2. Designing and Establishing Deposit Insurance Systems

Entries in this section discuss international experiences with deposit insurance, various surveys of international deposit insurance systems and structures, lessons learned, emerging best practices, and prescriptions for designing effective and efficient deposit insurance systems.

Bank for International Settlements (BIS). 1998. Report of the Working Group on Strengthening Financial Systems. BIS.

> The objective of the Working Group is to develop concrete methods to strengthen financial systems in industrial and emerging-market economies alike. The first part of this report reviews existing sets of sound practices and ongoing efforts to formulate them, and goes on to consider the development of understandings on sound practices in certain areas where, had they existed, the Asian crisis could have been prevented, or its severity reduced. The focus of the second part is on concrete methods to foster implementation. The third and final part considers ways to better coordinate international efforts to strengthen financial systems. The appendix provides a list of ongoing and planned work in international forums that is related to the subject of this report.

Boot, Arnoud W. A., and Sweder van Wijnbergen. 1995. Financial Sector Design, Regulation and Deposit Insurance in Eastern Europe. In *Banking Reform in Central Europe and the Former Soviet Union,* edited by Jacek Rostowski, 42–57. Central European University Press.

> A well-designed regulatory and legal framework in emerging markets will allow banks both to channel savings to enterprises efficiently and to play their role in corporate governance, while minimizing the vulnerability of the system to fraud, corruption, and financial crisis. The authors discuss issues in designing financial systems, including the goals of the financial system and deposit insurance.

Caprio, Gerard Jr., and Ross Levine. 1994. Reforming Finance in Transitional Socialist Economies. The World Bank *Research Observer* 9, no. 1:1–24.

> Four strategies that should guide reform of the financial sector of transitional socialist economies are discussed: (1) building infrastructure, (2) privatizing some financial institutions early, (3) publicizing losses of state-owned enterprises, and (4) improving the tax system.

Clair, Robert T., and Gerald P. O'Driscoll Jr. 1991. Learning from One Another: The U.S. and European Banking Experience. Research Paper no. 9108. Federal Reserve Bank of Dallas.

> The authors examine the U.S. and European banking industries and derive and discuss lessons that each system could learn from the other. For example, European banks demonstrate how (1) expanded asset powers allow banks to diversify their sources of income and reduce their risk of failure, and (2) fewer geographical restrictions benefit banks, allowing them to better diversify their

asset portfolios and reduce their risk of failure. From the U.S. experience, Europe can learn a valuable lesson, or warning: poorly constructed safety nets can reduce the incentives for, and the ability of, banks to monitor their own risks, with the result that there is less stability overall.

Ebhodaghe, John U. 1997. *Safe and Sound Banking Practices in Nigeria: Selected Essays*. Lagos: Page Publishers Services.

This book of essays by John U. Ebhodaghe offers insight into major developments in the Nigerian financial sector, particularly in the post–Structural Adjustment Programme era. Topics include deposit insurance, banking distress, bank receivership, bank management, bank internal-control systems, roles of banks' external auditors, and the future of banking business.

Fry, Maxwell J. 1993. The Fiscal Abuse of Central Banks. Working Paper WP/93/58. International Monetary Fund.

Reviews the fiscal activities in a sample of 26 developing countries that governments have obliged their central banks to undertake. In the main, these activities fall under five categories: (1) collecting signage; (2) imposing financial restriction; (3) implementing selective credit policies; (4) undertaking foreign exchange operations at nonmarket-clearing prices; and (5) providing implicit or explicit deposit insurance at subsidized rates and recapitalizing insolvent financial institutions. Not all central banks engage in all these activities, but some central banks perform additional fiscal activities such as collecting taxes and running food procurement programs. (©1999 EconLit)

Garcia, Gillian. 1996. Deposit Insurance: Obtaining the Benefits and Avoiding the Pitfalls. Working Paper WP/96/83. International Monetary Fund.

