

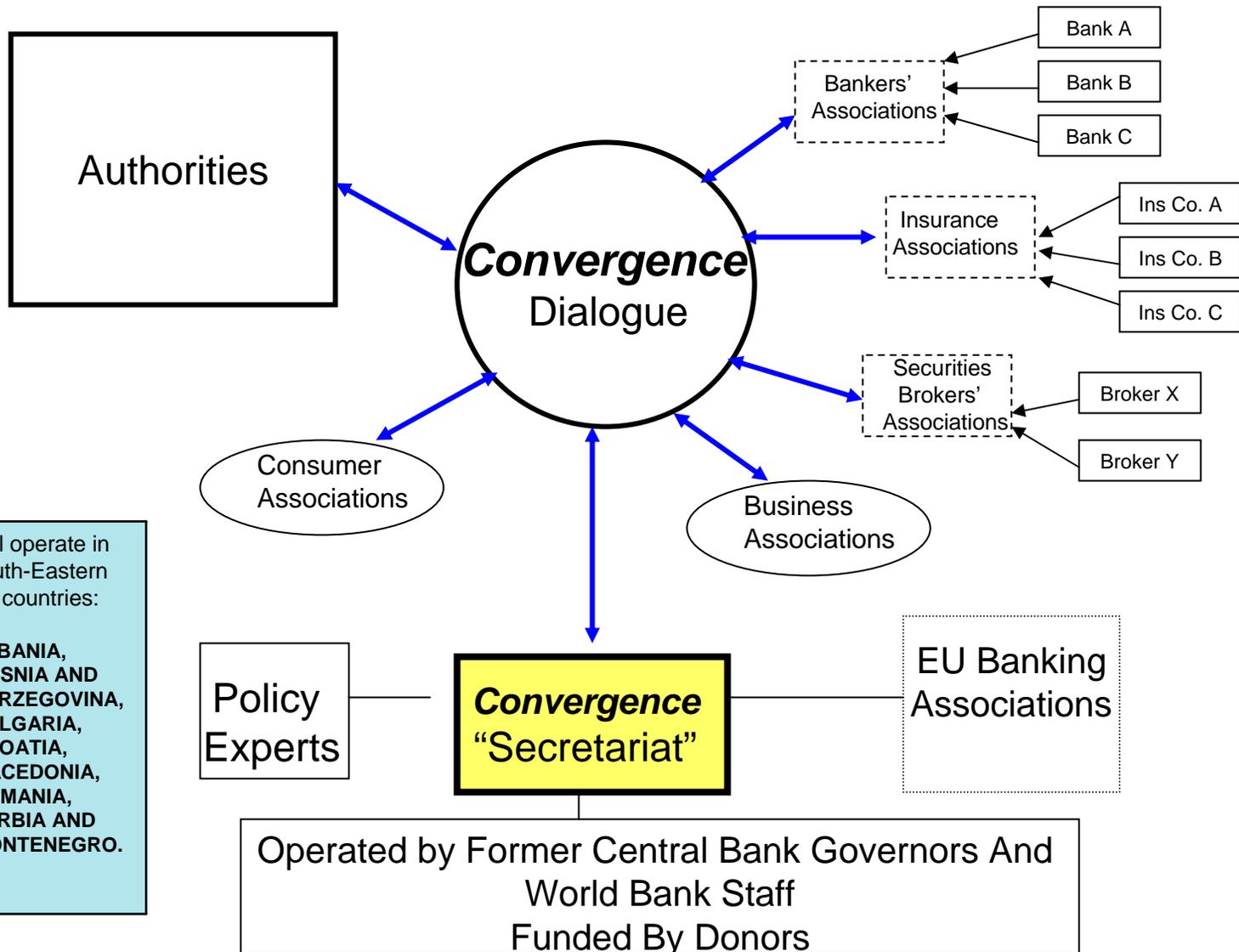


Convergence

A Public-Private Financial Sector Programme

EFDI Annual Meeting
Warsaw, Poland
October 13-14, 2005

Convergence A New World Bank Tool



Progressive Authorities Understand Market Forces Well

- “It is crucial to be aware that market-led progress does require co-operation among economic (public and private) agents. The driver of co-operation should be, as much as possible, moved by the private sector, i.e. by an enlightened perception of the private interest. [...] The necessary co-operation among private market participants does not materialize unless public authorities play an important role in promoting it”.

