



DEPOSIT INSURANCE

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**AN
ANNOTATED
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ANNUAL UPDATE

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Deposit Insurance: An Annotated Bibliography, Annual Update

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Foreword

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

This on-line installment is the first *Annual Update* of the deposit insurance bibliography. It contains citations and abstracts for books, journal articles, working papers, dissertations, conference proceedings, congressional hearings, and government and international agency reports on deposit insurance published primarily during the year 2000. The *Annual Update* may also include some citations from earlier years that were not discovered during our original search. Copies of materials listed in the *Annual Update* can be obtained from the user’s nearest reference library or by the use of 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; see <http://www.fdic.gov/deposit/deposits/international/bibliography/index.html>.

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Acronyms

AGDL	Deposit Guarantee Association of Luxembourg
BIF	Bank Insurance Fund
BIS	Bank for International Settlements
CEC	Commission of the European Community
CPA	Certified Public Accountant
DIF	Deposit Insurance Fund (of Bulgaria)
DIS	Deposit Insurance System
EC	European Community
ECU	European Currency Unit
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FHLB	Federal Home Loan Bank
FOBAPROA	The Fund for the Protection of Bank Savings
FRBNY	Federal Reserve Bank of New York
FSLIC	Federal Savings and Loan Insurance Corporation
GAO	General Accounting Office
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPAB	Bank Savings Protection Fund
LTCM	Long Term Capital Management
NAFTA	North American Free Trade Agreement
RFC	Reconstruction Finance Corporation
RTC	Resolution Trust Corporation
OCC	Office of the Comptroller of the Currency
OMB	Office of Management and Budget
PCA	Prompt Corrective Action
ROC	Republic of China
S&Ls	Savings and Loan Associations
SAIF	Savings Association Insurance Fund
SEACEN	South East Asian Central Banks
SFRC	Shadow Financial Regulatory Committee
SND	Subordinated Notes and Debentures
TBTF	Too Big to Fail
TEK	Hellenic Deposit Guarantee Fund

Deposit Insurance: An Annotated Bibliography, Annual Update

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.

Chai, Jingqing, and R. B. Johnston. 2000. An Incentive Approach to Identifying Financial System Vulnerabilities. Working Paper WP/00/211. International Monetary Fund.

This paper argues that any analysis seeking to identify potential vulnerabilities or instabilities in a financial system should explicitly account for that system's underlying incentive structure. Researchers have shown that three key structural and policy elements shape the incentives faced by the main agents in any financial system: the market structure within which the system operates, the existence of government safety nets, and the legal and regulatory frameworks. These factors influence agents' propensities to take risks and determine the inclinations of regulators, supervisors, and markets to monitor risk-taking. The paper outlines an approach for assessing the incentive structure in relation to risk-taking behavior that might threaten the financial system.

Economides, Nicholas, R. Glenn Hubbard, and Darius Palia. 1999. Federal Deposit Insurance: Economic Efficiency or Politics? *Regulation* 22, no. 3:15–17.

This article argues that the adoption of the federal deposit insurance system in the United States can be attributed more to political power than economic necessity. Although deposit insurance was proposed ostensibly to protect depositors against future bank failures, it would also safeguard the interests of small banks. At the same time that large, well-capitalized banks were supporting the less-restrictive branching legislation, small banks were lobbying both to maintain strict branching regulations, which would prevent competition from larger banks, and to create a deposit insurance fund, which would enable smaller banks to attract consumers while holding less capital. In the end, a concerted political campaign by small banks and their representatives was able to overcome the opposition of larger banks and deposit insurance legislation was enacted.

Kelly, William A., and Judith F. Karofsky. 1999. Federal Credit Unions without Federal Share Insurance: Implications for the Future. Paper no. 1752-46. Filene Research Institute.

This study compares the performance of uninsured credit unions with that of uninsured banks. Results show that federal share insurance has not bestowed sizable benefits on member institutions and that uninsured credit unions behave more conservatively towards risk-taking than uninsured banks. The authors suggest that uninsured accounts should therefore be permitted at credit unions, although they also urge that more research be done regarding the implementation of such a policy.

Kroszner, Randall S., and Philip E. Strahan. 2000. Obstacles to Optimal Policy: The Interplay of Politics and Economics in Shaping Bank Supervision and Regulation Reforms. Working Paper no. W7582. National Bureau of Economic Research.

This paper provides a positive political economy analysis of the most important revision of the U.S. supervision and regulation system during the last two decades, the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA). The authors analyze the impact of private interest groups as well as political-institutional factors on the voting patterns on amendments related to FDICIA and its final passage to assess the empirical importance of different types of obstacles to welfare-enhancing reforms. Rivalry of interests within the industry (large versus small banks) and between industries (banks versus insurance) as well as measures of legislator ideology and partisanship play important roles and, hence, should be taken into account in order to implement successful change. A "divide and conquer" strategy with respect to the private interests appears to be effective in bringing about legislative reform. The concluding section draws tentative lessons from the political economy approaches about how to increase the likelihood of welfare-enhancing regulatory change. (© 2002 EconLit)

Oda, Nobuyuki, and Tokiko Shimizu. 2000. Prospects for Prudential Policy: Toward Achieving an Efficient and Stable Banking System. Bank of Japan *Monetary and Economic Studies* 18, no. 1:119–36.

This paper discusses the role of public intervention in the banking market, emphasizing that although market mechanisms can be effective in achieving efficient banking markets, government intervention and prudential policy can be justified when there are notable market failures. Specific market failures in banking include asymmetries in the type and quantity of information available to banks and creditors, and negative externalities associated with bank failures. The authors provide a conceptual summary of the ways in which bank regulatory systems can address these market problems and ensure banking efficiency and stability. They recommend that the deposit insurer charge a variable premium and have the authority to take prompt corrective action against undercapitalized institutions. Separately, the central bank acts as a lender of last resort. In addition, the authors believe that a payments system should be devised to force risk takers to internalize the costs of their behaviors.

Stojanovic, Dusan, Mark D. Vaughan, and Timothy J. Yeager. 2000. Is Federal Home Loan Bank Funding a Risky Business for the FDIC? Federal Reserve Bank of St. Louis *The Regional Economist* (October): 4–9.

This paper discusses the recent growth of the Federal Home Loan Bank (FHLB) System, which was established in 1932 to address a perceived deficit in the nation's capital market by making collateralized loans to thrift institutions. The scope of the FHLB System has expanded considerably; the system now offers thrifts, commercial banks, and credit unions a wide range of products and services to help them fund mortgage loans, manage interest-rate risk, and otherwise meet

the challenges of a competitive banking market. Between 1992 and 1999 the FHLB's assets, membership, and outstanding advances increased dramatically. FHLB advances may prove costly for the FDIC, however, because they allow banks to take more risks, weakening the deposit insurer's position in failure resolutions.

Villanueva, Delano. 1999. *Early Warning Indicators, Deposit Insurance and Methods for Resolving Failed Financial Institutions: Selected Papers of the SEACEN Workshop on a Regulator's Action Plan on Bank Failures*. Southeast Asian Central Banks (SEACEN). Kuala Lumpur: SEACEN Centre.

This volume collects the lecture and teaching materials presented at the March 1998 SEACEN workshop, "A Regulator's Action Plan on Bank Failures." The materials cover various aspects of financial crisis management. Topics include early-warning indicators, deposit insurance as a mode of depositor protection, the resolution process, purchase-and-assumption transactions, deposit payoffs, open-bank assistance transactions, other resolution alternatives, the FDIC's role as receiver, and other significant issues.

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.

Alsalem, Ahmed Mohammed. 2000. An Evaluation of the IMF Best-Practice Deposit Insurance System: Lessons from the United States Experience. Ph.D. diss., Colorado State University.

It is generally agreed that a well-designed deposit insurance system should advance the vitality and stability of the banking sector while minimizing the informational asymmetries that are often associated with insurance programs: moral hazard, adverse selection, and agency problems. To this end, researchers have sought to create models that guide the development of effective deposit insurance systems by identifying specific best practices. One such model, proposed by Gillian Garcia, was adopted by IMF authorities for use by countries that are considering the establishment of a deposit insurance system. The author argues, however, that the Garcia-IMF model is flawed because it is based only on the lessons from the post-1991 period in the United States and recent experiences in other countries. It omits the long and rich pre-1991 experiences of the Federal Deposit Insurance Corporation (FDIC), the individual U.S. states, the failed Federal Savings and Loan Insurance Corporation (FSLIC), and The National Credit Union Share Insurance Fund (NCUSIF). The author makes use of this richer history to identify and incorporate additional institutional features that have proven successful in the past. He then shows that his modified Garcia-IMF model better addresses the fundamental problems of operating a deposit insurance system.

Financial Stability Forum. 2000. Working Group on Deposit Insurance: A Consultative Process and Background Paper. (June).

The Financial Stability Forum commissioned a Study Group in 1997 to analyze the feasibility of setting out international guidance regarding deposit insurance arrangements. The Study Group's report concluded that international guidelines would be an invaluable resource to countries looking to adopt or reform a deposit insurance system. Accordingly, the Working Group on Deposit Insurance was commissioned. This pamphlet outlines the issues on which the Working Group will focus in developing deposit insurance guidelines. As part of its charge, the Working Group will assess the conditions necessary to establish an effective system, delineate key attributes of the ideal system, and address issues related to making the transition from blanket guarantees to a limited-coverage insurance system.

Financial Stability Forum and Federal Reserve Bank of Chicago. 2000. *Designing an Effective Deposit Insurance Structure: An International Perspective*. Conference Proceedings. December 12, 2000.

This conference held at the Federal Reserve Bank of Chicago, served as a forum for academics, regulators, and industry practitioners to discuss ways to improve deposit insurance system design and reform. The Financial Stability Forum's Working Group on Deposit Insurance presented four draft issue papers covering public-policy objectives, methods of analyzing a nation's preparedness for deposit insurance, ways to limit moral hazard, and issues encountered when deposit insurance is altered to provide limited coverage rather than blanket guarantees. The discussants offered several suggestions for improving the papers, pointing out the need to determine when implicit insurance might be preferable to explicit insurance, the need to present definitive guidance rather than a vague list of alternatives from which countries can choose when implementing a deposit insurance scheme, and the important role of market discipline in a country's regulatory scheme.

Garcia, Gillian. G. 2000. Deposit Insurance and Crisis Management. Working Paper no. WP/00/57. International Monetary Fund.