This paper contrasts deposit protection with other forms of insurance, examines why goods and services of all kinds receive warranties and guarantees, and explores the particular characteristics of deposits and banks that merit deposit insurance. It examines a variety of reasons why countries choose to adopt systems of deposit insurance, the pitfalls that can arise from poorly designed schemes, and the features of a scheme that successfully avoids these pitfalls. (©1999 EconLit)

Garcia, Gillian. 1997a. Commonalities, Mistakes and Lessons: Deposit Insurance. In *Preventing Banking Crises: Analysis and Lessons from Recent Bank Failures Worldwide*, Proceedings of a conference co-sponsored by the Federal Reserve Bank of Chicago and The World Bank on June 12–13.

Suggestions are made for the best deposit insurance systems in normal times and during emergencies. A well-designed insurance system needs to build good incentives for owners, managers, depositors, borrowers, regulators, and politicians.

Garcia, Gillian. 1997b. Depositor Protection and Banking Soundness. In *Banking Soundness and Monetary Policy: Issues and Experiences in the Global Economy*, edited by Charles Enoch and John H. Green, 464–78. International Monetary Fund. [Followed by comments by Thomas N. Kibua.]

> This article explores the goals for a deposit insurance system, the tools of deposit insurance, best practices for the design of a system, and the effects of a poorly designed system. The author concludes that a well-designed deposit protection scheme can strengthen incentives for good governance for banks, but a poorly designed system will impair market discipline and lead to a deterioration in the banking system.

Garcia, Gillian. 1997c. Protecting Bank Deposits. International Monetary Fund *Economic Issues* 9:1–14.

> Governments must tread a fine line between ensuring the health of the banking system and encouraging recklessness on the part of individual banks (by overprotecting deposits). Ill-conceived deposit insurance can harm an economy if the scheme stifles innovation and economic growth. A deposit insurance system created in accord with both market and regulatory discipline can reinforce managers' efforts, thereby helping the banking system work efficiently.

Garcia, Gillian. 1998a. Deposit Insurance. In *Preventing Bank Crises: Lessons from Recent Global Bank Failures,* Proceedings of a conference co-sponsored by the Federal Reserve Bank of Chicago and the Economic Development Institute of The World Bank, edited by Gerard Caprio Jr., William C. Hunter, George G. Kaufman, and Danny M. Leipziger, 255–69. The World Bank.

> This chapter from the conference proceedings proposes a set of best practices for deposit insurance systems in normal times and during emergencies. These best practices draw on recent experience in dealing with financial crises around the world but are also influenced by the emphasis that modern finance theory places on good incentive structures for financial soundness. The chapter also examines departures from best practices, as revealed by an International Monetary Fund survey of 50 deposit insurance systems.

Garcia, Gillian. 1998b. Deposit Insurance: A Survey of Actual and Best Practices. Working Paper WP/99/54. International Monetary Fund.

> This paper surveys the characteristics of explicit systems of deposit insurance in 68 countries. It compares these actual practices with a set of best practices that has been adopted by IMF staff for advising member countries. These best practices seek to establish a system of deposit insurance that provides incentives for all parties to keep the financial system sound. The paper discerns some convergence toward best practices in recent years but notes several areas where improvements in the incentive structure are still necessary.

Gondo, G. 1995. La direttiva comunitaria sul sistema di garanzia dei depositi bancari (The communal directive on the bank deposit guarantee system). *Foro Italiano* 4:96–106.

In Italian without English summary.

Goodhart, Charles A. E., and Dirk Schoenmaker. 1995. Should the Functions of Monetary Policy and Banking Supervision Be Separated? *Oxford Economic Papers* 47, no. 4:539–60.

This paper investigates whether monetary policy and banking supervision should be separated. The main argument for separation is that the combination of functions might lead to a conflict of interest. An argument against is that separation is inconsistent with the central bank's concern for the systemic stability of the financial system. In a cross-country survey of 104 bank failures, the authors observe a trend toward using taxpayers' money for bank rescues, a trend that strengthens the case for splitting off the supervisory function to another government agency. It would, however, be difficult to have a separation, since the central bank generally remains the only source of immediate funding for bank rescues.

Helfer, Ricki Tigert. 1999. What Deposit Insurance Can and Cannot Do. International Monetary Fund *Finance and Development* 36, no. 1:22–25.