Tommaso Padoa-Schioppa, ex-Executive Board Member, ECB

- “We recognized early on that where intervention was judged to be necessary – in the interest of market transparency or of prudential or behavioral conduct – it needed to be informed by those who properly understood the subtleties of the market if we were to reduce the risk of unforeseen consequences or unnecessarily obstruct market innovation.”

Sir Edward George, Governor, Bank of England

Progressive Bankers Are Learning To Talk “Policy”

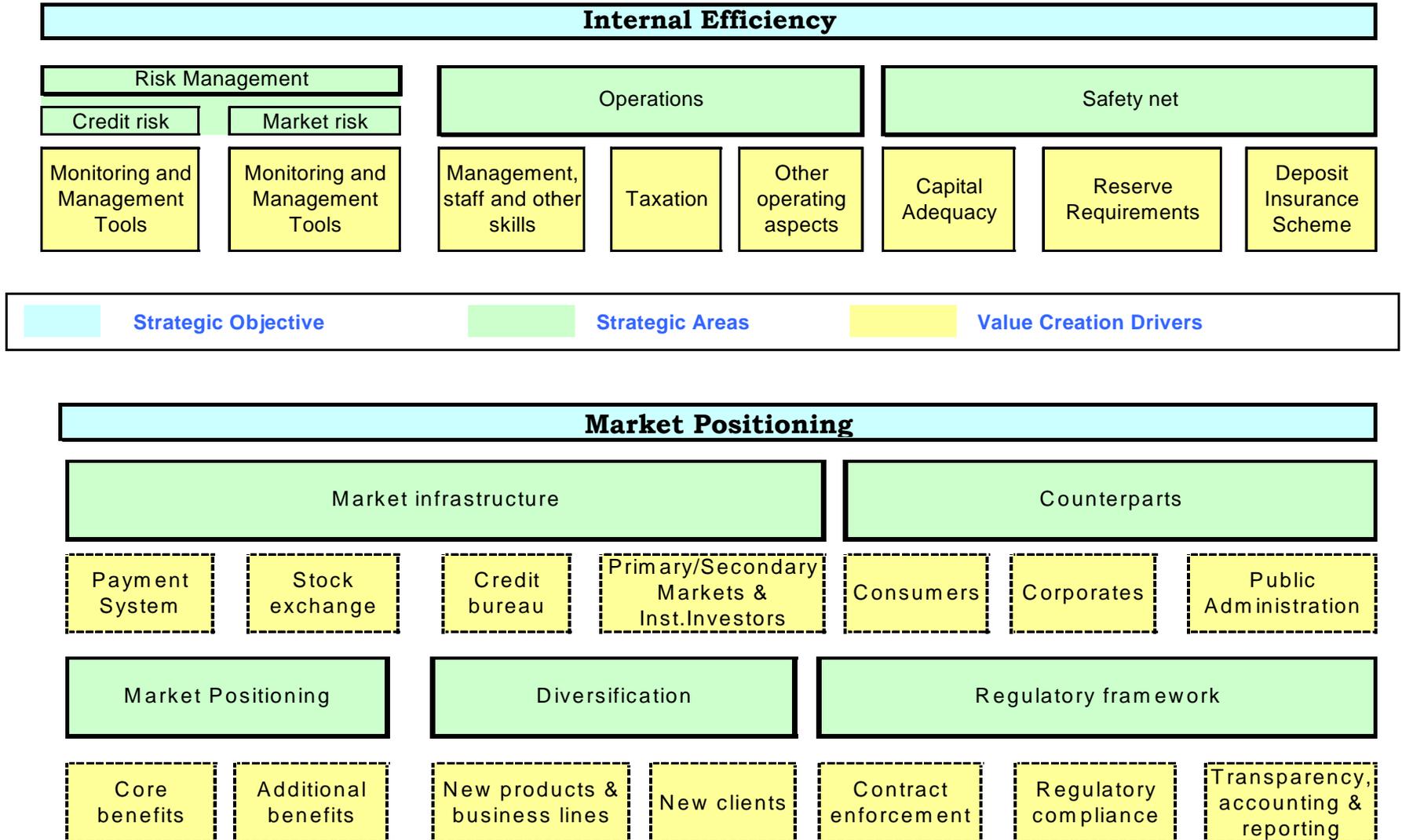
- The traditional mission of “representation” of the interests of the banking industry, focused on responding to public actions, is inadequate to promoting an enabling regulatory environment in support of new business strategies.
- Rapid changes in financial services make it now possible for market participants to pursue a more ambitious mission:
 - To become ACTIVE players in:
 - helping shape the definition and application of rules;
 - producing solutions to enhance the system’s competitiveness and synergies.

