Deposit Insurance Bibliography

Deposit Insurance: An Annotated Bibliography, Annual Update

For Calendar Year 2001

Deposit Insurance: An Annotated Bibliography, Annual Update for Calendar Year 2001

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Foreword

In 2000, the Federal Deposit Insurance Corporation (FDIC) published *Deposit Insurance: An Annotated Bibliography, 1989–1999,* a compilation of a decade's worth of deposit insurance–related research into one comprehensive reference source. The *Annotated Bibliography* is part of the FDIC's ongoing effort to assist policy makers and regulators around the world in the design and operation of deposit insurance systems and to promote additional research into deposit insurance issues.

This *Annual Update* of the deposit insurance bibliography contains relevant materials for calendar year 2001. As per the original and previous updates, this *Update* includes citations and abstracts for books, journal articles, working papers, dissertations, conference proceedings, congressional hearings, and government and international agency reports that focus on deposit insurance. The *Update* is available in a printer-friendly portable document format (PDF). Search and printing instructions are provided. Copies of materials listed in the *Update* can be obtained from any reference library or through standard interlibrary loan procedures.

Users may refer to the preface of the original edition of the *Annotated Bibliography* for more details about the purpose, scope, and sources of the bibliography. This information can be found at http://www.fdic.gov/deposit/deposits/international/bibliography/index.html.

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Acronyms

BIS	Bank for International Settlements
CDIC	Canada Deposit Insurance Corporation
CEC	Commission of the European Community
EC	European Community
EU	European Union
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FITD	Fondo Interbancario di Tutela dei Depositi
GDIA	Government Deposit Insurance Agency
GDP	Gross Domestic Product
GSE	Government-Sponsored Enterprise
IFS	International Financial System
IMF	International Monetary Fund
MIMIC	Mutual Insurance Model with Incentive Compatibility
MMMF	Money Market Mutual Fund
NBH	National Bank of Hungary
OECD	Organization for Economic Co-operation and Development
SADIS	South African Deposit Insurance Scheme
TBTF	Too Big to Fail
TEK	Hellenic Deposit Guarantee Fund

Deposit Insurance: An Annotated Bibliography
Annual Update for Calendar Year 2001

1. General Deposit Insurance Theory and Policy

Entries in this section are more general than entries in the other sections, and their perspective on deposit insurance issues is broader. These entries examine government-provided deposit insurance, alternative insurance structures and regimes, historical background, and budgeting and accounting issues.

Cull, Robert, Lemma W. Senbet, and Marco Sorge. 2001. Deposit Insurance and Financial Development. Policy Research Working Paper no. 2682. The World Bank.

National governments operate formal deposit insurance systems in order to stabilize their financial and payment systems. However, some economists have argued that deposit insurance can be socially counterproductive if the system is not appropriately structured and supported by adequate regulatory environments. In this paper, the authors examine the long-term effects of deposit insurance on financial development and stability (broadly defined to include the level of financial activity, the stability of the banking sector, and real-sector economic performance) in a sample of 58 countries. Overall, the paper's findings are consistent with the accepted thinking that deposit insurance schemes accompanied by sound regulatory environments have a positive effect on financial development and economic growth. However, the evidence also indicates that in countries lacking a sound regulatory environment (proxied by quality indices of the rule of law), the presence of a deposit insurance system could contribute to financial instability.

Demirgüç-Kunt, Asli, and Enrica Detragiache. 2001. Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation. Policy Research Working Paper no. 2247. The World Bank.

This study analyzes panel data for 61 countries during 1980-97 and concludes that explicit deposit insurance tends to be detrimental to bank stability, the more so where bank interest rates are deregulated and the institutional environment is weak. Also, the adverse impact of deposit insurance on bank stability tends to be stronger when the coverage offered to depositors is extensive, when the scheme is funded, and when it is run by the government rather than by the private sector. (© 2001 EconLit)

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.

Beck, Thorsten. 2001. Deposit Insurance as Private Club: Is Germany a Model? Policy Research Working Paper no. 2559. The World Bank.

The 1980s and 1990s have seen a marked increase in the number of countries that use explicit deposit insurance schemes as part of their government-provided financial safety net. Yet the benefits of having an explicit public system are not universally accepted. Indeed, a number of alternative deposit insurance systems—ones where the government's guarantee is less explicit or denied entirely—have existed for some time and have been quite successful. This paper describes and evaluates the deposit insurance scheme set up by private commercial banks in Germany in 1975. In contrast to many deposit insurance schemes, the German deposit insurance system is completely private, has no government supervision, and relies on peer monitoring by its member banks. The author evaluates the unique characteristics of the German scheme and the financial environment in which it operates to determine the extent to which it can serve as a model for other countries. He concludes that the German model might be applicable to developing countries that are characterized by concentrated banking sectors, provided there exists an institutional environment that fosters contract enforcement and exhibits a minimum level of corruption.

Canada Deposit Insurance Corporation (CDIC). 2001. International Conference on Deposit Insurance: Guidance and Future Directions. Conference Proceedings.

The first day of the CDIC international conference focused on guidance for countries developing deposit insurance systems and on emerging issues and future challenges for deposit insurers. The second day focused on technical presentations that covered issues such as premium and funding options, self-assessment methodologies, liquidation and failure-resolution options, and research priorities for deposit insurers. The final day of the conference was devoted to a discussion of the latest draft of the Basel II Capital Accord.

Demirgüç-Kunt, Asli, and Edward J. Kane. 2001. Deposit Insurance around the Globe: Where Does It Work? Policy Research Working Paper no. 2679. The World Bank.

In the late 1990s, several financial and banking crises occurred around the globe. As a result, a growing number of developing countries have been seeking advice about designing and adopting an explicit deposit insurance system. Previous research has delineated not only the well-known trade-off between banking stability and moral hazard but also the interaction between deposit insurance design features and country-specific elements of a country's financial and governmental contracting environment. This paper documents the extent of cross-country differences in deposit insurance design and reviews the empirical evidence on how particular design features affect private market discipline, banking stability, financial development, and the effectiveness of crisis resolution. The authors' findings suggest that countries with institutionally weak informational, legal, and supervisory environments should refrain from adopting an explicit deposit insurance system until they assess and remedy any weaknesses in their environments.

Demirgüç-Kunt, Asli, and Tolga Sobaci. 2001. Deposit Insurance around the World. *The World Bank Economic Review* 15, no. 3:481–90.