Deposit insurance can contribute to financial stability, but only if it is adequately funded and if other safeguards—such as a strong bank supervision program—are also in place. On the surface, it appears that a national deposit insurance system can be set up quickly and easily, with the announcement of a public guarantee of bank deposits. Some countries, hoping both to prevent wholesale deposit withdrawals that could cause healthy banks to fail and to bring stability to a troubled banking system, have tried to create a deposit insurance system in just this way. Unfortunately, unless the system has sufficient financing to ensure its survival in a serious financial crisis as well as a strong program of bank supervision, it is destined to fail.

Jackson, William. 1993. Mixing Banking and Commerce Using Federal Deposit Insurance: Industrial Banks and Nonbank Banks. Report for Congress (August 26), no. 93-769 E. Congressional Research Service.

Despite explicit federal legislation forbidding the combination of commercial banking and commerce, through corporate ownership it is possible under 1993 law to combine two kinds of banks with nonbanking activities. Continuing efforts to encourage these mixtures may be patterned on industrial banks or nonbank banks, whose operations are favorable for owners such as insurance, securities, or industrial firms.

Kane, Edward J. 1993. What Lessons Should Japan Learn from the U.S. Deposit-Insurance Mess? *Journal of the Japanese and International Economy* 7, no. 4:329–55.

In any representative democracy, public officials are subject to incentive conflict. Japan can benefit from understanding and eliminating the particular conflicts in bureaucratic incentives that make U.S. regulators reluctant to acknowledge and resolve deposit-institution insolvencies in a timely fashion. Weaknesses in accountability for the delayed consequences of regulatory decisions tempt regulators to help inefficient and insolvent banks to resist exit at the expense of other parties. To improve incentives, the consequences of regulatory choices must be made transparent enough for outsiders to monitor them. This can be done by assigning responsibility for privately insurable risks to private coinsurers and defining more fully government responsibilities for monitoring and minimizing financial institutions' exposure to catastrophic risk. (©1993 Academic Press)

Kane, Edward J. 1995. Establishing an Efficient Private–Federal Partnership in Deposit Insurance. In *Managerial Finance in the Corporate Economy*, edited by Dilip Kumar Ghosh and Shahriar Khaksari, 175–94. Routledge.

This article identifies some ethical constraints and patterns of privatization that promise to increase the efficiency and fairness of federal deposit insurance. The problems of deposit insurance show that congressional oversight of discretionary government loss-control is a system that continues to misserve taxpayer interests. The author outlines reform models that would constrain regulators and politicians to treat taxpayers' loss exposure more nearly as if it were their own.

Kane, Edward J., and Robert Hendershott. 1996. The Federal Deposit Insurance Fund That Didn't Put a Bite on U.S. Taxpayers. *Journal of Banking and Finance* 20, no. 8:1305–27.

Unlike the Federal Savings and Loan Insurance Corporation and the Bank Insurance Fund, the National Credit Union Share Insurance Fund (NCUSIF) survived the 1980s without falling into a state of accounting insolvency. This paper analyzes how differences in incentive structure constrain the attractiveness of interest-rate speculation and other risk-taking opportunities to managers and regulators of credit unions. Despite these better incentives, robust present-value calculations establish that NCUSIF fell into economic insolvency during the mid-1980s. Besides calculating the extent of this insolvency, the paper also seeks to explain why, after NCUSIF became insolvent, it could rebuild its reserves without an explicit or implicit taxpayer bailout. The authors' explanation turns on cross-industry coinsurance responsibilities and the shallowness of the fund's observed insolvency relative to industry net worth. We identify forces in the decision making environment tending to limit the depth and duration of unresolved insolvencies at individual credit unions. The authors conjecture that expanded use of coinsurance and private monitoring could reduce taxpayer loss exposure elsewhere in government deposit insurance systems. (©1999 EconLit)

Ketcha, Nicholas J. Jr. 1999. Deposit Insurance System Design and Considerations. Policy Paper no. 7:221–39. Bank for International Settlements.

This paper discusses deposit insurance and failed-bank resolution systems: the role they play in a nation's financial safety net; the advantages and disadvantages such systems provide; the establishment, coverage, and funding of such systems; the linkage with supervision and licensing; and failed-bank receivership and resolution processes and considerations. Although deposit insurance systems are in place in many countries, this paper is based heavily on the lessons learned from, and on the principal features of, the deposit insurance system in the United States.