A well-designed deposit insurance system (DIS) will provide incentives for citizens to keep the financial system sound. However, a poorly designed DIS can foster a financial crisis. This paper, therefore, makes recommendations for creating and running a limited, incentive-compatible DIS. The paper also examines factors in the decision to grant, temporarily, a comprehensive guarantee, and the design of that guarantee, should a systemic financial crisis nevertheless occur. It concludes with guidance on the removal of that guarantee. (© 2002 EconLit)

Hermes, Niels, and Robert Lensink. 2000. Financial System Development in Transition Economies. *Journal of Banking and Finance* 24, no. 4:507–24.

This paper provides an overview of the major issues with respect to financial system development in transition economies, which were discussed at a conference in Groningen, the Netherlands, December 1997. After a brief remark on the role of financial system design during economic transition, the paper focuses on the role of stock markets in the process of financial intermediation with emphasis on the role of regulations in these markets, the role of deposit insurance to improve bank system stability, and the importance of an independent central bank, measurement issues relating to central bank independence and its impact on inflation and growth. (© 2002 EconLit)

Lee, Wai Sing, and Chuck C. Y. Kwok. 2000. Domestic and International Practice of Deposit Insurance: A Survey. *Journal of Multinational Financial Management* 10, no. 1:29–62.

The literature on deposit insurance tends to be mostly confined to a discussion of the reform proposals and risk-related premium assessment methodologies. The theoretical explanation of the alternatives to the major components of a deposit insurance scheme is sketchy. Comparisons on the international practice of deposit insurance are not extensive and comprehensive enough. To fill the gaps in the literature, this paper examines the theoretical foundations of the key issues of a deposit insurance scheme, provides a critical comparison on the international practice of deposit insurance, and makes suggestions on how a complete deposit insurance scheme can be properly designed and implemented. (© 2002 EconLit)

3. Pricing and Valuation of Deposit Insurance

Entries in this section deal with the 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.

Morel, Christophe, and Jean-Louis Nakamura. 2000. Fonctions et tarification d'un fonds de garantie bancaire (functions and pricing of deposit insurance). *Revue française d'économie* 15, no. 2:77–116.

The purpose of this research is two-fold. Firstly, it presents the economic justifications for deposit insurance schemes as well as the features of such schemes identified as "optimal" in the literature in order to avoid moral hazard and adverse selection phenomena. Thus, according to the literature, deposit insurance should be limited, compulsory, universal and the fees paid by the banks should directly depend on each bank's risk level. Secondly, it tests two alternative ways of calculation for the fees paid by the banks to the deposit insurance. The first method consists in drawing a comparison between the insurance fee and a put option, whose price may be calculated from each bank's investment risk. The second proposal relies on a model of banking behavior which determines a "socially optimal" insurance fee. Such a fee should indeed maximise the banks' profits when no bank fails and depositors' indemnities when the bank is going bankrupt. (© 2002 EconLit)

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.

American Enterprise Institute (AEI). 2000. Reforming Bank Capital Regulation: A Proposal by the U.S. Shadow Financial Regulatory Committee. Policy Statement no. 160. AEI Press.

This statement by the Shadow Financial Regulatory Committee (SFRC) responds to the Basel Committee's 1999 proposal to reform international bank capital standards. The SFRC agrees with the Basel Committee's objective of relying more heavily on market-based risk assessments to determine bank capital standards but believes that the specific proposals under consideration may actually distort the relationship between capital requirements and risk. The SFRC recommends that the current risk-based requirements be replaced by a minimum leverage requirement. The group further recommends that banks be forced to meet these new capital requirements by issuing new subordinated debt; this would align market forces more directly with bank risk measures and would reward or penalize proper or inadequate bank risk management. The SFRC would not, however, reduce the role of bank supervisors and regulators but, instead, would supplement regulation with market discipline.

Association d'économie financière. 2000. *La Revue d'économie financière*, no. 60. [Published in English.]

This issue of the *Revue d'économie financière* focuses exclusively on issues relating to financial security and regulation. The pieces cover five themes: changes in the principles of prudential control, the legal aspects of prudential control, the organization of prudential supervision, supervisory problems posed by particular financial players, and the question of deposit insurance. The articles specifically related to deposit insurance are "The French System of Deposit Insurance," by Charles Cornut; "An Overview of France's New Deposit Insurance System," by Sylvie Matherat and Vitchett Oung; and "Deposit Insurance as a Tool for Banking Supervision," by Christophe Morel. Each of these is abstracted separately.

Benston, George J. 2000. Is Government Regulation of Banks Necessary? *Journal of Financial Services Research* 18, no. 2-3:185-202.

Banks have been involved with and regulated by governments for hundreds of years. Following a brief review of this history, the author delineates nine reasons that could justify continued regulation, particularly in the United States. These include deposit insurance, preventing banks from obtaining excessive economic power, reducing the cost of individual bank insolvency, avoiding the effects of bank failures on the economy, protecting the payments system, serving the interests of popularly elected officials, enhancing the Federal Reserve's control over the money supply, suppressing competition, and protecting consumers. Analysis of each leads the author to conclude that deposit insurance, which allows

banks to hold insufficient capital, is the only public-policy-justifiable rationale for regulation. This concern can be managed with capital requirements; otherwise, banks should only be regulated as are other corporations. (© 2002 EconLit)

Board of Governors of the Federal Reserve System. 1999. Using Subordinated Debt as an Instrument of Market Discipline. Staff Study no. 172. Board of Governors of the Federal Reserve System.

This report presents the results of a Federal Reserve System study of issues pertaining to the use of subordinated notes and debentures (SND) as policy instruments to achieve market discipline. The study examines the motivations for SND policies, given current banking industry conditions; presents a review of relevant literature discussing the extent to which SND policy can influence market discipline; and analyzes the different operational characteristics of an SND policy.

Board of Governors of the Federal Reserve System and U.S. Department of the Treasury. 2000. The Feasibility and Desirability of Mandatory Subordinated Debt. Report submitted to the Congress pursuant to section 108 of the Gramm-Leach-Bliley Act of 1999. Board of Governors of the Federal Reserve System.

This report assesses whether certain depository institutions and/or depository institution holding companies that are deemed to be systemically important should be required to issue and maintain a minimum amount of subordinated debt. The five primary objectives of a subordinated debt policy would be to improve direct market discipline, improve indirect market discipline, improve transparency and disclosure at depository institutions, increase the size of the financial cushion provided to the federal deposit insurer, and reduce the tendency for depository institution supervisors to forbear resolving a troubled institution. The report concludes that mandated subordinated debt can be expected to encourage market discipline and improve transparency, although it is uncertain whether such a policy would enlarge the deposit insurance financial cushion or dissuade regulators from practicing forbearance. Thus, the Board of Governors of the Federal Reserve System and the Secretary of the Treasury do not support the implementation of a subordinated policy at this time, but they welcome further research into the topic.

Calomiris, Charles W. 2000. *U.S. Bank Deregulation in Historical Perspective*. Cambridge University Press.

Six previously published papers describe how a combination of momentary political bargaining and long-run path dependence has produced the history of American banking regulation and, more recently, deregulation. Papers consider regulation, industrial structure, and instability in U.S. banking in historical perspective; recent models of the origins of banking panics in light of the available evidence; the origins of federal deposit insurance; American finance and the cost of rejecting universal banking based on a comparison with the German case, 1870–1914; the evolution of market structure, information, and spreads in

American investment banking; and change in U.S. corporate banking during the 1980s and 1990s and prospects for the future. (© 2002 EconLit)

Chapra, M. Umer, and Tariqullah Jeddah Khan. 2000. Regulation and Supervision of Islamic Banks. Islamic Development Bank, Islamic Research and Training Institute.

This paper considers the regulatory standards and supervisory framework needed for Islamic banks and whether existing international standards of best practice are adequate, given the differences from conventional banks arising from the need to comply with the Shari'ah. It provides background on the history, characteristics, and changing environment of Islamic finance. It addresses questions of prudential regulation and supervision, reviewing international standards and covering issues of capital adequacy and the implications of the emerging risk-weighting systems for Islamic banks, alternatives available for Islamic banks, risk management, internal controls and external audit, transparency, deposit insurance, accounting standards, and the possible establishment of an Islamic Financial Services Board and an International Islamic Rating Agency. It discusses some of the crucial fiqhi issues that need to be resolved to facilitate the effective supervision of Islamic banks and accelerate their development. (© 2002 EconLit)

Eisenbeis, Robert A., Frederick T. Furlong, and Simon Kwan, eds. 1999. Financial Modernization and Regulation. *Journal of Financial Services Research* 16, nos. 2/3. Kluwer Academic.

Twelve papers, plus comments, presented at a conference cosponsored by the Federal Reserve Banks of Atlanta and San Francisco in September 1998, identify the reasons for changes in the financial-services sector and the implications for financial supervision and regulation. Papers focus on the relation between interbank transactions and supervisory reform; implications for bank supervision of modernizing financial regulation; theory and evidence regarding the subsidy provided by the federal safety net; the effects of setting deposit insurance premiums to target insurance fund reserves; trends in organizational form and their relationship to performance in the case of foreign securities subsidiaries of U.S. banking organizations; financial regulatory structure and the resolution of conflicting goals; regulatory distortions in a competitive financial-services industry; how offshore financial competition disciplines exit resistance by incentive-conflicted bank regulators; alternative approaches to financial supervision and regulation; financial modernization and regulation in Japan; a perspective on financial regulation from the United Kingdom; and Europe's single banking market. (© 2002 EconLit)

Federal Reserve Bank of Chicago. 2000. *The Changing Financial Industry Structure and Regulation: Bridging States, Countries, and Industries*. Proceedings of the 36th Annual Conference on Bank Structure and Competition.

Papers relevant to deposit insurance include "Bond Market Discipline of Banks," by Donald P. Morgan and Kevin J. Stiroh; "Corporate Valuation and the Resolution of Bank Insolvency in East Asia," by Simeon Djankov, Jan Jindra, and Leora Klapper; "Are Fiscal Costs of Banking Crises Increased by Poor

Resolution Policies," by Patrick Honahan and Daniela Klingebiel; and "The Role of Subordinated Debt in Bank Safety and Soundness Regulation," by Larry Wall. The conference also included panel discussions on reforming bank capital requirements, Too Big to Fail, and other safety net issues. A summary of the conference was published in a special issue of the Chicago Fed Letter (September 2000, no. 157a).

Gilbert, R. Alton, and Mark D. Vaughan. 2000. Do Depositors Care about Enforcement Actions? Working Paper 2000-020A. Federal Reserve Bank of St. Louis.