Financial Sector Efficiency Has Several Facets

- Not only “usual” prudential requirements
 - Reserve requirements, capital adequacy,...
- Many other issues of public interest
 - General Market Infrastructure
 - Inter-bank, payment & settlement systems, credit bureau
 - Roll-out of New Products
 - Specialized finance, securities-based
 - Contract Enforcement and Taxation

...The Devil Is In The Detail...

Many Value Creation Ideas For Banks



How Can *Convergence* Help?

1. To Engage with Authorities
2. To Gather Information
3. To Quantify & Assess Information
4. To Support Decision-Making

To Engage With Authorities

- *Convergence* will convince authorities to listen to problems market particip. are facing
 - Not a foregone conclusion in several countries
 - WB, other IFI partners, senior management team credibility should help
- *Convergence* will operate on the basis of a mandate from authorities
 - Their continued commitment is key to exercise

To Support Decision-Making

- *Convergence* will help authorities understand pros and cons of proposed solutions
 - “Honest broker” role is key to preserving long-term credibility and influence
 - Market views will be represented throughout
- Hopefully, authorities will listen
 - *Convergence’s* credibility: IFI sponsorship, quality of management team and strength of market realities

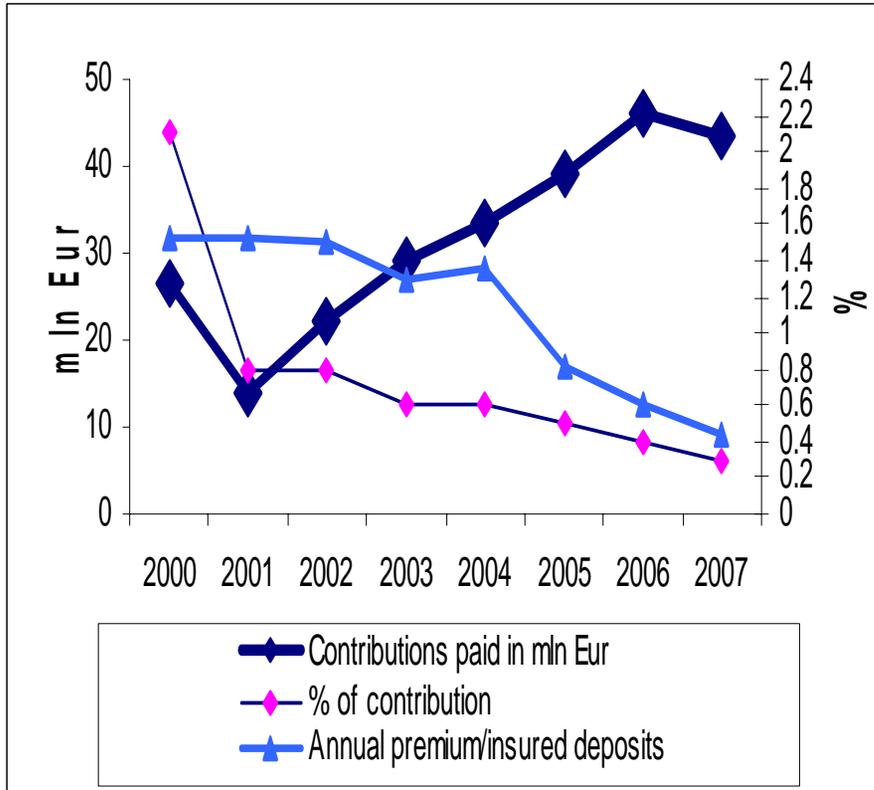
A Deposit Insurance Assignment

- Romanian authorities wish to make an updated assessment of the level of banks' contributions to the Deposit Guarantee Fund (DGF)
 - *“This assessment should take into consideration the latest developments in the Romanian banking sector, the international practice, as well as the need to maintain a well-funded guarantee scheme to preserve the confidence of depositors.”*
 - » DGF Letter to Convergence, May 2005
- “Convergence” works with the Italian Deposit Guarantee Fund (FITD)

Are DGF Resources Too High or Too Low?