In the past two decades, in a series of banking crises around the world, banks have become systematically insolvent. These crises have occurred in developed and developing economies alike. To make such financial system breakdowns less likely and to limit their costs if they occur, policymakers feel the need for financial safety nets. These include such policies as implicit or explicit deposit insurance, a lender of last resort function of the central bank, bank insolvency resolution procedures, and bank regulation and supervision. Of these policies, explicit deposit insurance has been gaining popularity in recent years. Since the 1980s the number of countries with explicit deposit insurance schemes almost tripled, with most OECD countries and an increasing number of developing economies adopting some form of explicit depositor protection. In 1994 deposit insurance became the standard for the newly created single banking market of the European Union. Establishing an explicit deposit insurance scheme became part of the generally accepted best practice advice given to developing economies. (© 2001 EconLit)

Evanoff, Douglas D. 2001. Designing an Effective Deposit Insurance Structure: An International Perspective. The Federal Reserve Bank of Chicago. *Chicago Fed Letter,* no. 167c.

In December 2000, the Federal Reserve Bank of Chicago and the Financial Stability Forum (an international regulatory and monetary authority created by the Group of 7 industrialized nations in 1998 to study ways of managing risk in the global financial system) cosponsored a symposium on designing effective deposit insurance systems. Based on the Financial Stability Forum's recommendations to countries that were considering introducing or modifying deposit insurance schemes, the symposium was intended to generate informed feedback from leading financial and banking economists. This *Letter* summarizes the discussion at the symposium and the conclusions that emerged.

Fondo Interbancario di Tutela dei Depositi (FITD). 2001. *Report on Deposit Insurance: An International Outlook*. Rome: FITD.

This report focuses on updated data on deposit insurance systems already in place and describes innovations that have been introduced that may be of use to countries developing their own deposit insurance systems. Section one of the report presents the results of an FITD survey of the institutional characteristics of deposit insurance schemes in 30 countries. The survey results show that though there are some similarities, there are still many institutional and operational differences among deposit insurers around the globe. Section two of the report is a speech by Philadelphia Federal Reserve Bank President Anthony M. Santomero on how deposit insurance in the United States has evolved and how it currently works.

Hartley, James E. 2001. Mutual Deposit Insurance. *The Independent Review* 6, no. 2:235–52.

Should government bank deposit insurance be scrapped in favor of a system of bank cross-guarantees? Some proponents claim to have found successful cross-guarantees among the banks of antebellum Indiana, Ohio, and Iowa, but a closer examination suggests otherwise. (© 2001 EconLit)

Kaufman, George G., and Steven A. Seelig. 2001. Post-Resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk, and Too-Big-to-Fail. IMF Working Paper no. WP/01/83. International Monetary Fund.

Losses may accrue to depositors at insolvent banks both at and after the time of official resolution. Losses at resolution occur because of poor closure rules and regulatory forbearance. Losses after resolution occur if depositors are denied access to their funds—even temporarily. This paper examines both the sources and the implications of potential depositor losses in bank resolutions—in particular, depositor losses due to delays in the payment of legitimate depositor claims. The paper also reports on a special survey of access practices in deposit insurance schemes around the world and contrasts those with the policy of immediate access currently followed by the FDIC in the United States. The paper concludes with "best-practices" recommendations regarding depositors' access to their funds at resolved institutions.

3. Pricing and Valuation of Deposit Insurance

Entries in this section deal with methodologies for calculating deposit insurance premiums. In particular, they explore option pricing theory and its application to deposit insurance pricing; the effects of fixed and risk-adjusted pricing regimes; estimation of actuarially fair premiums; and the market value of deposit insurance guarantees over time.

Dermine, Jean, and Fatma Lajeri. 2001. Credit Risk and the Deposit Insurance Premium: A Note. *Journal of Economics and Business* 53, no. 5:497–508.

Previous research on market-based evaluation of deposit insurance premia has modeled the bank as a corporate firm with risky assets and insured liabilities. No attempt was made to analyze explicitly the risk characteristics of bank assets. The purpose of this note is to model bank lending explicitly and calculate loan-risk sensitive insurance premia. The lending function of banks creates the need to model equity as a "capped" call option. A simulation exercise shows that market-based estimates of deposit insurance premia which ignore the cap lead to significant underestimation. (© 2001 EconLit)

Pennacchi, George G. 2001. Estimating Fair Deposit Insurance Premiums for a Sample of Banks under a New Long-Term Insurance Pricing Methodology. In *The Financial Safety Net: Costs, Benefits, and Implications for Regulation*, *Proceedings of the 37th Annual Conference on Bank Structure and Competition,* 756–76. Federal Reserve Bank of Chicago.

A number of theoretical and empirical studies have applied option pricing methods to value deposit insurance premiums. However, the research is based on models that typically specify a single maturity date for the deposit insurance contract. This paper presents a model for valuing deposit insurance wherein insurance rates are set according to a moving average of the value of the FDIC's exposure to future losses. That is, the methodology involves treating the insurance guarantee as a moving average of several long-term contracts going forward. In addition to calculating fair premiums, the paper also calculates what is referred to as "expected-value" premiums under this overlapping contract or moving-average approach. Expected-value premiums differ from fair-value premiums in that they do not provide compensation for the insurer's exposure to systemic risk. The author holds that this approach results in less volatile insurance premiums and avoids providing banks with a deposit insurance subsidy. However, this stability comes at a price: higher fair-value premiums are needed to compensate taxpayers for their exposure to systemic risk.

4. Regulation and Supervision of Insured Depository Institutions

The entries in this section deal with the regulation and supervision of insured depository institutions: the appropriate role for bank regulation, alternative regulatory structures, principles of effective regulation, regulatory forbearance and its effect on the cost of bank failures, bank capital regulations, the economic effect of bank regulation, and deregulation.

Barth, James R., Gerald Caprio, Jr., and Ross Levine. 2001. Bank Regulation and Supervision: What Works Best? Policy Research Working Paper no. 2725. The World Bank.

This article draws on a unique World Bank database on bank regulation and supervision in 107 countries to examine the relationship between regulation/supervision on the one hand and bank performance and financial system stability on the other hand. More specifically, the authors assess the effect of a number of regulatory and supervisory practices, including the regulation of bank capital, permissible bank activities, information disclosure, ownership, the features of deposit insurance schemes, supervisory power, and level of enforcement. The analysis raises cautionary flags about strategies that rely excessively on direct government oversight and restrictions on bank activities. Rather, the regulatory strategies that best promote sector performance and stability are found to be those that empower the private sector and limit the adverse effects of overly generous deposit insurance schemes.

Barth, James R., Gerald Caprio, Jr., and Ross Levine. 2001. The Regulation and Supervision of Banks around the World. Policy Research Working Paper no. 2588. The World Bank.

This paper presents and discusses a new database on the regulation and supervision of commercial banks in 107 countries; included in the database is information on deposit insurance schemes. The data are drawn from a 1998–99 survey of national supervisory and regulatory agencies and covers entry and capital requirements, activity and ownership restrictions, auditing and disclosure requirements, loan classifications and provisioning regulations, troubled-bank resolution activity, supervisory quality, and a number of characteristics of deposit insurance schemes. In addition to providing a basic description of the data, the paper also presents some descriptive statistics, including alternative groupings and aggregations, as well as some simple correlations among selected variables. The database is available at the World Bank's Web site for financial sector research (http://worldbank.org/research/interest/intrstweb/htm).

