THE RESOURCE BLESSING

An article by Perbadanan Insurans Deposit Malaysia

Protection funds in times of crisis

In the 16th century Italian story ‘La Spiritata’, Formosus secretly weds Rosimunda but needs a considerable sum of dowry to make it official. With the help of mock astrologers, his miserly father Amadeus is tricked into releasing 3,000 crowns from a treasured hoard. Lexicographers have traced the origin for the maxim “saving for a rainy day” to this comedy play.[1] As it turns out, this saying is no laughing matter. Having been passed down through centuries, its wisdom holds true for our present day circumstances.

The concept of building protection funds for the public and society is neither uncommon nor new. This works by pooling industry resources together and safeguarding it during good times. When crisis hits and unfortunate events occur – natural disasters, financial crises, corporate bankruptcies, losses of employment – the accumulated funds are released to support affected consumers or workers in that sector. This has come to be known as safety net protection against an otherwise hard fall. Such measures also prevent knock-on effects or a contagion of trouble in other firms, and provide the breathing space for industries to reorganise and recover. In the end, with such schemes, there is greater institutional resilience to weather storms.

[1] James. R. (1985). The Dictionary of Cliches. La Spiritata was adapted and renamed into an English play entitled The Bugbears in 1561 that popularised the phrase: “Wold he haue me kepe nothing against a raynye day?”

The resource blessing – protection funds in times of crisis

Across the globe, we have already seen how protection funds have served, or can serve, consumers, employees, and producers in the areas of finance, agriculture, social security and air travel.

The 1930s offer us a glimpse of unprecedented crises that led to pivotal responses in the form of new protection schemes. In those years, the US was engulfed by both the Great Depression and the Dust Bowl, a phenomenon where severe dust storms wiped out livestock and crops across the drought-stricken southern plains.[2] These events led to the creation of the Federal Deposit Insurance Corporation (FDIC) to protect depositors against bank failures, and the Federal Crop Insurance Corporation (FCIC), which insures farmers for crop losses arising from natural disasters or adverse weather.

In 2019, the FDIC's Deposit Insurance Fund stood at $110 billion.[3] Contributions are sourced from insured banks based on respective levels of deposit holdings, with higher rates applied to institutions that pose greater risk to the system. The less-known FCIC operates on the basis of combined premiums from farm producers and government subsidies. Although the scheme got off to a slow start, the FCIC has evolved into a public-private program covering total liabilities of $109 billion on 372 million acres for crop year 2019.[4] Crucially, both protection schemes are designed to improve the risk management practices of banks and farmers. This promotes financial system stability as well as the economic stability of agricultural producers and rural communities.

Turning to our more immediate circumstances, we expect to continue to feel the reverberations of COVID-19's dire impact for a while. In March 2020, the International Labour Organisation predicted a global income loss of $3.4 trillion from as many as 25 million unemployed workers.[5] We have seen these numbers being progressively surpassed. The social safety net of many countries, particularly Unemployment Insurance (UI) schemes, proved to be a critical lifeline for retrenched workers to stay afloat through income replacement, reskilling and upskilling. UI programs are typically funded by compulsory employer and employee contributions up to limits that cover claims within a time-bound period.[6]

A final example is an air travel consumer protection scheme in the UK, requiring licence holders in the travel business to pay a fee of £2.50 per traveller into an Air Travel Trust Fund. Since 1973, the UK has been protecting consumers from losses when travel businesses fail. At first sight trivial, but when the bankruptcy of Thomas Cook struck in September 2019, many of us obtained a new perspective of this fee. When an estimated 150,000 travellers were left stranded across the world, £152 million was spent for what became the largest repatriation in the UK's peacetime history. In the end, the trust fund absorbed £481 million or 85% of the total cost of £564 million for Thomas Cook's collapse.[7]