Economists claim that public revelation of bank supervisors' formal enforcement actions will enhance market discipline, whereas supervisors fear that such public disclosure will trigger bank runs. This study examines depositors' reactions to recent Federal Reserve announcements, comparing depositors' reactions to affected banks with their behavior toward banks not named in the announcements. The results demonstrate no evidence of unusual deposit runoffs or significant increases in deposit costs at affected banks, suggesting that the disclosures do not inspire depositor panic. However, although depositors seemed to be indifferent to enforcement announcements in the 1990s, they might be more responsive to such information in a less-favorable banking environment.

Gilbert, R. Alton, Andrew P. Meyer, and Mark D. Vaughan. 2000. The Role of a CAMEL Downgrade Model in Bank Surveillance. Working Paper no. 2000-021A. Federal Reserve Bank of St. Louis.

This paper compares two models that seek to predict when bank supervisory ratings will be downgraded to problem status. The first is a model used by the staff of the Board of Governors of the Federal Reserve to predict bank failures; the second is a model estimated specifically to predict downgrades of supervisory ratings. Although both models seem equally effective in predicting downgrades when using historical data from the early 1990s, the downgrade model's predictive power improves over the sample time period and eventually surpasses the effectiveness of the failure model. The authors suggest that the downgrade model may be a useful addition to supervisory analysis, especially during periods in which most banks are healthy, but that it should not supplant traditional supervisory practices.

Gup, Benton E., ed. 2000. *The New Financial Architecture: Banking Regulation in the 21st Century*. Quorum Books.

This book contains selected writings detailing methods of bank regulation that have been proposed to cope with the rapidly changing financial markets. Titles include "Regulating International Banking: Rationale, History, and Future Prospects," by Ronnie J. Phillips and Richard D. Johnson; "Are Banks and Their Regulators Outdated?" by Benton E. Gup; "Designing the New Architecture for U.S. Banking," by George G. Kaufman; "What Is Optimal Financial Regulation?" by Richard J. Herring and Anthony M. Santomero; "The Optimum Regulatory Model for the Next Millennium—Lessons from International Comparisons and

the Australian–Asian Experience,” by Carolyn Currie; “Banking Trends and Deposit Insurance Risk Assessment in the 21st Century,” by Steven A. Seelig; “Supervisory Goals and Subordinated Debt,” by Larry Wall; “Market Discipline for Banks: A Historical Review,” by Charles G. Leathers and J. Patrick Raines; “Market Discipline and the Corporate Governance of Banks: Theory vs. Evidence,” by Benton E. Gup; “Message to Basel: Risk Reduction Rather Than Management,” by Johannes Juttner; and “Drafting Land Legislation for Developing Countries: An Example from East Africa,” by Norman J. Singer.

Heinrichs, Hanna. 1999. *Barings: Leçons pour la réglementation prudentielle des banques*. Editions de l’Université de Bruxelles. [In French without English summary.]

This book discusses the fall of Barings, focusing on how failures of internal and external controls paved the way for the bank’s demise, highlighting obvious gaps in those current control mechanisms, and discussing future regulatory trends. The book begins with a general discussion of recent trends in the banking industry and the evolving goals and functions of bank regulation, especially as they relate to global financial diversification and the new need for cooperation between different regulatory authorities. The author then explains the specific complexities posed by derivatives and the challenges to regulators who seek to implement risk-management controls and capital standards. Finally, the author details the events that led to Baring’s failure and draws lessons for the future, suggesting ways in which prudential regulation of banking institutions can be improved to prevent similar collapses.

Jagtiani, Julapa, and Catharine Lemieux. 2000. Market Discipline Prior to Failure. Emerging Issues Series S&R-2000-14R. Federal Reserve Bank of Chicago.

This paper investigates how the bonds issued by bank holding companies are priced when a subsidiary is poised to fail. The findings show that during the period when the subsidy from deposit insurance is most crucial, just before a subsidiary bank’s failure, bond spreads increase to indicate the subsidiary’s financial deterioration. The implication is that increasing subordinated debt requirements would probably be an effective way to increase market discipline in the banking industry. This mechanism could be made even more accurate with improved and timely disclosures of information.

Jordan, John S. 2000. Depositor Discipline at Failing Banks. Federal Reserve Bank of Boston *New England Economic Review* (March): 15–28.

Uninsured depositors, whose deposits are not fully protected by federal deposit insurance, have an incentive to monitor banks’ activities and impose additional funding costs on risky banks. This pricing is a form of market discipline, since the market penalizes banks for taking on greater risk. For banks that become troubled, market discipline can take a more severe form: market participants may become unwilling to supply uninsured funds at any reasonable price. This study examines the effectiveness of depositor discipline at banks that failed in New England in the early 1990s. The empirical analysis examines whether failing banks in New England faced depositor discipline as they became troubled in the

early 1990s, and whether these banks attempted to shield themselves from this discipline. Failing banks in New England experienced a 70 percent decline in their uninsured deposits in their final two years of operation. The author finds that despite the magnitude of the gap to fill, and despite the presence of close regulatory scrutiny, many failing banks increased their use of insured deposits enough to offset much of the shortfall created by the decline in uninsured deposits, diminishing the effectiveness of market discipline by depositors. (© 2002 EconLit)

Kaufman, George G., ed. 2000. *Bank Fragility and Regulation: Evidence from Different Countries*. Research in Financial Services: Private and Public Policy, vol. 12. JAI Press.

Ten papers, presented at three invited sessions at the annual meeting of the Western Finance Association in Vancouver in July 2000, contribute to the understanding of the causes, symptoms, and consequences of banking problems by studying banking fragility and regulation in different countries. Papers examine the effects of bank regulation and financial structure on the likelihood and costs of banking crises in a diverse group of countries; the origin, objectives, and functioning of the European Shadow Financial Regulatory Committee and its recommendations; subordinated debt and bank capital reform; challenges to the structure of financial supervision in the European Union; deposit rate premiums and the demand for funds by thrifts; a regulatory regime for financial stability; the 1997 Market Risk Amendment to the Basel Capital Accord, which formally incorporates banks' internal, market-risk models into regulatory capital calculations, and lessons for the development of internal models-based approaches to bank regulation and supervision; the role of a CAMEL downgrade model in bank surveillance; credit registers and early warning systems of bank fragility; and deposit insurance funding and insurer resource allocation. (© 2002 EconLit)

Lin, Wei-Yi. 2000. The Role of the Financial Early-Warning System in Strengthening Financial Supervision and the Deposit Insurance Mechanism. Paper presented at the International Conference on Early-Warning Systems for Financial Crises, Taipei, Taiwan, January 20–21, 2000.

The author discusses the importance of establishing a financial early-warning system, the history and current operating conditions of the financial early-warning system in the Republic of China, the contribution of China's financial early-warning system to the strengthening of financial supervision and the deposit insurance mechanism in that country, the feasibility of using international cooperation to establish a regional financial early-warning system to prevent the occurrence of financial crises, the effect that strengthening the financial early-warning system may have on financial supervision and the deposit insurance mechanism in the future, and the problems that may occur.

Llewellyn, David T. 2000. Some Lessons for Bank Regulation from Recent Crises. Paper no. 51. De Nederlandsche Bank. Also 1999. Some Lessons for Bank Regulation from Recent Crises. Finance and Development Research Programme Working Paper Series, no. 11. Loughborough University. United Kingdom.

This paper discusses the concept of regulatory strategy, which involves optimizing the outcome of the regulatory regime as a whole rather than focusing on any of the particular components. Regulation is one part of the regulatory regime, but other aspects—for example, supervision—are equally important (and shareholders, managers, and the market all have a role in supervising financial firms). The author suggests an optimum “regulatory regime” that has seven key components: regulation, official supervision, incentive structures within banks, market discipline, intervention arrangements and corporate governance arrangements, and the accountability of the regulatory agencies. Since there are trade-offs between the components, effective regulatory strategy needs to focus on the overall effect of the regime and not just on regulation.

Mishkin, Frederic S. 2000. Prudential Supervision: Why Is It Important and What Are the Issues? Working Paper no. W7926. National Bureau of Economic Research.

This working paper was prepared for the NBER conference “Prudential Supervision: What Works and What Doesn’t?” held in Islamorada, Florida, January 13–15, 2000. It begins with an overview of the asymmetric information problems in the financial system and discusses how banks play a critical role in overcoming these problems. The author then explains why, giving banking institutions’ important role in the financial industry, effective supervision is crucial; and, drawing on the conference papers, he discusses how such supervision can be designed. The paper concludes with a general overview of the papers presented at the conference.

Morel, Christophe. 2000. Deposit Insurance as a Tool for Banking Supervision. *Revue d'économie financière*, no. 60:233-44. [Published in English.]

After reminding the reader of the economic justifications of bank regulation, this paper pays particular attention to one of the instruments of this regulation, the deposit insurance. While offering a protection to the depositors, the deposit insurance would allow to prevent bank runs and thus reduce the occurrence probability of a systemic crisis. The author presents the features of such a scheme identified as “optimal” in the academic literature in the sense that they avoid moral hazard and adverse selection phenomena. Thus, ideally, the system should be public and compulsory for all banks; the guarantee should be limited and all-in price; the premium paid by the banks should directly depends on each bank's risk level. (© 2002 EconLit)

Morgan, Donald P., and Kevin J. Stiroh. 2000. Bond Market Discipline of Banks: Is the Market Tough Enough? Staff Report No. 95. Federal Reserve Bank of New York.

This study uses bond spreads, ratings, and bank portfolio data on more than 4,100 new bonds issued between 1993 and 1998 to analyze the disciplinary role of markets. The findings demonstrate that the market prices of bonds serve as

efficient indicators of bank risk. Investors assess not only bond ratings but also banks' loans and assets in making their decisions. The market effectively disciplines banks such that an institution undertaking riskier activities can expect to pay higher spreads. But this disciplinary mechanism is less effective for bigger or more-complex banks; the implication is that other means of disciplining bank risk-taking might be appropriate in some cases.

Mwenda, Kaoma Mwenda. 2000. *Banking Supervision and Systemic Bank Restructuring: An International and Comparative Legal Perspective*. London: Cavendish Publishers.

This book, which provides an international, comparative perspective on legal issues in banking supervision and bank restructuring, is based on the premise that banking regulation is most effective when it smoothly and rationally incorporates the legal and extralegal (economic, political, sociocultural, and financial) aspects of supervision. The book examines such contemporary topics as the design and implementation of financial restructuring, the interactions between banks and nonbank financial-service providers and the ways in which these relationships affect bank supervision, methods of preventing and containing contagion problems, and the suitability of having a single prudential regulator. The author draws on various countries' experiences with bank reform efforts to illustrate the pertinent legal issues, while also emphasizing the importance of an interdisciplinary approach to bank regulation.