Broome, Lissa L., and Jerry W. Markham. 2001. *Regulation of Bank Financial Service Activities: Cases and Materials*. West Group.

This book presents a comprehensive overview of banking regulation and law in the United States and is intended for both academics and practitioners. It covers the history of banking regulation as well as federal, state, and international regulatory issues. It has chapters on bank commercial lending; Gramm-Leach-Bliley and its regulatory implications for the securities, derivatives, and insurance operations of banks; the regulation of thrifts and credit unions; trust activities; geographic expansion, mergers, and antitrust; bank liabilities and capital; and supervision, enforcement, and failed-bank resolution.

Elifoglu, I. Hilmi, and James W. Thompson. 2001. When May Examiners Review External Auditors' Workpapers? *Bank Accounting and Finance* 14, no. 2:51–58.

This article summarizes the key elements of the Memorandum (Transmittal 00-19), Reviews of External Auditors' Workpapers, that the FDIC issued on March 21, 2000. The memorandum provides guidance to examiners on situations in which they should review the workpapers prepared by an insured depository institution's external auditor.

Feldman, Ron, and Mark Levonian. 2001. Market Data and Bank Supervision: The Transition to Practical Use. Federal Reserve Bank of Minneapolis *Region* 15, no. 3:11–13, 46–54.

Economic research conducted over the last several years has shown that market prices contain information on the riskiness of banking organizations. Can bank supervisors use this information to enhance their assessment of a bank's financial condition? The authors of this essay argue that they can and should. Specifically, the authors offer three ways in which market data should be routinely used in the supervisory process: (1) to help supervisors assess the overall condition of banking institutions, (2) to help them assess the quality of loans and capital, and (3) to facilitate supervisory responses to institutional risk taking. Moreover, the authors recommend that despite some inherent difficulties in using market data, bank supervisors should move quickly to broaden their use of this information so as to gain practical knowledge about the data's strengths and weaknesses and about the best way of using the data to improve the supervisory process.

Garten, Helen A. 2001. *U.S. Financial Regulation and the Level Playing Field*. Palgrave.

Why have financial modernization and regulatory reform in the United States never led to regulatory simplification? This book attempts to answer that question by examining the forces that drive the U.S. regulatory process. In particular, the author offers an explanation for the apparent contradiction between the United States' stated commitment to freer and more open financial markets and the fact that the nation's financial markets really do not appear all that open or free. In brief, her explanation is that regulation is legitimized to the extent that it improves the competitive fairness that U.S. financial market players demand from their system. Several examples of how regulation is being used to further the competitive fairness of U.S. financial markets are provided.

Hall, Maximilian J. B., ed. 2001. *The Regulation and Supervision of Banks.* Volume 1: *The Case for and Against Banking Regulation.* Volume 2: *Deposit Insurance.* Volume 3: *The Regulation of Bank Capital.* Volume 4: *Regulation and Efficiency in Banking*. JAI Press.

This is a four-volume reference collection of articles about the regulation of banks. Volume 1 covers (a) the cases for and against banking regulation, and (b) the design of an "optimal" regulatory framework. Volume 2 examines arguments for and against the adoption of deposit insurance as well as the problems that may occur in implementing a deposit insurance scheme. Volume 3 explores the issue of capital adequacy assessment, touching on the role played by capital and capital regulation and on the assessment of capital adequacy at international banks. Volume 4 deals with the links between regulation and efficiency in banking.

Maclachlan, Fiona C. 2001. Market Discipline in Bank Regulation: Panacea or Paradox? *Independent Review* 6, no. 2:227–34.

Central bankers often speak of the three pillars supporting the safety and soundness of the banking system: regulation, supervision, and, increasingly, market discipline. Paradoxically, many recent proposals intended to improve market discipline would in fact undermine it by giving rise to counterproductive regulatory discretion. (© 2001 EconLit)

Mishkin, Frederic S., ed. 2001. *Prudential Supervision: What Works and What Doesn't*. University of Chicago Press.

This volume contains a collection of papers and comments presented at a conference held by the National Bureau of Economic Research in January 2000. Papers include "Prudential Supervision: Why Is It Important and What Are the Issues," by Frederic S. Mishkin; "Banking Systems around the Globe: Do Regulation and Ownership Affect Performance and Stability?" by James R. Barth, Gerard Caprio, Jr., and Ross Levine; "Supervising Large Complex Banking Organizations: Adapting to Change," by Laurence H. Meyer; "Market Discipline in Governance of U.S. Bank Holding Companies: Monitoring versus Influencing," by Robert R. Bliss and Mark J. Flannery; "Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina, 1992–99," by Charles W. Calomiris and Andrew Powell; "Dimensions of Credit Risk and Their Relationship to Economic Capital Requirements," by Mark Carey; "Obstacles to Optimal Policy: The Interplay of Politics and Economics in Shaping Bank Supervision and Regulation Reforms," by Randall S. Kroszner and Philip E. Strahan; "Synergies between Bank Supervision and Monetary Policy: Implications for the Design of Bank Regulatory Structure," by Joe Peek, Eric S. Rosengren, and Geoffrey M. B. Tootell; and "Did U.S. Bank Supervisors Get Tougher during the Credit Crunch? Did They Get Easier during the Banking Boom? Did It Matter to Bank Lending?" by Allen N. Berger, Margaret K. Kyle, and Joseph M. Scalise.

Norton, Joseph J. 2001 Selective Bank Regulatory and Supervisory Trends upon Entering the 21st Century. *Essays in International Financial and Economic Law*, no. 34. London Institute of International Banking and Development Law.

The first part of this three-part essay examines the environment facing the banking industry and bank supervisors. Special attention is paid to the debate about the structural context of bank supervision, the increasingly legislative nature of modern financial sector reform, the increasing globalization of financial services, and the pursuit of an international financial architecture. The second part of the essay discusses specific supervisory trends, such as the idea of a supervisory "public-private partnership," the redefinition of the "business of banking," and the regulatory issues raised by the existence of large, complex banks. The focus of the final part of the essay is on the need to create more-advanced "portfolio credit risk" approaches to bank supervision and the challenges to doing so.

Walker, George Alexander. 2001. *International Banking Regulation: Law, Policy, and Practice*. Kluwer Law International.

This book examines the current regulatory framework for international banks. It details the story of the collective efforts of national regulatory authorities to deal with the threats to a single global financial market and to reduce the risks of systemic crisis. It recounts the financial crises of the past 25 years and discusses the regulatory responses to them, beginning with the establishment of the Basel Committee on Banking in 1975.

5. Role of Deposit Insurance in Bank Failures

Entries in this section focus on bank failures and the role deposit insurance played in those failures: the underlying causes of bank crises, failed-bank resolution methods, bank closure rules, the costs of failed-bank resolutions, and historical perspectives on the U.S. savings and loan debacle and the commercial bank crisis of the 1980s and early 1990s.

