraction of -2.5% in 2009.

World Bank: GDP per capita growth (annual %) from 1996 until 2022



Source: World Development Indicators, https://data.worldbank.org/indicator

Like many calamities, a financial crisis may be hard to predict as to when it might happen or how it might unfold. Therefore, it is important to undertake pre-emptive planning and mitigating measures in advance, to lessen the potential impact and losses if a financial crisis were to happen. There are three lessons which could be drawn from global experiences in managing financial crises.

Lesson 1: Adopt and adapt

In the recent failures in the US, the US regulatory authorities' ability to swiftly carry out suitable resolution option was probably key in mitigating market wide confidence crisis. This agility is vital in crisis response. To ensure resolution authorities have this agility, it is an international best practice to have an array of resolution toolkit. This is also why adopting the international standards, but adapting them to the domestic context, is important for crisis preparedness.

In Malaysia, following the AFC, PIDM was established in 2005 as a deposit insurer and resolution authority to protect depositors and to resolve a failed member institution. PIDM's mandate, amongst others, is to ensure that a failed member institution could be resolved in a prompt and orderly manner, with minimal loss and impact to the financial system. We adopted the international best practices for effective deposit insurance system and were assessed as mostly compliant, during the Financial Sector Assessment Programme by the World Bank and the International Monetary Fund in 2013.

In response to the GFC, authorities globally have instituted reforms to put in place, amongst others, effective resolution regime (including implementing recovery and resolution planning), aimed to strengthen and make financial institutions more resilient against any major shocks. An effective resolution regime also aims to ensure that there will be minimal impact and losses to the financial system in the event of a bank failure or financial crisis.

Again, PIDM is on the path to embrace fully the international best practices for effective resolution regime, but adapted to suit the Malaysian context. As a resolution authority, PIDM is equipped with a wide range of legislative tools and powers which enables it to resolve a failed member institution in an effective and orderly manner, in line with international standards for an effective resolution regime. For example, PIDM may transfer the assets and liabilities of a failed bank to another healthy institution or even a bridge bank, so that critical financial services or functions to the economy and general public can be continued. In other cases, PIDM may choose to close a failed bank and reimburse depositors their insured deposits, if it is more appropriate to do so. PIDM is committed to ensure that the resolution option taken will be the most effective, least disruptive and least costly to the financial system and is best suited to the Malaysian context.

Lesson 2: Planning eases execution

Another key lesson in crisis response is swift execution. Crises have shown that prior planning helped significantly with execution.

As a strategic intent to further enhance the readiness of PIDM to deal with bank failure, PIDM intends to implement resolution planning for all its member banks. The resolution planning initiative forms part of the broader BNM-PIDM joint Framework on Recovery and Resolution Planning (RRP) whereby BNM leads the recovery planning for banks and PIDM on resolution planning. The idea of resolution planning is to enable PIDM to work closely with member banks during business-as-usual, to draw up a customised resolution plan (or a ‘living will’) for each member bank.

The resolution planning exercise is a form of pre-planning – it will help (i) provide deeper insights into PIDM’s member banks, (ii) enhance a member bank’s operational and resolvability capability by identifying and mitigating the impediments to resolution during normal times and to support the effective execution of a resolution during crisis, and (iii) provide for options and swift decision-making during a bank resolution or crisis.

As part of the overall pre-planning effort, PIDM has also incorporated bridge companies which will be used to facilitate the prompt and seamless transfer of assets and liabilities of a failed bank, in the event where there is no private sector buyer and that the bridge bank resolution strategy is to be implemented.

The collective careful and detailed pre-emptive planning and preparatory efforts by PIDM and the industry will contribute to seamless resolution process and help preserve the value of a member bank and minimise the impact and losses that could spill-over to the larger financial system and economy, especially when “time is of the essence” during a crisis.

Lesson 3: Cooperate to coordinate

The lack of coordination and cooperation between relevant agencies could lead to detrimental effects, especially to those already affected by a calamity and may result in higher financial costs and resources the longer it is delayed.

To better prepare and coordinate on matters relating to crisis management and resolution, PIDM works closely with other financial safety net players including BNM, Ministry of Finance and other foreign authorities, through inter-agency engagements, collaboration and simulation exercises. Simulations and practice exercises are important parts of pre-emptive planning as they equip PIDM and other relevant authorities with deeper perspectives and insights as well as established coordination arrangements on dealing with various situations and scenarios of crises, as and when they arise.

In the recent US banks failures, we noted the coordinated communication and collaboration between the agencies when the resolution of SVB was announced and handled. On this front, the US authorities have committed to issue a report by May 2023, covering, amongst others, how SVB failed, the effectiveness of the existing regulation and supervision, and the outcome of the actions taken on the failure. There will be much lessons to be drawn from this case study.

Preparing to weather uncertainties more effectively

We are increasingly living in an era of constant evolution and uncertainties. It is therefore essential for us to consider how effective we are able to respond to a crisis and to minimise losses and impact.

For the Malaysian financial industry, while banks might already have in place existing risk management and business continuity plans to manage risks during business-as-usual to address the probability of a default, it is also pertinent that PIDM as the resolution authority works with its member banks to undertake pre-emptive planning and put in place mitigating measures through resolution planning exercise to address the potential impact and losses at failure.

Resolution planning will not only help to enhance a member bank's own operational capabilities and readiness to support PIDM to implement an effective resolution during a crisis, but also will create synergies through the integration of enhanced operational capabilities into the day-to-day business processes and operations of the member bank. From the authorities' perspectives, resolution planning also contributes to enhancing inter-agencies cooperation and coordination during a crisis and for the prompt and orderly implementation of resolution, thus preserving financial stability.

The benefits from these efforts and investments in resolution planning may be substantial, and these include enhanced governance, improved operational efficiency and result in better risk monitoring and management by the member bank, as well as for the authorities. The collective effort and ability of PIDM and its member banks to respond effectively and in the least disruptive manner during a failure reflects the resiliency of the Malaysian financial system.

The decision we make today will determine the stories we tell tomorrow

Calamities do not discriminate, and bystanders are not spared from the destruction that follows. Likewise, a financial crisis affects all including bystanders; not only the financial institutions or their direct customers and counterparties. It is hence our collective responsibility to minimise the disproportionate impact of financial instability on innocent and vulnerable bystanders.

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This is Part 2 of the 'Insights into PIDM' series. More information about PIDM's role as a resolution authority is available here.