Spencer, Peter D. 2000. *The Structure and Regulation of Financial Markets*. Oxford University Press.

This financial textbook analyzes financial products from the perspective of information theory; explains why financial markets and institutions are prone to failure; and addresses how regulation can reduce the risk of failure and how legal and regulatory constraints help shape a country's corporate and financial structures. Discusses asymmetric information in financial markets; adverse selection in the market for retail financial services; the structure and regulation of insurance markets; capital-market microstructure and regulation; information revelation, transparency, and insider regulation; security research and regulation; the equity market and managerial efficiency; the theory of financial intermediation; moral hazard in the bank loan and public bond markets, excessive risk, and bank regulation; bank runs, systemic risk, and deposit insurance; bank regulation in practice; and financial structure and regulation. Includes end-of-chapter exercises. (© 2002 EconLit)

Spong, Kenneth. 2000. *Banking Regulation: Its Purposes, Implementation, and Effects*. 5th ed. Federal Reserve Bank of Kansas City.

This book discusses the motivations and justifications for regulating banks; the history of banking regulation; the definition and structure of banks, bank holding companies, and financial holding companies; the functions of the different bank regulatory agencies; regulations for depositor protection and monetary stability; regulation consistent with an efficient and competitive financial system;

regulation for consumer protection; and future trends in banking regulation. Deposit insurance is a major component of the bank regulatory structure and, as such, is thoroughly detailed throughout the book; the author recounts the history of deposit insurance, explains the major pieces of legislation that have shaped the deposit insurance system, and describes the current purpose and functioning of the FDIC.

U.S. General Accounting Office (GAO). 2000. *Risk-Focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges*. GAO/GGD-08-48. GAO.

This study assesses the new risk-focused approaches to bank examination that are now being used by the Federal Reserve and the Office of the Comptroller of the Currency (OCC). The report describes the new techniques, which assess the effectiveness of banks' internal controls, and explains how they differ from more traditional practices, which sought to evaluate the quality of bank assets. It also compares the ways in which these two bank regulators implement the risk-focused techniques: the OCC's large-bank supervision program is highly centralized and standardized, whereas the Federal Reserve's program displays much less uniformity. Finally, the study looks at the challenges faced by regulators, who must examine ever-larger and more-complex banking organizations.

Walker, George Alexander. 2000. *International Banking Regulation: Law, Policy and Practice*. International Banking, Finance and Economic Law. vol.19. Kluwer Law International.

This volume addresses all aspects of international banking supervision and financial stability. The three main headings (and the subordinate headings under each) are as follows: (1) The Basel Committee on Bank Supervision (International Banking Supervision—Financial Instability and the Establishment of the Basel Committee; International Banking Supervision and the Basel Committee Framework); (2) Financial Conglomerates (Conglomerate Law and International Financial Market Control; Lead Regulation and International Financial Market Supervision); and (3) Financial Stability (International Financial Crisis and the Financial Stability Forum; Observations with Regard to the Continued Development of International Banking and Financial Market Supervision and Control).

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.

Kaufman, George G., and Steven A. Seelig. 2000. Post-Resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk, and Too-Big-To-Fail. Working Paper no. WP-00-16. Federal Reserve Bank of Chicago.

This paper examines the sources of potential depositor losses in bank resolutions, focusing in particular on the losses incurred when regulatory delays impede access to depositors' monies at insolvent banks. Although the possibility of such losses can induce depositors to monitor and discipline their banking institutions, it can also inspire depositors to pressure regulators to protect all deposits. In determining the optimal delay time, one must balance the potential gains from additional market discipline against the losses from increased bailout pressure. To this end, the paper assesses depositor access and funds availability at insolvent institutions as reported in a recent FDIC survey of deposit insurance practices across 64 countries. The survey indicates that the United States is one of the few countries whose deposit insurer does not freeze funds but advances monies almost immediately after a failure. In contrast, many other nations impose financial and legal restrictions that delay payments to both insured and uninsured depositors. The paper argues that the best strategy for achieving bank-system stability is to provide depositors with full and immediate access to their funds.

Krieg, John Michael. 1999. Four Essays on Deposit Insurance, Bank Branching, and Bank Performance (Profitability). Ph.D diss., University of Oregon.

This dissertation examines the effect that bank branching restrictions and deposit insurance guarantees have on bank failures and bank profitability in the United States. The work begins with an historical overview of bank branching and deposit insurance, positing that legislation designed to preclude extensive branching also prevented banks from adequately diversifying their assets and thus was a major factor contributing to the massive number of bank failures during the Great Depression. These failures, in turn, led to the establishment of the deposit insurance program, which was meant to safeguard the stability of the banking system. However, deposit insurance itself can actually contribute to bank failures, inasmuch as the safety net encourages banks to undertake riskier activities while holding less bank capital.

Morris, Roselyn E., and Jerry R. Strawser. 1999. An Examination of the Effect of CPA Firm Type on Bank Regulators' Closure Decisions. *Auditing* 18, no. 2:143–58.

This study examines whether the type of accounting firm that audits a bank influences that bank's chances of being closed by regulators. The authors find that when banks' financial and other characteristics are held constant, the type of CPA firm (Big 6 or non-Big 6) that performs a bank's audit does in fact help determine regulators' decisions. Specifically, banks that engaged Big 6 firms

were more likely to be left open. Of all banks that received modified audit opinions, the institutions that had been audited by a Big 6 firm were less likely to be closed than those that received the opinion from a non-Big 6 firm. One explanation for this result is that regulators may perceive Big 6 firms as more likely than other firms to issue modified audit opinions because the Big 6 face greater economic and legal risks (loss of clients, litigation) if they are found negligent in conducting audits or reporting results.

Olson, G. N. 2000. *Banks in Distress: Lessons from the American Experience of the 1980s*. Kluwer Law International.

In this book the author offers his perspectives on the lessons to be drawn from the U.S. banking crisis of the 1980s. The work includes an historical review of banking in the United States, with particular focus on the policies that gave rise to the crisis. The author argues that uncoordinated monetary and fiscal policies combined with haphazard implementation of bank regulatory and enforcement policies to produce the crisis. The book also highlights the critical role played by asset valuation, asset-value inflation and deflation, and capital adequacy in the development and enactment of an effective regulatory regime. Finally, the author suggests that governments need to design more transparent, coordinated, and proactive policies to ensure stability in their financial sectors.

Seidman, L. William. 2000. *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*. 2d ed. Washington, D.C.: Beard Books.

This memoir documents the author's tenure as Chairman of the FDIC and the Resolution Trust Corporation during the U.S. savings and loan and banking crises of the 1980s. He delineates the causes of the S&L crises and details the ways in which the bank regulatory agencies—the FDIC in particular—worked to resolve the financial institutions' problems. He also provides political insight, describing his dealings with bureaucrats, lawmakers, politicians, and the press.

Sprague, Irvine H. 2000. *Bailout: An Insider's Account of Bank Failures and Rescues*. 2d ed. Washington, D.C.: Beard Books.

This book, by a former Chairman and Board member of the FDIC, examines the largest bank bailouts of the 1980s, focusing specifically on Unity Bank, Bank of the Commonwealth, First Pennsylvania Bank, and Continental Illinois. As interest rates soared in the late 1970s and early 1980s, banks and savings and loan associations suffered severely, and hundreds of financial institutions failed. In the face of this financial crisis, the author reveals the inner workings of the FDIC and provides a personal account of the Corporation's approach to bank failures, rescues, and resolutions.

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.

Biswas, Rita, Donald R. Fraser, and Gregory Hebb. 2000. On the Shareholder Wealth Effects of Deposit Insurance Premium Revisions on Large, Publicly Traded Commercial Banks. *Journal of Financial Research* 23, no. 2:223–41.

This paper analyzes market responses to several deposit insurance premium change announcements. The authors find that announcements of premium changes are negatively associated with abnormal returns in banking institutions' share values. These results are generally consistent with the premium absorption theory. However, the market adjustments to deposit insurance premium revisions vary with the type of bank; large banks are more affected than smaller ones. Further, share values are more affected at banks with low equity-to-asset ratios than at well-capitalized banks. The authors suggest these differences may reflect the differing competitive nature of the markets served by individual banks in that market competitiveness may affect a bank's ability to shift the cost of deposit insurance to its loan and deposit customers.

Demirgüç-Kunt, Asli, and Enrica Detragiache. 2000. 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. (© 2002 EconLit)

Diamond, Douglas W., and Philip H. Dybvig. 2000. Bank Runs, Deposit Insurance, and Liquidity. Federal Reserve Bank of Minneapolis *Quarterly Review* 24, no. 1:14–23.

This article develops a model which shows that bank deposit contracts can provide allocations superior to those of exchange markets, offering an explanation of how banks subject to runs can attract deposits. Investors face privately observed risks which lead to a demand for liquidity. Traditional demand deposit contracts which provide liquidity have multiple equilibria, one of which is a bank run. Bank runs in the model cause real economic damage, rather than simply reflecting other problems. Contracts which can prevent runs are studied, and the analysis shows that there are circumstances when government provision of deposit insurance can produce superior contracts. (© 2002 EconLit)

Dowd, Kevin. 2000. Bank Capital Adequacy versus Deposit Insurance. *Journal of Financial Services Research* 17, no.1:7–15.

This paper re-evaluates the Diamond-Dybvig analysis of deposit insurance by constructing a model in which an agent not in need of liquidity sets up a financial

intermediary to sell liquidity insurance to other agents who desire such insurance. This intermediary resembles a real-world bank in that it is financed by both demand deposits and equity. It also dominates the Diamond-Dybvig intermediary, which is funded only by demand deposits. Provided the intermediary has adequate capital, it also is perfectly safe. Deposit insurance then is both unnecessary and incapable of achieving a superior outcome to that which private agents could achieve on their own. (© 2002 EconLit)

Gangopadhyay, Shubhashis, and Gurbachan Singh. 2000. Avoiding Bank Runs in Transition Economies: The Role of Risk Neutral Capital. *Journal of Banking and Finance* 24, no. 4:625–42.

In a general equilibrium model with risk neutral and risk averse agents, the authors show that if banks issue both demand deposits and equity, then free banking is run-proof and efficient. In particular, the authors obtain the first best insurance solution if there is adequate risk neutral capital. If sufficient risk neutral capital is unavailable, then a partial suspension of convertibility is optimal. In general, therefore, policies like capital adequacy norms and deposit insurance are neither necessary nor desirable. (© 2002 EconLit)

Gunther, Jeffrey W., Linda M. Hooks, and Kenneth J. Robinson. 2000. Adverse Selection and Competing Deposit Insurance Systems in Pre-Depression Texas. *Journal of Financial Services Research* 17, no. 3:237–58.