Bennet, Rosalind L. 2001. Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers. *FDIC Banking Review* 14, no. 1:1–28.

In January 2000, the FDIC surveyed 73 foreign deposit insurance agencies regarding their failure-resolution and asset-liquidation practices. This article reports on the nature and extent of those practices and compares them with the resolution policies and practices of the FDIC. The comparison indicates that the FDIC is uniquely empowered to act expeditiously in resolving bank failures, in disposing of failed-bank assets, and in reimbursing insured depositors. The author suggests that some of the failure-resolution techniques developed by the FDIC might be effectively applied in other countries.

6. Economics of Deposit Insurance

Entries in this section are more academic and focus on the following: bank risk taking, managerial incentives, bank stability, portfolio choice, charter values and shareholder return, and bank capital regulation. Also discussed are the costs and benefits of deposit insurance.

Grossman, Richard S. 2001. Double Liability and Bank Risk Taking. *Journal of Money, Credit and Banking* 33, no. 2:144–59.

This article examines double liability as it existed in the United States before the establishment of federal deposit insurance and assesses whether banks in states with double-liability laws undertook less risk than banks in states operating under conventional limited liability. The author finds that in times of relative financial calm, double liability was consistent with reduced bank risk taking (as evidenced by higher capital ratios and liquidity ratios) and lower failure rates. During times of severe financial disruption, however, double liability seems not to have contributed to financial stability. In fact, during tumultuous financial times, double liability seems to have been associated with greater levels of instability.

Hanousek, Jan, and Richard Podpiera. 2001. Detekce bankovnich selhani v tranzitivnich ekonomikach: Pripad CR (Detection of Bank Failures in Transition Economies: The Case of the Czech Republic). [With English summary.] *Finance A Uver* 51, no. 5:252–64.

This paper studies bank-failure models in the context of transition economies. In order to capture the default risk of banks, data on the structure of retail deposit rates is used to improve the prognostic quality of bank-failure prediction. The Czech bank crisis of 1994-1996, during which 14 banks failed, is used to verify the suggested approach. It is shown that banking supervision did not have—most likely given the low quality of the available accounting data—better information with respect to foretelling bank failures than the general public did via retail interest rates. In addition, the combination of balance-sheet and interest-rate data significantly improves the quality of bank-failure prediction. Thus, the utilization of information related to interest rates can increase the efficiency of banking supervision and can provide early warning signals of bank failures. (© 2001 EconLit)

Kahn, Charles M., and João A. C. Santos. 2001. Allocating Bank Regulatory Powers: Lender of Last Resort, Deposit Insurance, and Supervision. BIS Working Papers no. 102. Bank for International Settlements.

In this paper the authors examine the institutional allocation of the regulatory functions of lender of last resort, deposit insurance, and supervision. The authors argue that because these functions are interrelated, they require coordination among regulatory agencies whose mandates may be in conflict. By focusing on the interplay between the allocation of these powers and the design of both the deposit insurance scheme and the lending contract used by the lender of last resort, the authors find that having these functions performed by a single regulator leads to insufficient bank monitoring and suboptimal bank investment in loans. It may also lead to too much forbearance. Under alternative structures, however, the authors' model shows that it is feasible to specify an optimal arrangement of regulatory authority that overcomes these problems.

Kocherlakota, Narayana R. 2001. Risky Collateral and Deposit Insurance. *Advances in Macroeconomics* 1, no. 1:1–18.

This paper provides a new rationalization for deposit insurance and systemic disintermediations. The author considers an environment in which borrowers face no penalty for failing to repay obligations except the loss of their collateral under the assumption that this collateral has aggregate risk. For a subset of the exogenous parameters, the author demonstrates that an optimal arrangement features deposit insurance. For a strictly smaller set of parameters, it is optimal in some states of the world to have systemic distintermediations and concomitant falls in real output. (© 2001 EconLit)

Luzio-Antenzana, Rodolfo Santiago. 2001. Market Discipline, Asymmetric Information and Banking Regulation: An Application to Bolivia. Ph.D. diss., University of Chicago.

This dissertation examines whether market supervision by depositors could control risk taking and play an important role in government regulatory policy. Data from Bolivian banks is used to study the heterogeneity of deposit interest rate premia and net flows across banks in the presence of deposit insurance. The author traces the heterogeneity to fundamental attributes of banks that determine the risk exposure of deposits to the possibility of bank default. A private information model of bank asset and liability management is developed that helps to explain the heterogeneity of deposit interest rates and flows across banks in the context of asymmetric information between depositors and bank insiders when partial deposit insurance is present. The author finds that "good" banks signal their status as "good" by holding a large portion of low-risk, liquid assets. This not only differentiates them from "bad" banks but also lowers their financing costs and results in their getting a higher share of deposits. Empirical evidence supporting the presence of adverse selection in the market for bank debt in Bolivia is also presented.

Martin, Antoine. 2001. Liquidity Provision vs. Deposit Insurance: Preventing Bank Panics without Moral Hazard? Working Paper no. RWP 01-05. Federal Reserve Bank of Kansas City.

It is widely recognized that deposit insurance can lead to excessive risk taking by banks—a problem known as moral hazard. This paper develops a model to analyze whether a central-bank policy of providing liquidity to banks during panics can prevent bank runs without causing moral hazard. The model contains three key features: (1) bank panics may occur in equilibrium, (2) moral hazard can occur, (3) the central bank can create more money that is readily held. The results show that a central-bank repurchase policy provides liquidity to the banking system that can prevent panics without causing moral hazard. In contrast, the results also indicate that deposit insurance, although capable of preventing runs, does create moral hazard.

Miles, William. 2001. Can Money Market Funds Provide Sufficient Liquidity to Replace Deposit Insurance? *Journal of Economics and Finance* 25, no. 3:328–42.

Narrow banking is an arrangement in which deposit-taking and lending functions are separated and performed by different institutions. This separation is aimed at avoiding panics at uninsured banks, without the moral hazard associated with deposit insurance. Money Market Mutual Funds (MMMFs) are promoted as replacements for bank deposits. For MMMFs to compete with banks, they must be able to withstand a monetary shock without losing shareholders in a flight to quality at government-insured institutions. VAR analysis indicates that MMMFs increase share issue subsequent to a monetary tightening. This bolsters the case that liquidity can be provided in a narrow banking framework. (© 2001 EconLit)

Peria, Maria Soledad Martinez, and Sergio L. Schmukler. 2001. Do Depositors Punish Banks for Bad Behavior? Market Discipline, Deposit Insurance, and Banking Crises. *The Journal of Finance* 56, no. 3:1029–51.