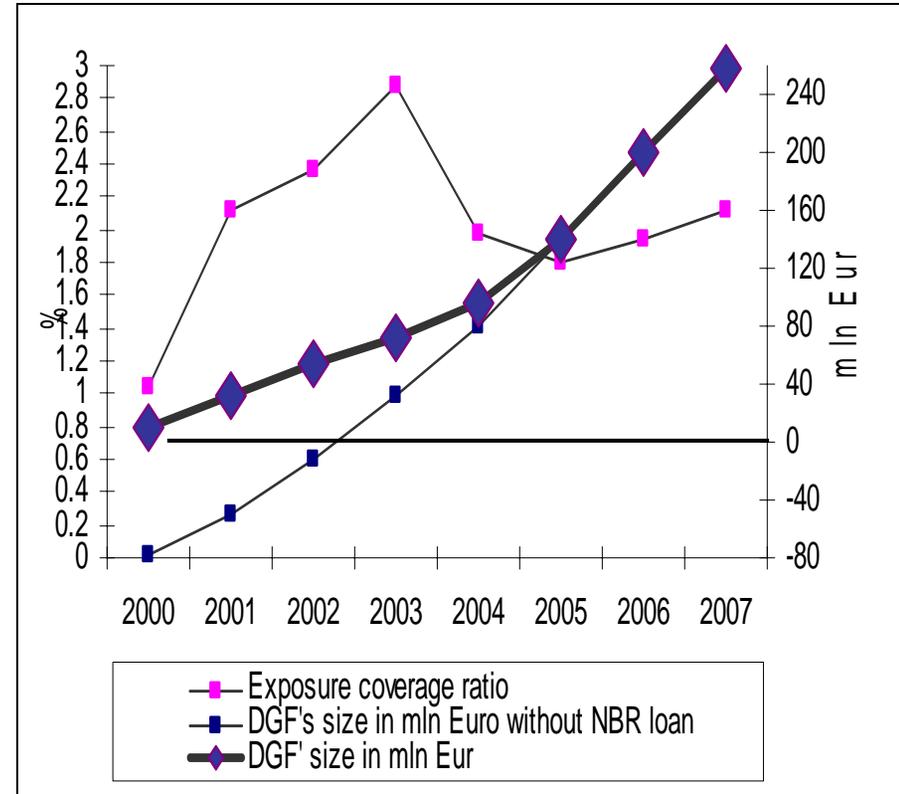
Annual Premium

Premium is dropping fast; annual payment up



DGF Size

Size will be doubling over next 2 years; but relative size stabilizing at 2%



At Bankruptcy, DGF Covers Only “Residual” Risk

Simplified Analysis

Assets	Liabilities
RISKS	INSURED DEPOSITS (DGF)

More Realistic Analysis

Assets	Liabilities	
Liquid assets & reserves	Insured deposits	DGF's Nominal Exposure
Performing assets	Non-insured liabilities	
Loan Losses	Equity	Market Self-Insurance