In 1910, Texas instituted a unique deposit insurance program for its state-chartered banks by providing a choice between two separate plans: the depositors guaranty fund, similar to insurance schemes in several other states, and the depositors bond security system, which required the procurement of a privately issued guarantee of indemnity. While, under most deposit insurance schemes, the incentive to monitor the financial condition of individual banks simply devolves from depositors to regulators, the bond security system established in Texas distinguished itself by attempting to reintroduce market discipline through the indemnity requirement. Using a probit model with heteroskedasticity, the authors find evidence that the choice of insurance coverage led to risk-sorting among the banks, with relatively conservative and financially secure institutions opting for the comparatively rigorous bond security system. In addition, the bank failure record indicates the risk differentials between banks in the two plans persisted over time and even possibly grew, suggesting the bond security system at least partially avoided the moral hazard incentives associated with the fixed-rate depositors guaranty plan. These findings support the general view that market discipline is effective in banking. (© 2002 EconLit)

Hovakimian, Armen, and Edward J. Kane. 2000. Effectiveness of Capital Regulation at U.S. Commercial Banks, 1985 to 1994. *Journal of Finance* 55, no. 1:451–68.

Unless priced and administered appropriately, a governmental safety net enhances risk-shifting opportunities for banks. This paper quantifies regulatory efforts to use capital requirements to control risk-shifting by U.S. banks during 1985 to 1994 and investigates how much risk-based capital requirements and other

deposit-insurance reforms improved this control. The authors find that capital discipline did not prevent large banks from shifting risk onto the safety net. Banks with low capital and debt-to-deposits ratios overcame outside discipline better than other banks. Mandates introduced by 1991 legislation have improved but did not establish full regulatory control over bank risk-shifting incentives. (© 2002 EconLit)

Jagtiani, Julapa, and Catharine Lemieux. 1999. *Stumbling Blocks to Increasing Market Discipline in the Banking Sector: A Note on Bond Pricing and Funding Strategy Prior to Failure*. Working Paper no. S&R-99-8R. Federal Reserve Bank of Chicago.

This paper seeks to discern whether market forces can successfully discipline banking firms during the period before bank failure. The analysis finds that bond prices do seem to reflect risks as early as six quarters before failure, when the banking institution's financial condition and credit rating worsen and this find implies that increasing subordinated debt would be an effective way to increase market discipline. However, as a bank's finances deteriorate, the bank is increasingly likely to rely on insured deposits, which represent an increased liability to the FDIC insurance fund; thus, responsibility for disciplining bank management is shifted from the market to the bank regulator. Proposals to increase market discipline must therefore contain provisions to limit the failing institution's ability to replace market funding with insured funding. Further, although the bond spreads could potentially serve as market indications of a bank's condition, the authors suggest that such information might not add value to the information that is already routinely collected in the supervisory process.

Kangpenkae, Popon. 2000. *Three Essays in Financial Economics: Partial Deposit Insurance; Strategic Nonperforming Loans; Debt Auctions*. Ph.D diss., Queen's University at Kingston, Ontario.

The first of these three essays models partial deposit guarantees to discern banks' optimal funding strategies under different deposit insurance schemes, and examines the influence that regulations and ownership structure can have on bank risk-taking. The study shows that the deposit rate is an endogenous variable, determined by the riskiness of a bank's activities. One policy implication is that the fair premium rate for deposit insurance should vary directly with the uninsured deposit rate. (The second and third essays do not address deposit insurance.)

Khorassani, Jacqueline. 2000. *An Empirical Study of Depositor Sensitivity to Bank Risk*. *Journal of Economics and Finance* 24, no. 1:15–27.

This paper tests the hypothesis that during the mid-1980s and early 1990s depositors did not react to bank risk. It has been suggested that high deposit insurance limits, along with an informal policy of protecting all deposits in large-bank failures, have made depositors almost completely indifferent to bank risk. To assess the effect of deposit insurance on depositors' behavior, the author regresses the natural log of bank deposits on bank risk (measured by the probability of bank failure) and a set of control variables. The coefficient, which

reveals the sensitivity of deposits to risk, shows that depositors did indeed base their decisions on banks' risk profiles.

Kocherlakota, Narayana R. 2000. Risky Collateral and Deposit Insurance. Research Department Staff Report no. 274. Federal Reserve Bank of Minneapolis.

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. The author assumes 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 disintermediation and concomitant falls in real output. (© 2002 EconLit)

Kopcke, Richard W. 2000. Deposit Insurance, Capital Requirements, and Financial Stability. Working Paper no. 00-3. Federal Reserve Bank of Boston.

This paper uses a modified capital asset pricing model to analyze equilibrium returns on assets and intermediaries' capacity to bear risk; the model allows the intermediaries and the public to have different assessments of risks and returns on some assets. The model also incorporates the effects of deposit insurance and capital requirements on the risk premiums that intermediaries incur on their liabilities. Specifically, the extent of intermediation can contract as capital requirements are imposed, but can increase when deposit insurance systems are in place. When the yields of assets fall significantly, however, both insurance and capital requirements can encourage disintermediation and precipitate financial crises, especially when intermediaries must maintain their scale of operations in order to earn their rent.

Lane, Philip R., and Selen Sarisoy. 2000. Does Deposit Insurance Stimulate Capital Inflows? *Economics Letters* 69, no. 2:193–200.

The authors empirically investigate the relationship between explicit deposit insurance and private capital inflows to developing countries during the 1990s. The results do not indicate a significant relationship between explicit deposit insurance and the scale of capital inflows. (© 2002 EconLit)

Schumacher, Liliana. 2000. Bank Runs and Currency Runs in a System without a Safety Net: Argentina and the "Tequila" Shock. *Journal of Monetary Economics* 46, no. 1:257–77.

This paper tests the random-withdrawals vs. informed-based theories of bank runs in the context of the bank panic that took place in Argentina as a consequence of the Mexican devaluation of December 20, 1994. This evidence is unique in several ways: it is the case of a contemporary banking system with virtually no explicit safety net (a currency board with no deposit insurance scheme) and a case in which the bank runs were triggered by a currency run. The findings of the

paper provide support to the informed-based theories and show that depositors are concerned with the impact of a currency run on bank solvency. (© 2002 EconLit)

The World Bank Group. 2000. Deposit Insurance Conference, Washington, D.C., June 8–9, 2000.

In June 2000, The World Bank hosted a conference on issues relating to deposit insurance design in developing countries. No formal proceedings were published but the agenda, papers, data, presentation slides, discussant comments, and a video link to the conference are available *via* The World Bank's Web site [http://www.worldbank.org/research/interest/conf/upcoming/deposit_insurance/home.htm]. Also available is a synthesis paper by Asli Demirgüç-Kunt and Edward Kane, entitled "Deposit Insurance around the Globe: Where Does It Work?" (June 2001). Individual papers presented at the conference include: "Adjusting Financial Safety Nets to Country Circumstances," by Edward Kane; "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation," by Asli Demirgüç-Kunt and Enrica Detragiache; "Deposit Insurance Design and Bailout Costs," by John Boyd and Bruce Smith; "Market Discipline and Financial Safety Nets Design," by Asli Demirgüç-Kunt and Harry Huizinga; "Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina," by Charles Calomiris; "Do Depositors Punish Banks for "Bad" Behavior? Market Discipline, Deposit Insurance, and Banking Crises," by Maria Soledad, Martinez Peria, and Sergio Schmukler; "Deposit Insurance as Private Club: The Case of Germany," by Thorsten Beck; "Deposit Insurance and Financial Development," by Robert Cull, Lemma Senbet, and Marco Sorge; "Evidence of Safety-Net Support for Banks during Economic Development in Canada, the U.K., and the U.S.: A Progress Report," by Edward Kane and Berry Wilson; and "Quantifying the Cost of Blanket Deposit Insurance and Other Ex Post Rescue Strategies," by Patrick Honohan and Daniela Klingebiel.

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.

Barajas, Adolfo, and Roberto Steiner. 2000. Depositor Behavior and Market Discipline in Colombia. Working Paper no. WP/00/214. International Monetary Fund.

This study of Colombia's banking market tests how bank depositors choose which institutions to patronize, and whether depositors discipline their banks. The findings demonstrate that customers are concerned with measures of both risk and return. Depositors tend to favor state banks and larger banks; these show more significant deposit growth than other banking institutions. Depositors also prefer banks with stronger performance fundamentals; these institutions can charge higher rates on loans and pay lower rates on deposits. This latter finding implies that market discipline is a factor in the Colombian banking market. Depositors assess bank statistics, especially capital-asset ratios and loan-loss provisions. Their subsequent willingness or reluctance to offer deposits sends signals to banks, which then adjust their fundamentals accordingly. Although this result may be attributed to the Colombian deposit insurance system's ability to limit moral hazard in favor of market discipline, the authors point out that banks' behavioral adjustments might be the product of compliance with regulatory mandates.

Bisignano, Joseph R., William C. Hunter, and George G. Kaufman, eds. 2000. *Global Financial Crises: Lessons from Recent Events*. Kluwer Academic Publishers.

Forty papers, presented at a conference held in Chicago in the fall of 1999, examine worldwide banking and currency crises between 1970 and 1995, identifying and analyzing lessons from these crises that could be used to prevent or mitigate the magnitude of future financial crises. Papers focus on lessons from the Asian crisis; lessons from recent global financial crises; review of recent financial crises; review of policy responses; what has been learned from the crises and policy responses; redesign of capital regulations; deposit insurance reform and moral hazard and agency problems; nonbank financial institutions, too big to fail, and state ownership; the role of supervision and regulation; and the future of official international organizations. (© 2002 EconLit)

Note: Part VI contains deposit insurance-related papers, including "Notes on Market-Based Bank Regulation," by Peter M. Gabor; "Moral Hazard and Reform of the Government Safety Net," by Frederic S. Mishkin; "Banks' Fragility and the Lender of Last Resort," by Jean-Charles Rochet; "Moral Hazard and Reform of the Government Safety Net: A Comment," by Gerard Caprio, Jr.; and "Moral Hazard in Banking: The Recent Argentine Experience," by Guillermo J. Escude.

Bliss, Robert R., and Mark J. Flannery. 2000. Market Discipline in the Governance of U.S. Bank Holding Companies: Monitoring vs. Influencing. Research Department Working Paper Series, no. 2000-03. Federal Reserve Bank of Chicago.