This paper empirically investigates two issues largely unexplored by the literature on market discipline. Specifically, the authors evaluate the interaction between market discipline and deposit insurance and the impact of banking crises on market discipline. Focusing on the experiences of Argentina, Chile, and Mexico during the 1980s and 1990s, the authors find that depositors discipline banks by withdrawing deposits and by requiring higher interest rates. Deposit insurance does not appear to diminish the extent of market discipline. Aggregate shocks affect deposits and interest rates during crises, regardless of bank fundamentals, and investors' responsiveness to bank risk taking increases in the aftermath of crises. (© 2001 EconLit)

Perotti, Enrico C., and Javier Suárez. 2001. Last Bank Standing: What Do I Gain If You Fail? Discussion Paper no. 2933. Center for Economic Policy Research.

Banks' attitude towards speculative lending is typically regarded as the result of trading-off the short-term gains from risk-taking against the risk of loss of charter value. In this paper, the authors study the trade-off between stability and competition in a dynamic setting where charter value depends on future market competition. Promoting the takeover of failed banks by solvent institutions results in greater market concentration and larger rents for the surviving incumbents. This converts banks' speculative lending decisions into strategic substitutes, granting an additional incentive to remain solvent. Entry policy may subsequently serve to fine-tune the trade-off between competition and stability. (© 2001 EconLit)

Souma, Toshiyuki. 2001. Efficient Lending and a New Aspect of Government Deposit Insurance Agency. *Osaka Economic Papers* 3, no. 1:1–21.

The number of insolvent banks in Japan has increased substantially in recent years. Common wisdom is that insolvent banks should be liquidated immediately. This paper questions the wisdom of immediate liquidation of insolvent banks because it results in a loss of funding not only for projects with negative net present values but also for projects with positive present values. To determine what types of agents must loan funds to an insolvent bank in order to prevent the bank from engaging in inefficient lending, the author uses a model in which an insolvent bank borrows funds and lends, regardless of a project's return. The author shows that financing from a government deposit insurance agency (GDIA) can make a bank's lending efficient. This finding contradicts those from a number of other studies in which the existence of a GDIA encouraged a bank to take too much risk. The paper also shows that efficient lending can be achieved regardless of the total deposits to be insured.

Zhu, Haibin. 2001. Bank Runs, Welfare and Policy Implications. BIS Working Paper no. 107. Bank for International Settlements.

The banking sector is naturally vulnerable to bank runs because banks issue liquid liabilities but invest in illiquid assets. This paper puts forward a model in which bank runs are closely related to the condition of the business cycle. In a market economy, the basic model shows that bank runs result in welfare costs. Extensions of the model examine the welfare effects of certain government policies aimed at preventing bank runs. The results show that an interest-cap deposit insurance scheme is an efficient policy for the prevention of bank runs, whereas other policies (such as the suspension of convertibility, an interest-rate penalty on short-term deposits, or a full coverage deposit insurance scheme) result in adverse side effects.

7. Deposit Insurance and Moral Hazard, Risk, and Incentives

Entries in this section deal with the moral-hazard problem caused by the provision of deposit insurance, methods of mitigating the problem, the effect of deposit insurance on bank risk-taking behavior and on the incentives of bank management, and the principal–agent problem in bank regulation.

Gropp, Reint, and Jukka Vesala. 2001. Deposit Insurance and Moral Hazard: Does the Counterfactual Matter? European Central Bank Working Paper Series no. 47. European Central Bank.

This paper analyzes the relationship (for European banks) between deposit insurance and debt-holder monitoring, bank charter values, and risk taking. Using cross-sectional and time-series variation about deposit insurance schemes in the European Union, the authors find that the establishment of explicit deposit insurance significantly reduces the risk taking of banks. This finding is in sharp contrast to the long-standing belief that deposit insurance induces moral hazard. The authors explain this anomaly by suggesting that even though European banking systems formerly did not have explicit deposit insurance schemes, they were characterized by strong implicit deposit insurance operating through expectations of public intervention during times of distress. Hence, the introduction of an explicit system may imply a de facto reduction in the scope of the financial safety net. In addition, the authors test hypotheses about the interaction between deposit insurance and debt-holder monitoring, charter values, and "too big to fail" and find that banks with more subordinated debt and lower charter values reduce risk taking more after the introduction of explicit deposit insurance. "Too-big-to-fail" problems, however, are not found to be mitigated after the introduction of explicit deposit insurance.

Osborne, Dale K., and Seokwon Lee. 2001. Effects of Deposit Insurance Reform on Moral Hazard in US Banking. *Journal of Business Finance and Accounting* 28, nos. 7–8:979–92.

Previous empirical studies have found that larger banks and banks with lower charter values or capital levels tend to increase the riskiness of their portfolios when deposit insurance is present. Reforms enacted as part of FDICIA (enacted in 1991 and fully implemented in 1993) were designed to combat such moral-hazard behavior. In this article, the authors test the effect of deposit insurance reform on the moral-hazard behavior of banks. Specifically, the authors compare the pre- and post-reform associations between bank risk taking and bank charter value, bank size, and bank capital—three variables previously found to play an important role in the moral hazard induced by deposit insurance. As hypothesized, the authors find that the associations between systematic risk and charter value and asset size are significantly weaker after deposit insurance reform. The association between systematic risk and capital is also found to be weaker, but the change is not statistically significant. The authors see this finding as evidence that reform has indeed reduced the moral hazard created by government-provided deposit insurance.

8. Safety Nets, Deposit Insurance, and Subsidies

Entries in this section include works on bank safety nets in general and deposit insurance in particular. Also covered are the costs and benefits of official government safety nets, the existence of safety net–related banking subsidies and their competitive implications, and policies for containing such subsidies.

Carnell, Richard Scott. 2001. Federal Deposit Insurance versus Federal Sponsorship of Fannie Mae and Freddie Mac: The Structure of Subsidy. In *The Financial Safety Net: Costs, Benefits, and Implications for Regulation, Proceedings of the 37th Annual Conference on Bank Structure and Competition*, 118–32. Federal Reserve Bank of Chicago.

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are government-sponsored enterprises (GSEs)—privately owned profit-oriented corporations with federal charters and a public mission to develop and improve the secondary market for residential mortgage loans. Because of their public mission, these GSEs receive a variety of government benefits, including exemption from federal corporate income taxes. More importantly, the GSEs derive a cost-of-funds advantage that stems from capital market participants' perception that the securities issued by the GSEs carry an implicit government guarantee. This article describes the federal government's sponsorship of Fannie Mae and Freddie Mac and recounts the firms' recent attempts—by depicting federally insured depository institutions as GSEs—to deflect the criticism that the government gives these GSEs overly generous benefits. The article then outlines six structural reasons that federal sponsorship of Fannie Mae and Freddie Mac, with their perceived implicit guarantee, tends to impart a greater net government subsidy than does explicit federal deposit insurance.

Cerda, Oscar, Elijah Brewer III, and Douglas D. Evanoff. 2001. The Financial Safety Net: Costs, Benefits, and Implications. The Federal Reserve Bank of Chicago. *Chicago Fed Letter* (Special Issue), no. 171a.