Kupiec, Paul H., and James M. O'Brien. 1998. Deposit Insurance, Bank Incentives, and the Design of Regulatory Policy. Federal Reserve Bank of New York *Economic Policy Review* 4, no. 3:201–11. Also 1997. Deposit Insurance, Bank Incentives, and the Design of Regulatory Policy. Finance and Economics Discussion Series, no. 1998-10. Board of Governors of the Federal Reserve System.

This study highlights the difficulties inherent in designing an optimal bank regulatory policy. When banks can issue equity at the risk-adjusted risk-free rate, collateralization of deposits with a risk-free asset costlessly resolves moral-hazard inefficiencies and insurance pricing issues. Heavy information requirements inhibit incentive-compatible designs in obtaining optimal bank-specific results.

MacDonald, Ronald. 1996. Deposit Insurance. *Handbooks in Central Banking*, no. 9. Centre for Central Banking Studies, Bank of England.

This handbook aims to give practical guidance on the essential questions that must be addressed in the establishment of deposit insurance schemes. It examines the rationale for deposit insurance, given the risk that insurance creates moral hazard. It then discusses the differences between formal deposit insurance schemes and implicit (or ad hoc) arrangements for depositor insurance, and the feasibility of private insurance. After describing different types of schemes, it deals with detailed matters such as triggers for the payment of compensation, selection of the categories of deposit that are to be protected, compensation ceilings, and co-insurance. Finally, it discusses the financing of compensation and of administrative arrangements.

Mas, Ignacio, and Samuel Talley. 1990. Deposit Insurance in Developing Countries. International Monetary Fund *Finance and Development* 27, no. 4:43–45.

As conditions in developing countries have become highly unstable, the affected governments have taken a variety of actions to restore stability to their banking systems. One such action has been to establish deposit insurance. This article contrasts explicit and implicit systems of deposit guarantees, explains the pros and cons of each insurance scheme, and details how best to design an insurance system.

McCallie, John D. 1995. Early Warnings of the Hazards of Federal Deposit Insurance at the Time of Its Inception. *History of Political Economy* 27, no. 4:687–703.

This article demonstrates that most of the criticisms of federal deposit insurance were well understood and warned about at the time of its inception, thus it is difficult to explain the guarantee nature of the plan by an earlier lack of understanding. The moral hazard problem had in fact been explicitly detailed by the early 1920s and regulatory forbearance was experienced and discussed by the early 1930s. Even proponents of deposit insurance were especially critical of the guarantee feature of the plan. Moreover, earlier remedies and alternatives match closely those advocated today. (©1999 EconLit)

Murton, Arthur J. 1989. Bank Intermediation, Bank Runs, and Deposit Insurance. *FDIC Banking Review* 2, no. 1:1–10.

This article examines why the government provides deposit insurance and how the provision of deposit insurance can improve economic performance. The author argues that the primary reason for deposit insurance is to promote financial stability by preventing bank runs. He points out, however, that deposit insurance may allow excessive risk-taking, and the costs of possible misallocation of resources associated with excessive risk-taking must be balanced against the benefits of financial stability. The terms of this trade-off depend on the availability of alternatives to bank deposits as sources of liquidity, the importance of bank lending activities, and the difficulty associated with monitoring bank asset values and monitoring risk-taking. Finally, the author considers alternatives to, and reforms of, deposit insurance.

Pulkkinen, Thomas E., and Eric S. Rosengren. 1993. Lessons from the Rhode Island Banking Crisis. Federal Reserve Bank of Boston *New England Economic Review* (May 1): 3–12.

The 1989 failure of the Rhode Island Share and Deposit Indemnity Corporation (RISDIC), a private insurance fund, and the closure of its 45 remaining member institutions froze the accounts of 300,000 individuals—10 percent of all deposits in the state. Although the closure of two institutions triggered RISDIC's demise, flaws in both design and management had set the stage for failure and are the focus of this article. The authors group RISDIC's problems into three categories: risk concentrations, control of the insurance fund by those it insured, and RISDIC's inadequate regulatory oversight of members. Concentrations of risks abounded. Both the fund and the geographic area it covered were small, and member institutions lent heavily in real estate. The fund's failure to reserve sufficiently against this exposure was especially problematic.