For market discipline to be a valid regulatory tool, security holders must be able to monitor a bank's condition accurately and influence managerial decisions accordingly. This study tests whether changes in the prices of U.S. bank holding companies' securities can affect managements' behavior. The evidence reveals that stock and bond holders do not seem to be able to influence bank management, a finding implying that market discipline may not be an effective tool and that regulators and supervisors must maintain responsibility for directing managerial activities as necessary.

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 of official government safety nets, their benefits, the existence of safety net–related banking subsidies and their competitive implications, and policies for containing such subsidies.

Brock, Philip L. 2000. Financial Safety Nets: Lessons from Chile. *The World Bank Research Observer* 15, no. 1:69–84.

This article explores issues of safety-net design and implementation in small, open economies, using Chile’s experiences in the 1980s as a case study. Safety nets are the result of a government decision to assume risk that would otherwise be borne by depositors and shareholders. Society, especially in small, open economies, benefits from the expansion of banks and bank lending (financial deepening) associated with this protection, but excessive expansion can occur if the government does not limit the amount of risk it assumes. The authors argue that governments in these small economies would be wise to create a strong supervisory and regulatory framework to limit the size of the safety net. However, these governments should also recognize the value of encouraging financial deepening to promote domestic lending and economic growth.

The Financial Services Roundtable. 1999. *Refuting the Federal Safety Net “Subsidy Argument.”* The Financial Services Roundtable.

This collection of commissioned papers supports the Roundtable’s position that a net federal safety-net subsidy does not exist. Among the papers are “Banks Do Not Receive a Federal Safety Net Subsidy,” by Bert Ely; “The Issue of the Federal Safety Net Subsidy: Evidence from the Pricing of Banking Company Subordinated Debt,” by Gerald A. Hanweck; “Fact, Fiction and Fuzzy Logic: Is There a U.S. Commercial Bank “Safety Net Subsidy”? Evidence from Canadian Banking,” by Zagros Madjd-Sadjadi and C. Daniel Vencill; “Is There a Safety Net Subsidy? Some Evidence Based on Non-Bank Entry into Banking,” by Donald J. Mullineaux; “The Cost of Regulation: A Review of the Evidence,” by Gregory Elliehausen.

Halme, Liisa, Christian Hawkesby, Juliette Healy, Indrek Saapar, and Farouk Soussa. 2000. *Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market Discipline.* Bank of England.

This volume collects four papers written as a follow-up to the academic workshop “Central Bank Responsibility for Financial Stability,” held by The Bank of England’s Centre for Central Banking Studies in September 1999. The papers all concern the financial safety net’s ability to promote market discipline. “Too Big to Fail: Moral Hazard and Unfair Competition?” by Farouk Soussa, contains a theoretical and empirical investigation of the rationale behind the too-big-to-fail principle. Soussa finds that too-big-to-fail banks take on no more risk than smaller banks, but contends that there still may be a moral-hazard problem. “Bank Corporate Governance and Financial Stability,” by Liisa Halme, stresses the importance of good bank corporate governance to financial stability, and uses legal and economic theories to frame a discussion of the design and

implementation of incentive structures that would encourage sound regulation and supervision. “Financial Conglomerates: Implications for the Financial Safety Net,” by Indrek Saapar and Farouk Soussa, discusses the increasing trend toward consolidation and conglomeration in the financial-services industry, focusing particularly on the policy implications for deposit insurance and lender-of-last-resort mechanisms. Finally, Christian Hawkesby’s “Central Banks and Supervisors: The Question of Institutional Structure and Responsibilities” assesses the costs and benefits of various financial supervisory structures and identifies factors that might make a country particularly well suited to having a single prudential supervisor outside of the central bank system.

Kane, Edward J. 2000. Designing Financial Safety Nets to Fit Country Circumstances. Domestic Finance Working Paper no. 2453. The World Bank Group.

Countries vary significantly with respect to their informational and contracting environments, and financial safety nets should be designed accordingly. In particular, banks in different countries afford depositors varying levels of transparency and deterrence, so safety nets should be expected to differ in terms of the enforceability of private contracts. In cases where a country’s technological, ethical, and corporate governance is weak, a government safety net that fully and explicitly guarantees deposits can undermine, instead of strengthen, bank safety and stability. As technological, ethical, and corporate conditions change over time, a country’s safety net should also evolve. Regulators’ capacities for valuing banking institutions, assessing and disciplining risk-taking, and promptly resolving failures should be critical determinants of a safety net’s design and operation. Above all, political accountability is required to ensure the effective and efficient performance of these tasks.

Kaplan, Idanna. 2000. The Financial Crisis in Southeast Asia: Measuring the Size of Implicit Deposit Insurance Guarantees (Indonesia, Malaysia, Singapore, Korea, Thailand). Ph.D diss., University of Washington.

This dissertation investigates the 1997 financial crisis in Southeast Asia, looking specifically at the Indonesian, Malaysian, Singaporean, South Korean, and Thai banking sectors to determine the role that implicit government guarantees played in weakening of these financial systems. Because deposit insurance makes bank deposits less risky, it decreases the compensation rate required by depositors and thus represents a subsidy to banking institutions. Deposit insurance can therefore lead to moral-hazard problems. Using an option-pricing model, the author computes the size of the Asian governments’ contingent liabilities relative to their banking systems before 1997. The author finds that in all cases the deposit insurance subsidies were substantial and varied with the severity of a country’s subsequent crisis. The author also assesses the value of using option-pricing models to analyze emerging markets and shows that such models are superior to traditional macroeconomic techniques, which did not predict banking system weaknesses as accurately as the options-pricing approach. The final section of the dissertation, a study of the five countries’ banking institutions, concludes that moral-hazard incentives may have worsened the financial crisis inasmuch as they

encouraged banks to exploit the government subsidy that deposit insurance provides.

Laeven, Luc. 2000. Banking Risks around the World: The Implicit Safety Net Subsidy Approach. Policy Research Working Paper no. 2473. The World Bank Group.

This study examines a sample of banks from 12 countries around the world to determine whether a bank's corporate governance influences its level of risk-taking. Risk-taking is operationalized as the gross safety-net subsidy extended to the bank; the implicit subsidy is calculated as a one-year put option on the value of the bank's assets. The author finds that throughout the 1990s, banks were generally subsidized by their governments. The gross subsidies were highest for banks with concentrated ownership arrangements—for example, institutions owned by a single company, financial institution, family, or individual. Large subsidies, and therefore excessive risk-taking, were also associated with banks that (1) were affiliated with business groups, (2) were small and/or had high credit growth, or (3) were located in countries with low per capita GDP, high inflation, inadequate legal systems, low bank concentration, and low foreign-bank penetration. These findings suggest that the distortions inherent in governmental deposit insurance programs vary across banks with different ownership arrangements and institutional environments.

Repullo, Rafael. 2000. Who Should Act as Lender of Last Resort? An Incomplete Contracts Model. *Journal of Money, Credit and Banking* 32, no. 3:580–610. [With comments by Patrick Bolton.]

This paper presents a model of a bank subject to liquidity shocks that require borrowing from a lender of last resort. Two government agencies may perform this function: a central bank and a deposit insurance corporation. The agencies share supervisory information, which provides a nonverifiable signal of the bank's financial condition, and use it to decide whether to support it. It is shown that the optimal institutional design involves the two agencies: the central bank dealing with small liquidity shocks, and the deposit insurance corporation with large shocks. Furthermore, except for very small shocks, they should lend at penalty rates. (© 2002 EconLit)

Sleet, Christopher, and Bruce D. Smith. 2000. Deposit Insurance and Lender-of-Last-Resort Functions. Federal Reserve Bank of Cleveland *Proceedings* 32, no. 3, pt. 2:518–79. [With comments by Ed Stevens.]

The authors consider issues concerning the design of a banking system "safety net" when both a deposit insurer and a lender of last resort are present. In their model both entities have a role to play. Moreover, issues related to deposit insurance pricing are relatively unimportant in this context, whereas issues related to discount window access and pricing are not. They discuss when and why (or why not) a lender of last resort should lend liberally but charge high rates of interest. And, the authors raise the possibility that discount window policy may enhance or reduce the scope for multiplicity of equilibria. (© 2002 EconLit)

9. Deposit Insurance: 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.

Association pour la garantie des dépôts Luxembourg (AGDL). 2000. The Deposit Guarantee and Investor Compensation Scheme in Luxembourg. AGDL.

This handbook details depositors' rights under the Deposit Guarantee Association of Luxembourg (AGDL). The AGDL administers a mutual guarantee system covering deposits and claims resulting from investment transactions. Members of the AGDL are credit institutions, that is, banks and investment firms. The purpose of the guarantee scheme is not just to compensate savers for their losses, but to expedite the procedure by paying the customer all or part of the savings before liquidators are able to do so. In addition to explaining the AGDL's statutes and by laws, the publication illustrates how to apply the coverage rules.

Central Deposit Insurance Corporation, Legal Department. 2000. Case Studies on Strengthening the Mechanism of Handling the Problem Financial Institutions. Central Deposit Insurance Corporation, Taiwan, Republic of China. [In Chinese.]

This paper discusses the definition, the realities, and effects of problem financial institutions in Taiwan and examines current supervisory issues related to capital management, safe-and-sound practices, and prompt corrective action. In reviewing some specific cases from the past 15 years, the paper points out deficiencies in the traditional methods by which authorities handle problem financial institutions. The paper also proposes that changes be made to Taiwan's financial regulations and supervisory standards to adjust the financial safety net and establish a mechanism for phasing failed financial institutions out of the market in an orderly manner.

Cornut, Charles. 2000. The French System of Deposit Insurance: Interview. *Revue d'économie financière*, no. 60:215–19. [Published in English.]

The author presents the French system of deposit insurance. This system has recently been modified: it should take a greater role in the French prudential regulation system in the years to come. (© 2002 EconLit)

Deposit Insurance Fund (DIF) of Bulgaria. 1999. Deposit Insurance in Bulgaria in the Period of Transition to a Market Economy. DIF.

This study is included in the appendix to the 1999 Annual Report of the DIF and describes the various deposit insurance initiatives taken in Bulgaria as part of the post-1989 political and economic reforms in that country. The study explains the laws and regulations that were put in place to govern deposit insurance; discusses the Law on Bank Deposit Guaranty, which established the DIF in 1999; and details the current structure and functioning of the DIF, as well as the deposit insurance coverage rules.

Deposit Insurance Fund (DIF) of Bulgaria. 2000. Deposit Insurance in Central and East European Countries Negotiating for EU Accession: Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. DIF.