On May 9–11, 2001, the Federal Reserve Bank of Chicago hosted its 37th annual Conference on Bank Structure and Competition. This year's conference focused on the implications of the various explicit and implicit financial safety nets, ranging from deposit insurance and subsidies to government-sponsored enterprises (GSEs) to the notion that some financial institutions are "too big to fail." This *Letter* summarizes some of the issues discussed at the conference by the keynote speaker and by special discussion panels composed of subject-matter experts from academia and government regulatory agencies.

Federal Reserve Bank of Chicago. 2001. *The Financial Safety Net: Costs, Benefits, and Implications for Regulation, Proceedings of the 37th Annual Conference on Bank Structure and Competition.* Federal Reserve Bank of Chicago.

Conference proceedings include topics such as Financial Safety Net Issues; GSEs: Their Impact on Markets; The Effects of Bank Consolidation and Expansion; The Role of Banking Relationships; Bank Business Strategies; Bank Risk and Capital Issues;

Financial Crisis and Contagion; Perusing Regulatory Reform; Regulatory Incentive Alignment; and Alternative Deposit Insurance Structures. Papers related to deposit insurance include "Community Banking Institutions, Deposit Insurance Reform, and Too Big to Fail," by Kenneth A. Guenther; "Controlling the Safety Net," by Laurence H. Meyer; "Recommendations for the Changes in the Way Federal Deposit Insurance Is Funded," by Arthur J. Murton; "Deposit Insurance and Moral Hazard," by Asli Demirgüç-Kunt and Enrica Detragiache; "Issues in Deposit Insurance Reform," by James A. Wilcox; "Allocating Bank Regulatory Powers: Lender of Last Resort, Deposit Insurance, and Supervision," by Charles M. Kahn and João A. C. Santos; "Developing Effective Deposit Insurance Systems," by J. P. Sabourin; "How Good Are EU Deposit Insurance Schemes?" by Maximilian J. B. Hall; "Designing Financial Safety Nets for Countries in Different Circumstances," by Edward J. Kane; and "Estimating Fair Deposit Insurance Premiums for a Sample of Banks under a New Long-Term Insurance Pricing Methodology," by George G. Pennacchi.

Kane, Edward J. 2001. Financial Safety Nets: Reconstructing and Modeling a Policymaking Metaphor. *Journal of International Trade and Economic Development* 10, no. 3:237–73.

This paper explains that financial safety nets exist because of difficulties in enforcing contracts and shows that elements of deposit-insurance schemes differ substantially across countries. It shows that differences in the design of financial safety nets correlate significantly with differences in the informational and contracting environments of individual countries and that a country's GDP per capita is correlated with proxies for a country's level of: (1) informational transparency, (2) contract enforcement and deterrent rights, and (3) accountability for safety net officials. The analysis portrays deposit insurance as a part of a country's larger safety net and contracting environment. This means that there is no universal method for preventing and resolving banking problems and that the structure of a country's safety net should evolve over time with changes in private and government regulators' capacity for valuing financial institutions, disciplining risk taking and resolving insolvency promptly, and for being held accountable for how well they perform these tasks. (© 2001 EconLit)

Kane, Edward J. 2001. Using Disaster Planning to Optimize Expenditures of Financial Safety Nets. *Atlantic Economic Journal* 29, no. 3:243–53.

Using a multiperiod model, this paper offers a benchmark standard for efficient safety net management. This standard embodies a market-mimicking strategy for identifying, preventing, and resolving bank insolvencies. Around the world, governmental reluctance to acknowledge weaknesses in their crisis prevention efforts supports an underinvestment in contingent plans for handling financial disaster. The model features the hypothesis that this underinvestment misserves taxpayers by increasing the ability of stakeholders in insolvent banks to extract implicit and explicit subsidies when and as the threat of an actual crisis intensifies. (© 2001 EconLit)

9. Country- or Region-Specific

Entries in this section focus on deposit insurance in a specific country or region and cover the following: country-specific descriptions of deposit insurance systems, comparative surveys, international experiences with deposit insurance systems, and banking and deposit insurance reforms outside of the United States.

Dar, Humayon A., Maximilian J. B. Hall, and Dadang Mujawan. 2001. A Strategic Design of Islamic Banking Regulations. Middle East Business and Economic Review 13, no. 2:28–38.

It is important for sound operation of an Islamic banking system to have a set of prudential regulations that not only protect and promote fundamentals of Islamic banking but also bridge the gap between Islamic and conventional banking styles. There is a lot in common between the two systems, which makes it easy to apply some principles of western banking supervision to Islamic banks. The regulators should also recognize the difference between theory and practice of Islamic banking while devising regulatory framework for Islamic banks. This paper proposes that prudential regulations for Islamic banks should aim at achieving two objectives. First, they should accommodate the issue of practicality in order to promote soundness of Islamic banking operations, which have moved away from its perfect paradigm. Second, they should provide right incentives so that the players are encouraged to embrace the perfect paradigm of Islamic banking in the future. (© 2001 EconLit)

Hall, Maximilian J. B. 2001. How Good Are EU Deposit Insurance Schemes in a Bubble Environment? In *Research in Financial Services: Private and Public Policy*, edited by George G. Kaufman, vol. 13, 145–93. JAI Press.

In the wake of the EU member states' adoption in 1994 of the EC Deposit Guarantee Schemes Directive, most EU member states were forced to either introduce a deposit insurance system or modify their existing scheme to comply with the new community legislation. This article examines the main features of the deposit insurance schemes now operated in the 15 members states of the European Union and assesses the extent to which, individually, they comply with "best-practice" rules for explicit deposit insurance systems as promulgated by the International Monetary Fund. Using what he describes as a "relatively crude but nevertheless objective measure of the extent of such compliance," the author ranks the member states and compares the results with the ratings achieved by the deposit insurance systems operating in the United States and Japan. The comparison indicates that all schemes operated by member states compare poorly with their North American counterpart. The main factors responsible for depressing the EU scores are the failure to adopt prompt corrective action provisions, the failure of most nations to impose co-insurance on depositors, overgenerous levels of protection, and the failure to commit to the recommended timetable for reimbursing depositors. The author submits, however, that some of these failings partly reflect the errors and omissions contained in the guiding EC directive.

Hellenic Deposit Guarantee Fund (TEK). 2001. *Hellenic Deposit Guarantee Fund*. TEK.

This publication provides depositors and researchers with comprehensive information about the role and functions of the Greek deposit insurance scheme, the Hellenic Deposit Guarantee Fund (TEK). The publication explains the management of the TEK, sources of financing and revenue, coverage levels and eligible deposits, obligations of participating credit institutions, supervision of the TEK, cooperation with the deposit guarantee schemes of other countries, and the current status of and future outlook for the TEK. (© 2001 EconLit)

Kopecky, Ondrej. 2001. Bankovni regulace v mezivalecnem Ceskoslovensku (Banking Regulation in Czechoslovakia 1918–1938.) [With English summary.] *Finance a Uver* 51, no. 5:280–98.