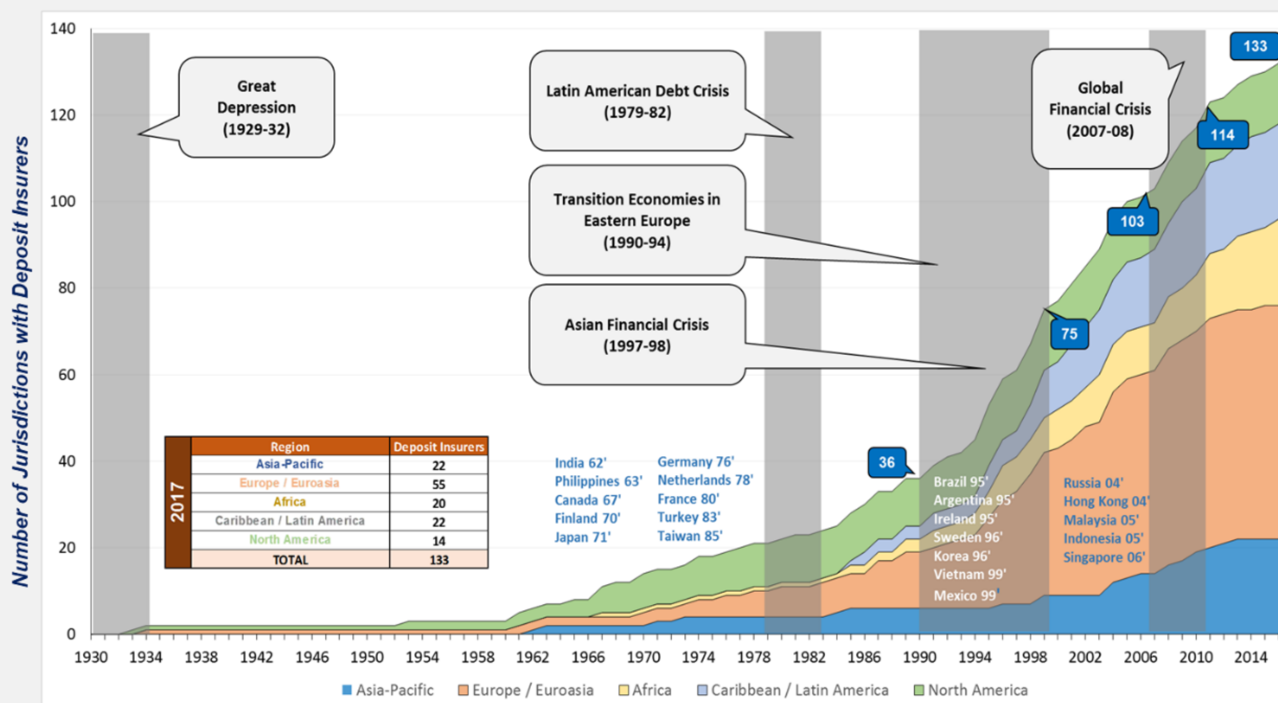
[2] United States Department of Agriculture (2020). History of the Crop Insurance Program
[3]FDIC (2020). Fourth Quarter 2019 Quarterly Banking Profile
[4]FCIC (2019). FCIC/ Risk Management Agency's Financial Statements for Fiscal Years 2019 and 2018
[5]International Labour Organisation, ILO (27 March 2020). COVID-19 has exposed the fragility of our economies
[6]In Malaysia, SOCSO has managed the Employment Insurance Scheme since 2018 via funding contributions of 0.4% of an employee's monthly salary up to a limit (equal sharing of 0.2% employers and employees). Claims can last up to 6 months with pre-determined limits.
[7]UK National Audit Office (March 2020). Investigation into Government's response to the collapse of Thomas Cook

Prior to this high-profile bankruptcy, the UK government had commissioned a national airline insolvency review. In 2019, its study had proposed for a flight protection scheme to cover the failure of airlines, to be funded by a 50 pence levy on individual air passengers. In hindsight, such a scheme would have been timely had it been established, as the airline industry now struggles to tide over the COVID-19 economic fallout.

Low probability, high-impact events are a fact of life....Humanity reveals instead a preference to ignore them until forced to react – even when foresight's price-tag is small
The Economist, 26 June 2020

Behavioural science shows that people have a natural tendency to avoid insuring against low likelihood, high impact events.[8] The trends from past experience are clear. Typically, it would seem that it is only after struggling through the difficulties of a deep crisis or the failure of large institutions without adequate funding that protection schemes are established.