This study is included in the appendix to the 2000 Annual Report of the DIF. Deposit insurance has been a particularly important requirement for countries applying for European Union (EU) accession. This short paper describes the EU directive that seeks to harmonize members' deposit insurance practices. It also summarizes each country's deposit insurance system and coverage rules.

Hellenic Deposit Guarantee Fund. 2000. Hellenic Deposit Guarantee Fund.

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.

Kane, Edward J., and Tara Rice. 2000. Bank Runs and Banking Policies: Lessons for African Policymakers. Working Paper no. W8003. National Bureau of Economic Research.

This paper examines the near-constant stresses that have plagued African banking systems over the last 20 years and seeks to explain the sources of the persistent crises. The author's central hypothesis is that stress comes predominantly from unbooked losses and that the level of unbooked losses that a banking system can accumulate depends on its information environment and on the effectiveness of government efforts to supervise and guarantee bank solvency. To wit, the authors' present evidence that over the 1980–99 period the average length of time an African banking system spent in crisis increased with the level of government corruption. The paper concludes with recommendations on how African policy makers can reduce incentive conflict and improve the allocation of economic resources. Among these recommendations are calls for imposing adequate disclosure protocols on banks, improving the ways in which regulators analyze bank-level data, and developing sufficient administrative capacity throughout the various systems to allow for the efficient absorption of an economic or financial shock.

Kuwayama, Patricia Hagan. 2000. Postal Banking in the United States and Japan: A Comparative Analysis. *Monetary and Economic Studies* 18, no.1:73–104.

This paper analyzes the experience of the U.S. postal savings system, and compares it to Japan's experience, with a view to assessing the past and potential future role of the postal savings system in Japan. It finds that demand for postal savings deposits is explained, in both countries, mainly by two variables: price (interest differentials) and confidence in private banks. Geographical accessibility in rural areas is of less, and diminishing, importance. It is argued that postal banking should be viewed as an alternative to publicly sponsored deposit

insurance, as a means to ensure households' access to safe and convenient savings and payment services. Accordingly, the reforms undertaken in the next few years under the outline set out by the 1998 Basic Law on the Reform of Central Government Ministries and Agencies might best aim to restructure postal savings as a "narrow bank," whose services are priced to fully reflect costs and risks incurred. (© 2002 EconLit)

Mackey, Michael M. 1999. Report on the Comprehensive Evaluation of the Operations and Functions of the Fund for the Protection of Bank Savings "FOBAPROA" and Quality of Supervision of the FOBAPROA Program 1995–1998. Report to the Congress of Mexico. Institute for the Protection of Bank Savings, Mexico.

This report was requested by the Congress of Mexico so that the lawmakers would be better equipped to evaluate a 1998 proposal to recognize the debt of the Fund for the Protection of Bank Savings (FOBAPROA) as public debt. To this end, the author analyzes how well FOBAPROA and the entities charged with supervising it fulfilled their mandates during the restabilization of the Mexican financial sector. The report also provides background information on the establishment of FOBAPROA, a description of the regulatory and supervisory framework in which the fund operated, a review of FOBAPROA's sources and uses of funding, and a calculation of the fiscal costs incurred by FOBAPROA's rehabilitation programs. The report concludes that although the fund's operations were costly and structurally deficient, FOBAPROA did succeed in protecting depositors and, at least partially and temporarily, did mitigate the problems engendered by Mexico's weak and inadequately capitalized banking system.

Matherat, Sylvie, and Vichett Oung. 2000. An Overview of France's New Deposit Insurance System. *Revue d'économie financière*, no. 60:221–32. [Published in English.]

Although deposit insurance schemes are theoretically redundant with capital adequacy standards, experience showed that a system combining both approaches was necessary in maintaining financial stability. Applications of regulation on the subject vary in countries concerned. As regards deposit insurance schemes however, models implementing risk-related premiums—more effective but more costly to maintain—are developing. The new French deposit insurance scheme is in line with this trend, by establishing deposit insurance premia that are based not only on deposits but also on the level of risk specific to each credit institution. The level of risk is determined by different parameters that are solvency, profitability, risk diversification and transformation. (© 2002 EconLit)

Mayes, David. 2000. A More Market Based Approach to Maintaining Systemic Stability. Occasional Paper no. 10. [New Zealand] Financial Services Authority.

This paper reviews the new and innovative system of banking supervision that New Zealand implemented in 1996. The system gives bank managers and directors the responsibility for maintaining individual banks' vitality, while the bank regulator concentrates on maintaining stability in the financial system as a whole. The system contains a network of incentives to ensure that bank shareholders, directors, managers, depositors, and analysts all focus on risk

management. To this end, extensive disclosure is required. The system also controls the structure, ownership, and management of banks so as to encourage prudential behavior. Finally, the system grants the Reserve Bank ample powers to take swift action in case of bank crises, including the power to place insolvent banks under statutory management as necessary. The paper discusses ways in which these principles can be applied in the EU countries. One obstacle to the transferability of the New Zealand system, however, is the fact that New Zealand has no explicit deposit insurance scheme.

Padierna, Dolores. 2000. *La Historia Oculta del FOBAPROA* (The Hidden History of the FOBAPROA). Mexico: Ediciones Biblioteca Plural. [In Spanish without English summary.]

This book recounts the story of the Mexican banking crisis of the mid-1990s and the fall of the FOBAPROA (Fund for the Protection of Bank Savings), an insurance fund then in place to assist banks and cover their liabilities. After describing the conditions and events that led to the banking collapse and the policies implemented to rescue the industry, the author concentrates on the political context of the crisis and subsequent bailout, identifying each of the individuals and groups that had a role in financial sector management, regulation, and policymaking.

Reserve Bank of India. 1999. Report on Reforms in Deposit Insurance in India. Reserve Bank of India.

This is the report of the Working Group on Reforms in Deposit Insurance in India. The Working Group makes recommendations in the areas of institutional coverage, types of deposits covered, level of deposit insurance coverage, the deposit insurance fund, the premium system, the capitalization of the Deposit Insurance Corporation (DIC), the DIC's tax status, and inspection and supervision programs, the corporation's role as liquidator and receiver, and the deposit insurance public-awareness program.

Rodriguez, Vega, Francisco Javier, Salvador Vega, and Luz Elvira Quiroz. La singular historia del rescate bancario mexicano de 1994 a 1999, y el relevante papel del Fobaproa: Un analisis del papel del "prestamista de ultima instancia." [In Spanish without English summary.]

The financial crisis that began with the devaluation of the Mexican peso in December 1994 eventually led to the collapse of that country's entire financial sector; the international financial community helped Mexico rescue its banks, but the crisis still took an enormous toll on the country's economy. This book recounts the dramatic story of the Mexican banking industry's rescue from financial crisis. It begins with an historical overview of banking crises around the world and background on the Mexican banking system, including a comprehensive economic, political, and social history of the Mexican financial sector. It then focuses on the Mexican banking crisis, addressing the peso's devaluation, the FOBAPROA's (Fund for the Protection of Bank Savings) catastrophic absorption of bad loans, and the subsequent creation of the Instituto

para la Protección al Ahorro Bancario, or IPAB (the Bank Savings Protection Institute).

Rosales, Ricardo Solis, ed. 2000. *Del FOBAPROA al IPAB: Testimonios, analisis y propuestas*. Mexico, D. F: Plaza y Valdes Editores: Universidad Autonoma Metropolitana, Iztapalapa. [In Spanish without English translation.]

This collection presents testimonies, analyses, and proposals regarding the transition of the Mexican deposit insurance system from the FOBAPROA to the Bank Savings Protection Institute (IPAB).

Shim, Young. 2000. *Korean Bank Regulation and Supervision: Crisis and Reform*. Boston: Kluwer Law International.

This work analyzes Korea's current bank regulatory scheme, identifies the weaknesses that persist in the wake of the financial crisis of 1997, and discusses possible reforms, focusing particularly on who should assume the role of regulator, what supervisory standards the regulator should apply, and how these standards should be implemented. The suggested regulatory approach is that the supervisory system be allowed to operate within a competitive market environment while being shielded from excessive governmental and/or political influences that may interfere the safety-and-soundness objectives of the bank regulator. This new degree of independence would have to be balanced, however, by a heavy emphasis on transparency and accountability, with appropriate monitoring and enforcement mechanisms in place to ensure adherence to the primary policy objectives of bank regulation.

Spiegel, Mark M. 2000. Bank Charter Value and the Viability of the Japanese Convoy System. *Journal of the Japanese and International Economies* 14, no. 3:149–68.

This paper compares the performance of a convoy banking system, similar to that which prevailed in Japan, to a fixed-premium deposit insurance regime. While neither regime is generally preferable over the other, the performance of the convoy system is shown to be more sensitive to changes in bank charter values and the overall health of the banking system under fairly general conditions. The recent breakdown of the convoy system may therefore be partly attributable to adverse movements in these characteristics in Japan. (© 2002 EconLit)

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

The Federal Deposit Insurance Corporation Improvement Act 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 the law; 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.

Evanoff, Douglas D., and Larry D. Wall. 2000. Subordinated Debt as Bank Capital: A Proposal for Regulatory Reform. Federal Reserve Bank of Chicago *Economic Perspectives* 25, no. 2:40–53.

This article outlines an approach to help limit the government's safety net by enhancing market discipline with the use of subordinated debt. The authors argue that subordinated debt can be a useful mechanism for providing market discipline and that it can be particularly effective when combined with the prompt corrective action and least-cost resolution provisions contained in the FDIC Improvement Act of 1991 (FDICIA). The author's plan provides for a phased implementation of a subordinated-debt requirement for large banks that allows for future modifications, should they be necessary. In its final form, the author's plan calls for a minimum sub-debt requirement of at least 3 percent of risk-weighted assets that would be applicable to the nation's 25 largest banks. The paper also summarizes some of the existing subordinated debt proposals and responds to some of the concerns raised about the viability of subordinated-debt proposals.

Federal Deposit Insurance Corporation (FDIC). 2000. *Deposit Insurance Options Paper*. FDIC.

This document assesses the FDIC's ability to maintain the safety and soundness of the nation's banking system during the next decade as industry consolidation, globalization, expanded service provision, and new technologies continue to change the nature and operation of the industry. Three areas for reform are emphasized: (1) pricing risks, (2) funding insurance losses, and (3) setting coverage limits. First, given the premise that insurance should be priced to reflect the risk that an individual bank presents to the deposit insurance system, the report discusses methods of implementing expected loss pricing and analyzes the types of information on which such risk differentiations could be based. Next, it explores options for funding deposit insurance losses. One option is to use a fee system in which banks have no claim on past premiums; another is a mutual approach in which banks would have some claims on past payments, either in the form of rebates when the insurance fund is too large or as direct claims on the insurance fund, similar to mutual fund shares. Finally, the report addresses the trade-off between stability and market discipline in establishing coverage levels, and discusses various methods for setting these levels. The relative merits of the current system of *ad hoc* statutory adjustments are compared with structures that would index coverage for inflation, limit a specified coverage amount to one account per person, provide higher coverage to municipal and other public deposits, increase reliance on private insurance, and introduce new types of excess insurance.