The article surveys the establishment of a legislative framework providing for banking regulation in Czechoslovakia during 1918-38. The state intervened in bank sanitation twice during economic recessions in the early 1920s and 1930s. The shocks resulted in the adoption of banking laws to strengthen the stability of the banking sector. The laws interfered with the internal organization of banks, compelled personal responsibility on the part of bank management, protected creditors, and supported inexpensive credit. The Ministry of Finance supervised and pursued license policies. Other control activities were delegated to autonomous professional institutions. The article goes into great detail in describing the development of the areas mentioned above, and concludes in presenting an estimate of state assistance related to sanitation waves. (© 2001 EconLit)

Okeahalam, Charles C., and Tudor Maxwell. 2001. Deposit Insurance Design and Bank Regulation in South Africa. *Journal of Financial Regulation and Compliance* 9, no. 2:139–50.

Many nations have established explicit deposit insurance systems to prevent bank runs and to mitigate the economic costs associated with individual bank failures. Experience has shown, however, that explicit deposit insurance can increase the risk-taking behavior of banks. In this article, the authors explore the implications of the relationship between deposit insurance design and bank system stability. They then relate this to the recent history of bank failure in South Africa. Finally, they describe the development and testing of a model of the proposed South African Deposit Insurance Scheme (SADIS).

Szapary, Gyorgy. 2001. Banking Sector Reform in Hungary: Lessons Learned, Current Trends and Prospects. NBH Working Paper no. 2001/5. National Bank of Hungary.

Hungary was the first of the Central and Eastern European Countries to begin reforming its banking system. This paper first reviews the history of reform and current trends in the Hungarian banking system and then draws some lessons that may be useful for countries in the early stages of the reform process. The paper makes the specific point that, when state enterprises are in poor condition, it is essential that the restructuring of banks be concurrent with the restructuring of state enterprises.

Thomson, Di, and Malcolm Abbott. 2001. Banking Regulation and Market Forces in Australia. *International Review of Financial Analysis* 10, no. 1:69–86.

The purpose of this paper is to use Kane's notion of the regulatory dialectic to analyze the changing nature of bank regulation in Australia. Throughout Australia's economic history, economic regulation of the Australian banking system has not been static but has responded to changes in technology, market forces, and the behavior of regulated institutions. From this analysis, some inferences about general banking principles and policy can be made. (© 2001 EconLit)

Walker, David, and Pongsak Hoontrakul. Transitioning from Blanket to Limited Deposit Guarantees: Thailand Policy Considerations. *Sasin Journal of Management* 7, Supplement.

This article proposes a two-tiered deposit insurance system model for Thailand's banking system similar to those used by the Canada Deposit Insurance Corporation (CDIC) and the Federal Deposit Insurance Corporation (FDIC). The first tier of the system would be compulsory and publicly administered and would provide deposit protection for low levels of bank deposits in the same manner as the FDIC and CDIC do. The second tier would be similar to the public/private system that is used in Germany to provide voluntary additional protection for high-coverage-level bank deposits not covered by the public system.

Yang, Jiacai. 2001. *Cun Huan Bao Xian Zhi Du Ji Zhongguo Mo Shi*. Zhonggu Jin Ron Chu Ban She.

This book explores whether China has the market basis for the establishment of a deposit insurance system. The first chapter examines the theoretical foundation for deposit insurance systems. The second chapter is an overview of the operating characteristics and achievements of deposit insurance systems in other countries and territories. The third chapter explains market foundations for developing a deposit insurance system in China. The fourth chapter proposes a design for a deposit insurance system with Chinese characteristics, and the fifth chapter addresses moral hazard and the moral corruption that could result from the adoption of such a system.

10. Deposit Insurance Reform in the United States: Pre-FDICIA

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) was passed in December 1991. Entries in this section were published before or soon after its passage and describe the problems and weaknesses of the pre-FDICIA deposit insurance system. Highlighting the need for reform, these entries contain numerous recommendations for reforming, if not abolishing or privatizing, deposit insurance.

NO ENTRIES

11. Deposit Insurance Reform in the United States: Post-FDICIA

Entries in this section were published after passage of the FDICIA reform legislation in December 1991. They include overviews of that legislation; periodic assessments of its application and effectiveness, weaknesses and shortcomings, and effect on bank operations and incentive structures; discussions of continuing problems with bank regulation and deposit insurance; and recommendations for additional reforms.

Akhigbe, Aigbe, and Ann Marie Whyte. 2001. The Impact of FDICIA on Bank Returns and Risk: Evidence from the Capital Markets. *Journal of Banking and Finance* 25, no. 2:393–417.

This study examines the effect of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 on bank stock returns and risk. The authors find that FDICIA had a generally positive effect on bank stock returns and resulted in a significant reduction in bank risk. The extent of the risk reduction varies based on the capitalization, size, and credit risk of the institutions with poorly capitalized, large, and high credit risk banks experiencing the greatest risk reduction. The results obtained using two separate control groups also bolster the conclusion that FDICIA's passage resulted in a significant decline in bank risk. (© 2001 EconLit)

Kaufman, George G. 2001. Reforming Deposit Insurance—Once Again. Federal Reserve Bank of Chicago. *Chicago Fed Letter* 171

In 2001 the FDIC published two papers on deposit insurance reforms. The first singled out provisions of the current deposit insurance structure that the FDIC believed needed to be revisited, and the second presented the FDIC's recommendations for changes to those provisions. This *Chicago Fed Letter* describes the current structure of deposit insurance and discusses some of the provisions that the FDIC wanted reexamined.

Kaufman, George G., and Peter J. Wallison. 2001. The New Safety Net. *Regulation* 24, no. 2:28–35.

Following the costly banking and thrift crises of the 1980s and early '90s, the United States dramatically reformed the federal government safety net for depository institutions, which economists blamed for the outbreak and high cost of the crises. The reforms, highlighted by the 1991 Federal Deposit Insurance Corporation Improvement Act, curtailed poor agency behavior by federal regulators, curtailed the notion that the federal government would "bail out" uninsured depositors of large or politically well-connected banks, and decreased abuse of Fedwire and Federal Reserve Lending. However, other reforms are still needed to limit moral hazard behavior and to make the banking industry, itself, responsible for the health of individual banks. (© 2001 EconLit)

Thomson, James B. 2001. Who Benefits from Increasing the Deposit Insurance Limit? Federal Reserve Bank of Cleveland. *Economic Commentary* (September).

This article explores issues related to the notion of raising the federal deposit insurance limit to $200,000, and particularly the issues of which parties would benefit from increases in the limit and would the benefits be consistent with the social objectives of deposit insurance. Potential benefits to three groups are examined: stakeholder-depositors, community banks, and taxpayers. The author argues that if the social objective of deposit insurance is to protect small savers, there is little justification for raising the coverage limit. However, raising the coverage limit might have positive social-welfare effects if the objective is to level the playing field between small and large banks. The author also contends that there is little evidence that taxpayers would benefit from increases in the limit; the experience of the 1980s suggests they might even be harmed. Finally, in summarizing, the author raises the question of whether government intervention is still necessary, given all the advances in information and technology and the financial market reforms enacted in the 1990s.