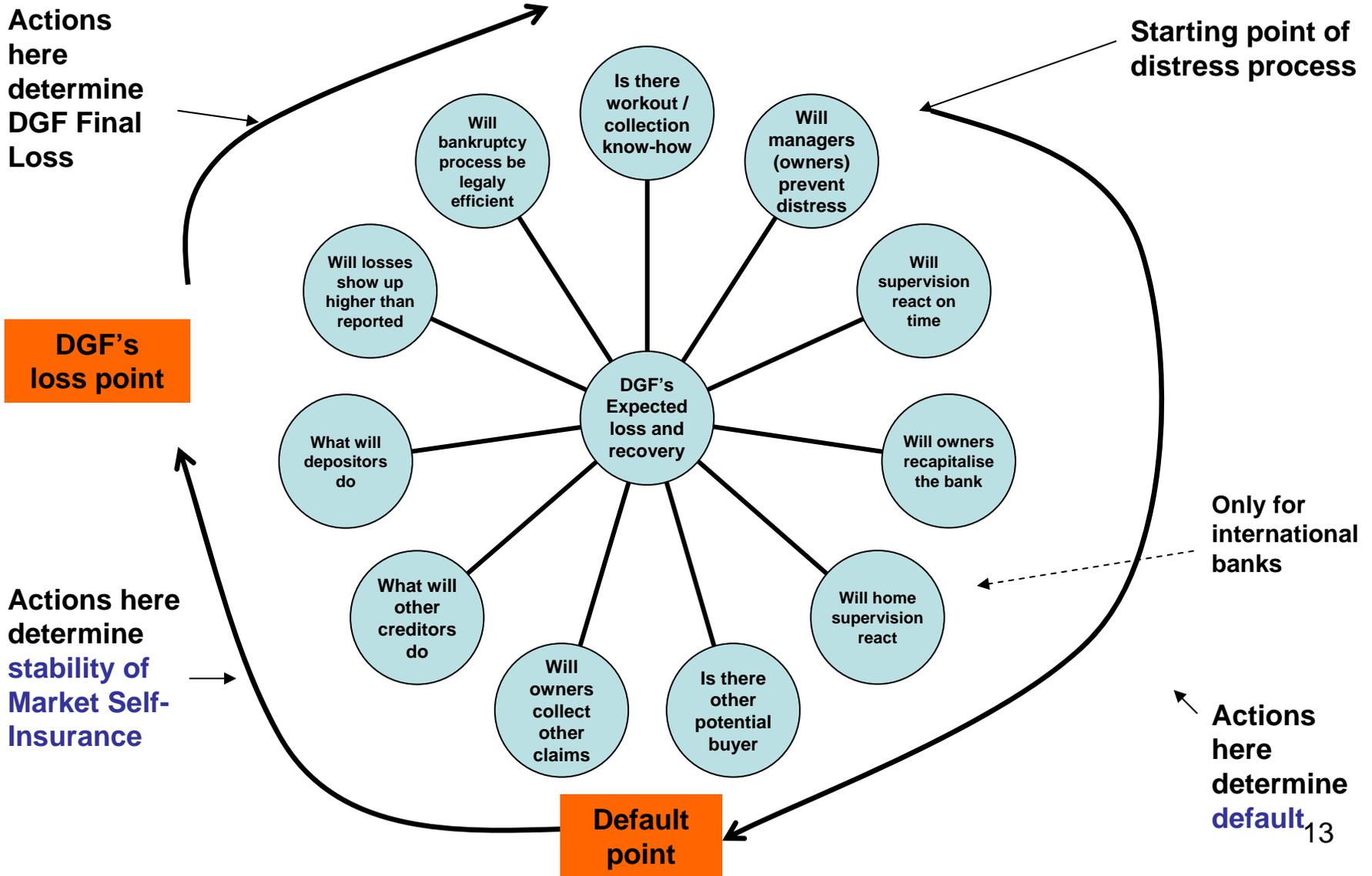
We need to focus on real balance sheet structures

DGF is commonly misperceived to carry the entire risk of the banking system assets, per this stylized balance sheet structure.

Discussion:

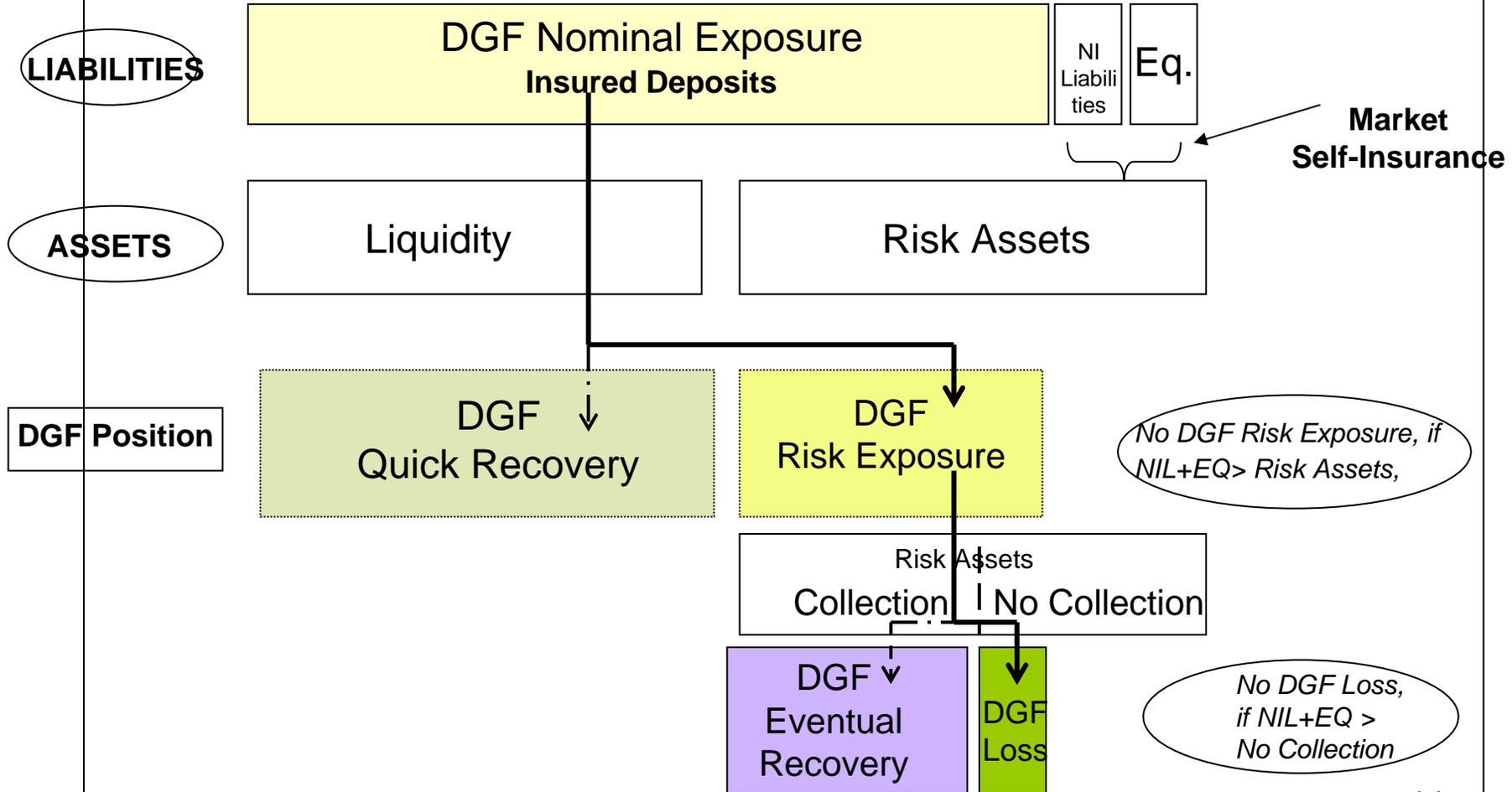
- DGF Nominal Exposure activated at bankruptcy (when Loan Losses > Equity)
- But no DGF Risk Exposure if Liquid Assets > Insured Deposits
- And no DGF Loss, if recoveries from liquid assets, performing loans and other assets eventually cover its Nominal Exposure
- DGF Loss only if Loan Losses exceed Market Self-Insurance

DGF Loss: After A Long Distress Path



DGF: From Nominal Exposure To Loss

Conceptual Illustration



DGF Policy Focus Shift Possible?