Isaac, William M. 2000. Financial Reform's Unfinished Agenda, A Look at Deposit Insurance Funds. Federal Reserve Bank of Minneapolis *The Region* 14, no. 1:34–37.

The author, Chairman of the FDIC from 1981 to 1985, believes that Congress should reexamine the federal financial safety net and the financial-service industry's regulatory structure, with the goal of reforming the deposit insurance system. He thinks that the Bank Insurance Fund and the Savings Association Insurance Fund should be merged, the Office of Thrift Supervision and the Office of the Comptroller of the Currency should be combined, and the FDIC should be removed from the federal budget. The author also believes that banks and thrifts have not borne the cost of the deposit insurance system and that they should be required to pay more. Note: This article is a condensed version of the author's testimony on February 16, 2000, before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services (see entry below for U.S. House).

Murphy, Michael J. 2000. *Washington Public Deposit Protection Commission Manual*. Washington Public Deposit Protection Commission.

This document delineates the operations of Washington State's Public Deposit Protection Commission, which extends insurance coverage to public funds that exceed the FDIC coverage limits. Beginning in 1969, full protection of public funds has been achieved through the concept of "mutuality of responsibility" where all participating banks in the State of Washington collectively assure that no loss of public funds will be suffered by any public treasurer or custodian of public funds.

Thomson, James B. 2000. Raising the Deposit-Insurance Limit: A Bad Idea Whose Time Has Come? Federal Reserve Bank of Cleveland *Economic Commentary* (April 15).

This article examines the potential costs and benefits of doubling the deposit insurance coverage limit, raising it to \$200,000 from the current \$100,000 and substantially extending the federal financial safety net. The author argues that the average depositor will not benefit from a higher deposit insurance ceiling because the \$100,000 coverage currently provided is sufficient to meet the average depositor's requirements. According to the author, less than 2 percent of depositors need an increase in coverage. In addition, the current deposit insurance limit provides a level of coverage that is well in excess of the real coverage granted in 1934. Thus, the author finds no compelling reason to increase the insurance coverage limit and suggests that reducing the ceiling may in fact be more appropriate.

Thomson, James B. 2000. Two Deposit Insurance Funds Are Not Necessarily Better Than One. Federal Reserve Bank of Cleveland *Economic Commentary* (October 15).

This commentary examines the question of merging the two separate insurance funds that exist for banks and savings associations. Many arguments have been made in support of a recent reform proposal to join the funds: a fund merger would lower the FDIC's administrative costs, reduce the paperwork processed by

banks and thrifts that currently have deposits covered by both funds, and decrease the taxpayer risk associated with federal deposit guarantees. However, merging the insurance funds can also stifle regulatory competition and expose banks and housing finance lenders to risks they would not normally bear. The author concludes that the benefits associated with maintaining separate funds are minimal and that the proposal to combine the funds should be seriously considered.

U.S. House. 2000. Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services. *Merging the Deposit Insurance Funds: Hearing*. 106th Cong., 2d sess., February 16.

This congressional hearing focused on the feasibility of merging the FDIC's two deposit insurance funds, the Bank Insurance Fund and the Savings Association Insurance Fund, which provide insurance coverage for banks and thrifts, respectively. The hearing also considered two related questions: should a merged fund include an upper cap on its growth, and should the fund pay rebates. The witnesses included Donna Tanoue, Chairman, FDIC; Gregory Baer, Assistant Secretary for Financial Institutions, Department of the Treasury; Hjalma Johnson, Chairman and CEO, East Coast Bank Corporation, on behalf of the American Bankers Association; William Fitzgerald, Chairman and CEO, Commercial Federal Bank, on behalf of America's Community Bankers; Thomas Sheehan, President, Chairman, and CEO, Grafton State Bank, on behalf of the Independent Community Bankers of America; William Isaac, Chairman, the Secura Group and Secura Burnett Company; Martin Mayer, Guest Scholar, the Brookings Institution; Kenneth Thomas, Lecturer on Finance, the Wharton School, University of Pennsylvania.

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.

Athavale, Manoj. 2000. Uninsured Deposits and the Too-Big-to-Fail Policy in 1984 and 1991. *American Business Review* 18, no. 2:123–28.

In this paper, an examination is made of changes in the FDIC's TBTF policy regime and the market assessment of default risk in the pricing of uninsured certificates of deposit. Specifically, the author examines changes in the deposit regimes that occurred in 1984 and 1991, using a time series of observations on the interest rates applicable to uninsured certificates of deposit. The results suggest that the pricing of uninsured certificates of deposit has reflected a reduction in default risk over time, implying that market participants believe that regulators will continue to rely on a TBTF policy.

Bordo, Michael D., and Anna J. Schwartz. 2000. Measuring Real Economic Effects of Bailouts: Historical Perspectives on How Countries in Financial Distress Have Fared with and without Bailouts. Working Paper no. W7701. National Bureau of Economic Research.

The authors offer an historical perspective on financial crises around the world and discuss the types of aid that have been extended, and the policy changes that have been made, in the wake of such crises. The study addresses the question of how bailouts and rescues affect borrowers' incomes and broader macroeconomic measures, such as inflation and interest rates. Empirical analysis focusing on Latin American and Southeast Asian nations tests how macroeconomic variables behaved before, during, and after the countries' bank, debt, or currency crisis. Countries that received IMF or other financial assistance are contrasted with those that did not receive such aid. The model is then refined to account for a self-selection bias that might drive some countries to seek assistance whereas others do not. Results suggest that the performance of countries that obtained IMF assistance during crises was worse than that of countries receiving no assistance.

Spiegel, Mark M., and Nobuyoshi Yamori. 2000. The Evolution of "Too-Big-to-Fail" Policy in Japan: Evidence from Market Equity Values. Pacific Basin Working Paper Series, no. PB00-01. Federal Reserve Bank of San Francisco.

This study uses equity return data to assess bank investors' behavior during the years 1995–1998, a particularly turbulent period for the Japanese financial industry. Equity prices reveal that a bank's regulatory status was an important determinant of investors' beliefs about whether the institution would be considered TBTF. When a bank failure occurred, excess negative returns accrued to other banks in the same or lower regulatory category as the failed bank. Investors' beliefs about which types of banks would be protected changed throughout the sample period; it was initially believed by investors that the government would allow only the smallest banking institutions to fail (Credit Cooperatives). But as the government's regulatory policy evolved, so did investors' behavior. Eventually, investors reacted as if all banks, even the larger

regional and city banks, were susceptible to failure. Once all banks were deemed vulnerable, there was no measurable difference in the excess returns between banks of different regulatory classes; investors no longer behaved as if bank deposits were guaranteed.

Stern, Gary H. 2000. Thoughts on Designing Credible Policies after Financial Modernization: Addressing Too-Big-to-Fail and Moral Hazard. Federal Reserve Bank of Minneapolis *The Region* 14, no. 3:2–4, 24–29.

In this essay, the author argues that modernization efforts have the potential to expand the financial safety net and exacerbate the moral-hazard problem. He suggests that regulators can limit these consequences only by enacting credible policies to control moral hazard. The author categorizes and discusses different means of establishing credibility. One group of policies consists of legal restrictions that prohibit bailouts and thus force regulators to ignore the incentives to expand the safety net. Another suggested approach would be for lawmakers to pass legislation that explicitly penalizes regulators for providing bailouts. Or regulators themselves can take steps to reduce the incentives to bail out creditors. Finally, the author recommends that the executive branch and lawmakers appoint regulators who would resist pressures to enact bailouts.

U.S. General Accounting Office (GAO). 2000. *Responses to Questions Concerning Long-Term Capital Management and Related Events*. GAO/GGD-00-67R. GAO.

In this document, the GAO responds to 14 questions posed by U.S. senators regarding Long-Term Capital Management (LTCM), its near failure, and its recapitalization in September 1998. When the failure of LTCM seemed imminent, the Federal Reserve Bank of New York (FRBNY) was highly concerned about the likely systemic implications and worked to facilitate a private-sector resolution. Market observers became concerned that large banking institutions might be inspired to assume riskier positions, believing that the Federal Reserve would always intervene to prevent disruptive liquidations. Federal Reserve and industry officials contend that the Federal Reserve acted as an “honest broker” and did not discuss the terms or conditions of the agreement devised by LTCM’s creditors. The senators’ questions attempt to clarify the exact role of the FRBNY.

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 banking industry's continuing consolidation on the exposure of the insurance funds.

Federal Deposit Insurance Corporation (FDIC). 1999. *The Financial Institution Employee's Guide to Deposit Insurance*. FDIC.

This manual outlines current FDIC deposit insurance rules. It is a reference guide that can help employees of insured institutions respond better to depositors' questions about FDIC insurance coverage. The topics covered include FDIC insurance basics, general principles of insurance coverage, account ownership categories, and procedures to be followed when an institution fails. It also includes in-house seminar materials that insured institutions can use in offering training programs on deposit insurance.

Federal Deposit Insurance Corporation (FDIC). 2000. *Questions and Answers about Your Insured Deposits from the Federal Deposit Insurance Corporation*. FDIC.

This document explains the insurance coverage that the FDIC provides depositors. It details the basic objectives of the coverage regulations and limits, and describes how the FDIC establishes ownership of funds. The booklet identifies the various categories of accounts and explains how the coverage limits apply in each case. Many examples illustrate how an individual account holder's insurance coverage is determined.

U.S. General Accounting Office (GAO). 2000. *Financial Audit: Federal Deposit Insurance Corporation's 1999 and 1998 Financial Statements*. GAO/AIMD-00-157. GAO.

This document presents the GAO's opinions on the financial statements of the Bank Insurance Fund, the Savings Association Insurance Fund, and the FSLIC Resolution Fund for 1998 and 1999. It also presents the results of audits of the effectiveness of the FDIC's internal controls and the FDIC's regulatory and legal compliance. The audits found the financial statements to be fairly prepared in accordance with generally accepted accounting principles and determined that the FDIC's financial reporting is generally under effective internal control, although information systems control could be strengthened. The FDIC was found to be in compliance with all tested laws and regulations. The funds' financial statements and accompanying notes are presented.