Demand for deposit insurance accelerates after every financial crisis to raise public confidence in financial systems



2017 Region	Deposit Insurers
Asia-Pacific	22
Europe / Euroasia	55
Africa	20
Caribbean / Latin America	22
North America	14
TOTAL	133

Source: International Association of Deposit Insurers (IADI), 2018

Yet all of the earlier examples go to show that protection funds can be of great value in times of crisis. How, then, should emergency funds be developed and administered for tough times? What has and has not worked so far?

[8]Gary C., Brookings Institution (2017). Achieving Regulatory Excellence

Stewardship, foresight and confidence – three pillars of protection funds

A central anchor for protection funds is the principle of stewardship. This can be thought of in 3 parts – funding design, investment management and governance. As discussed earlier, funds can come from industry players, government subsidies or consumers. The next step is then to decide on when, how and how much to collect. In making these decisions, there needs to be a balance between achieving adequate consumer protection and sustainable, long term industry growth. These decisions will also be largely affected by the industry's state of affairs at the time.

Once the system and the fund have been established, the managers of the system need to safeguard these resources through sound investment policies and governance practices. In line with its accountability for prudent use of these funds, a key imperative for a manager of protection schemes is a governance structure - ideally enshrined in legislation - to have operational independence so that the fund is applied as intended in its mandate and not for other conflicting reasons.

The second pillar is foresight. Protection schemes are a long game that operate behind the scenes for large passages of time before being called into action. This tends to create the perception that protection funds are overly cautious and wasteful, particularly when industries are flourishing.

As an example, in 1972, the mayor of Fudai was heavily criticised for investing $12.7 billion over 12 years to build a 51-foot seawall protection against tsunamis. Almost 40 years later, however, the 2011 tsunami devastated Japanese coastal villages with more than 25,000 persons feared dead or missing – but residents and property in Fudai remained safely harboured throughout. The same thinking applies to the business of building protection funds. This requires clear vision and resolve to stay the course and pursue goals despite disparagement by detractors.

The final aspect for such schemes to work is public confidence. Managers of protection schemes pay attention to levels of public awareness because in times of crisis, confidence and the flow of accurate information are critical.[9] This culminates from years of investment to build societal trust and credibility, as consumers grow to understand the system designed to protect them – what is covered, who to call, how to claim. Since protection schemes exist to deal with troubled situations, consistency in the content and pace of public messaging is vital. There is a delicate balance between saying enough to assure the public and the unintended consequence of prompting anxiety by saying too much. Maintaining public confidence, especially today, is not a straightforward task with binary outcomes.

[9] PwC Global Crisis Survey (2019). Crisis Preparedness as the next competitive advantage: learning from 4,500 cases

PIDM's protection funds act as a safety net for financial consumers

For the last 15 years, PIDM has established and administered several funds. These resources serve to protect depositors and owners of takaful certificates and insurance policies against the failure of any member banks, insurance companies or takaful operators (PIDM members). PIDM's funding mechanism operates on an ex-ante and differential basis. This means collections are made from PIDM members in good times, rather than post-crisis. The amount of contribution depends on the risk profile of PIDM members based on predetermined criteria. As for Islamic protection funds, these are separately managed in accordance with Shariah principles.

In addition, there are arrangements in place for alternative funding sources as well as clear disclosures of target fund sizes and accompanying methodologies. Investment policies aim to preserve capital and maintain liquidity in case of need. These facets of prudence are in line with global best practices for deposit insurance schemes.[10] PIDM will continue to deliver its mandate through stewardship of the funds, maintaining public confidence in its protection scheme, strengthening the financial safety net for financial consumers, and promoting stability of the Malaysian financial system.

A key lesson from the global experiences of crises is that rainy day funds are crucial, but often lacking when most needed. Going forward, the provision of resources from protection schemes built up during good times could serve as blessings for the various different sectors and individuals impacted by events or economic uncertainty.

[10] International Association of Deposit Insurers, IADI (2014). IADI Core Principles for Effective Deposit Insurance Schemes