“Pay-Out” Focus

- DGF able to absorb joint distress only in smallest banks
- Inability to handle large banks
 - Constraining NBR intervention powers
 - Moral hazard
- Pre-emptive monitoring through close cooperation with NBR not a priority
- Weak incentive to pursue post-bankruptcy collection
- Strong incentive to maximize Fund’s size
 - To play “safe”



“Final Loss” Focus

- DGF able to absorb joint distress of a larger sub-set of the banking system
- Builds on strengthened NBR capabilities and new shareholder incentives
- Focus on speedy bankruptcy procedures
- Run to minimize net cost to banking system
- Requires careful assessment of financial structures
 - Allows use of early warning signals
- Makes banking system a co-monitoring party

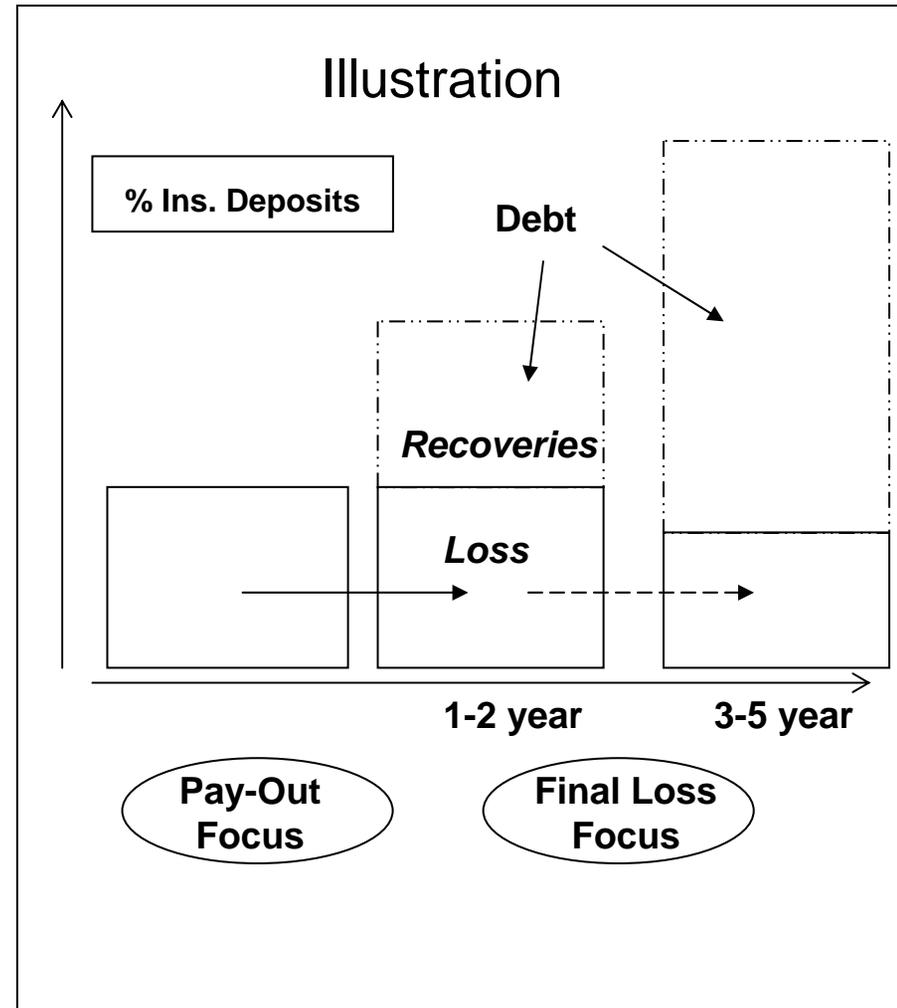
Implications for Annual Premium

- Short-term

- As liquidity back-stop line is raised from banks, premium could be calculated to keep DGF's size constant relative to insured deposits
 - To cover shortfall for deposit growth unmet by investment income
 - Actual level depends on deposit growth

- Long-term

- Under appropriate conditions in absence of defaults and foreseeable risks, premium could be calculated to allow DGF's relative size to shrink
 - Premium could even be suspended once aggregate liquidity back-stop lines exceed a certain level relative to insured deposits



How Can *Convergence* Help DIs?

1. Strengthening analytical capabilities, improving financial operations and risk monitoring capabilities in cooperation with CBs.
2. Playing an “honest broker” role between you and supervisory authorities to help design the most appropriate role for the DI within the changing banking system structure.
3. Exploring how could market participants contribute to more efficient DIs activities.