Radecki, Lawrence J. 1990. A Survey of the Origins and Purposes of Deposit Protection Programs. Research Paper no. 9034. Federal Reserve Bank of New York.

This paper presents a selective survey of deposit guarantee programs. First, it reviews the establishment of programs guaranteeing bank accounts in several countries and puts them in historical context. Second, the paper analyzes the intended purposes of a deposit protection program. The usefulness of a protection program and its role in the safety net for the banking system become clearer when one recognizes that reorganizing a failing bank is preferable to closing it down and that a deposit insurance fund may provide the resources needed to expedite an assisted merger or a recapitalization. Third, a deposit protection program, while intended primarily to maintain order and safety, has secondary and sometimes subtle effects on the banking sector.

Santomero, A. M., and J. T. Trester. 1993. Structuring Deposit Insurance for a United Europe. Working Paper no. 94-22. Wharton Financial Institutions Center, Wharton School of Business, University of Pennsylvania.

This paper analyzes the difficulties associated with bank regulation and deposit insurance in a unified Europe. Specifically, it explores the consequences of the Second Coordinating Banking Directive and the "common passport" branching regulation. The paper analyzes issues of deposit insurance premiums and taxes on banks (including reserve taxes) in the context of a general equilibrium model. The results indicate that in such a structure, taxes and deposit insurance are interdependent. At the minimum, exceedingly close macroeconomic policy coordination will be necessary if the single market for financial services is truly to come to fruition and be stable. A similar degree of cooperation will be necessary in the area of bank regulation.

Shull, Bernard. 1993. How Should Bank Regulatory Agencies Be Organized? *Contemporary Policy Issues* 11, no. 1:99–107.

The U.S. Treasury Department (1991) makes a strong case for consolidating federal bank regulatory authority. However, its proposal to eliminate direct FDIC authority over insured nonmember banks contributes little to this end because deposit insurance requires supervisory oversight. The U.S. Treasury Department (1991) also maintains an independent role for the Federal Reserve. Elimination of neither the insurance agency nor the central bank appears practical. A better approach to regulatory agency consolidation would combine supervision with deposit insurance and central banking in an institutional structure modified somewhat from the present Federal Reserve structure. (©1999 EconLit)

Talley, Samuel H., and Ignacio Mas. 1992. The Role of Deposit Insurance. In *Financial Regulation: Changing the Rules of the Game*, edited by Dimitri Vittas, 321–51. The World Bank.

This article first analyzes and evaluates the implications and desirability of creating a deposit insurance system in countries that do not already have such systems. It then identifies the major features of deposit insurance systems and reviews the pros and cons of alternative structures for each major feature.

Todd, Walker F. 1994. Lessons from the Collapse of Three State-Chartered Private Deposit Insurance Funds. Federal Reserve Bank of Cleveland *Economic Commentary* (May). Also 1994. Similarities and Dissimilarities in the Collapses of Three State-

Chartered Private Deposit Insurance Funds. Working Paper 9411. Federal Reserve Bank of Cleveland.

> This economic commentary analyzes the collapse of the Rhode Island Share Deposit Indemnity Corporation (RISDIC) with a view toward differentiating between the elements of failure and resolution that RISDIC shared with other large state-chartered deposit insurance funds—principally the Ohio and Maryland funds—and the elements that were unique to Rhode Island. Also examined are the factors that led to differences between the solution chosen by state and federal officials in Rhode Island and the solutions used in Ohio and Maryland. Finally, the author draws inferences from these episodes for the design and viability of private deposit insurance plans.

Towe, Christopher M. 1989. Optimal Fiscal Policy and Government Provision of Contingent Liabilities: The Example of Government Loan and Deposit Guarantees. Working Paper WP/89/84. International Monetary Fund.

> The optimal provision of loan guarantees or deposit insurance is examined in the context of an overlapping generations model. He demonstrates that even in the face of a market imperfection that precludes diversification of the private sector's loan portfolio to eliminate risk, full government guarantee of private sector loans (or deposits) is suboptimal. The results suggest that although some degree of guarantee is appropriate, such policies should be designed to avoid an inefficient level of capital accumulation. (©1999 EconLit)