U.S. House. 2001. Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services. *Deposit Insurance Reform: Hearing*. 107th Cong., 1st sess., May 16.

Witnesses include David Bochnowski, Robert I. Gulledge, James E. Smith, and Hon. Donna Tanoue.

U.S. House. 2001. Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services. *Viewpoints of Select Regulators on Deposit Insurance Reform: Hearing*. 107th Cong., 1st sess., July 26.

Witnesses include Hon. Sheila C. Blair, Hon. John D. Hawke Jr., Hon. Laurence H. Meyer, and Hon. Ellen Seidman.

U.S. House. 2001. Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services. Viewpoints of the FDIC and Select Industry Experts on Deposit Insurance Reform: Hearing. 107th Cong., 1st sess., October 17.

Witnesses include Richard S. Carnell, Nolan L. North, Hon. Donald E. Powell, and Kenneth H. Thomas.

Wilcox, James A. 2001. MIMIC: A Proposal for Deposit Insurance Reform. *Journal of Financial Regulation and Compliance* 9, no. 4:338–49.

In this article the author proposes a mutual insurance model with incentive compatibility (MIMIC). The MIMIC model is an alternative model for deposit insurance that emulates the incentives and procedures of a mutual insurance organization in order to better align the incentives of banks and the FDIC with those of the government and taxpayers. The main characteristics of the MIMIC model are annual, fully risk-based premiums; payments by the FDIC to the Department of the Treasury for its line of credit and catastrophe insurance; rebates to banks when the reserve ratio exceeds a risk-based ceiling; surcharges for banks when the reserve ratio falls below a risk-based floor; dilution fees on deposit growth to maintain the reserve ratio; and refunds to maintain the reserve ratio when deposits shrink. Adopting the features of the MIMIC model would result in the deposit insurance system's embracing the policies and practices of a private sector mutual insurance organization.

12. Legal Aspects of Deposit Insurance

This section includes entries of a more legal nature, including but not limited to works dealing with national depositor preference, liability issues in bank-failure cases, case studies from bank-failure resolutions, and legislative histories.

NO ENTRIES

13. Too Big to Fail

Entries in this section deal specifically with the implicit bank regulatory policy known as "too big to fail" (TBTF): its origins; its economic consequences; its effects on bank behavior and risk taking, on banks' cost of funds, and on depositor behavior; and corrective policy prescriptions.

Bastidon, Cecile, and Philippe Gilles. 2001. Prêteur en dernier ressort et statut de "too big to fail" d'un emprunteur souverain: Le "jeu de faux-semblants" appliqué à la crise finançière russe. (When the International Lender of Last Resort Faces a "Too Big to Fail" Sovereign Borrower: The Russian Financial Crisis. With English summary.) *Economie Appliquée* 54, no. 2:129–51.

This paper aims to analyze the moral hazard relationship between Russia and the IMF. The model used, which is original, is one with a multilateral lender, whose utility depends on the stability of the International Financial System (IFS), and a borrowing country, whose debt threatens this stability. For this reason, lending can be optimal for the IMF, knowing that the loans will not be repaid. (© 2001 EconLit)

Kane, Edward J. 2001. Dynamic Inconsistency of Capital Forbearance: Long-Run vs. Short-Run Effects of Too-Big-to-Fail Policymaking. *Pacific-Basin Finance Journal* 9, no. 4:281–99.

This paper begins by reviewing the costs and benefits that fully informed creditors would consider in deciding whether to recapitalize or liquidate an insolvent corporation. It goes on to identify the additional concerns and conflicts of interest that incompletely informed taxpayers face when short-horizoned government regulators manage the insolvency of giant banks. Regulatory decisions may exhibit dynamic inconsistency because opportunistic forbearance offers personal and bureaucratic rewards and officials who confront bank insolvency in a timely way are threatened with substantial reputational and career penalties. However, the model also indicates that dynamically inconsistent capital forbearance could emerge because current taxpayers believe they can shift the costs of resolving bank insolvencies to future taxpayers. (© 2001 EconLit)

Penas, Maria Fabiana. 2001. Bank Mergers and Too-Big-to-Fail Policy. Ph.D. diss., University of Maryland.

It is believed that most governments follow an implicit too-big-to-fail policy of protecting unsecured creditors of large insolvent banks in order to prevent a failure that could trigger a contagious crisis throughout the financial system. This dissertation introduces a model that analyzes a bank's risk and funding decisions within a framework that includes both deposit insurance and a bailout policy. Contrary to conventional wisdom, the model predicts that it is possible for risk to decrease after an increase in the probability of a bailout, and vice versa. The dissertation also provides empirical evidence that an important motivation for bank mergers is to become too big to fail. For example, merging banks' bond-adjusted returns were found to be positive and significant in premerger and announcement months, and the acquiring banks' credit spreads on new debt issues were lower after the merger. Also, cross-sectional regression results (after the effects of diversification, changes in leverage, and asset quality are controlled for) show that the increase in size resulting from the merger is a significant determinant of the positive bond returns and the decline in credit spreads. However, these results are significant only for medium-sized banks, which are the group most likely to attain too-big-to-fail status after a merger.

Wolgast, Michael. 2001. "Too Big to Fail": Effects on Competition and Implications for Banking Supervision. *Journal of Financial Regulation and Compliance* 9, no. 4:361–72.

Since the 1980s, there have been increasing discussions about the potential consequences of government intervention to prevent a large bank from failing. One basic concern is that large banks may be receiving a competitive funding advantage from the public's belief that, were problems to arise, a large bank would not be allowed to fail. This concern has been echoed by Germany's public sector banks, which claim that, because of TBTF, major (private sector) banks—against which they compete—enjoy "implicit guarantees" similar to their own "explicit" state guarantees. In this article, the author argues that under realistic assumptions, especially with respect to incentives for bank management and shareholders, TBTF does not lead to excessive risk taking by large banks. Nor, he contends, does the advantage bestowed by TBTF surpass or even approach the financing advantages enjoyed by public sector banks in Germany. The author suggests, however, that with banking becoming increasingly global, TBTF does have substantial implications for international banking supervisory arrangements and suggests that one possible counter to cross-border systemic risk would be a lender of last resort serving the entire European Union.

14. FDIC-Administered Insurance Funds

Entries in this section relate specifically to the structure, status, and future condition of the two bank insurance funds administered by the Federal Deposit Insurance Corporation. Entries also discuss the merits of maintaining separate insurance funds for thrifts and commercial banks, and the effects of the industry's continuing consolidation on the exposures of the insurance funds.

NO ENTRIES