

# **Deposit Insurance around the World**

**Issues of Design and Implementation**

**Edited by Aslı Demirgüç-Kunt, Edward Kane, and Luc Laeven**

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## Preface

Explicit deposit insurance (DI) systems are multiplying rapidly in the developing world. The number of countries offering explicit deposit guarantees surged from twenty in 1980 to eighty-seven by the end of 2003. Although many recent adopters were transition countries of Eastern Europe seeking to comply with the European Union Directive on Deposit Insurance, adopters can be found in every region of the world. This book argues that this is an alarming trend that should not be interpreted as evidence that designing and operating an efficient system are straightforward tasks. To the contrary, the analysis presented in this book confirms that officials in many countries would do well to delay the installation of a deposit insurance system. The message is timely because despite the rise of deposit insurance over the last decades, holdouts—particularly among low-income countries with poor institutional development—still outnumber DI adopters.

One reason for this surge is that having an explicit deposit insurance scheme has come to be seen as one of the pillars of modern financial safety nets. Establishing explicit deposit insurance has become a principal feature of policy advice on financial architecture that outside experts give to countries undergoing reform. Starting in the 1990s, IMF crisis management advice recommended erecting DI as a way of either containing crisis or winding down crisis-generated blanket guarantees. The World Bank has also actively supported the adoption of DI and provided adjustment loans for initial capital of deposit insurance funds in a number of countries. This book challenges the wisdom of encouraging countries to adopt DI without first remedying observable weaknesses in their institutional environment.

An extensive body of economic theory analyzes the benefits and costs of deposit insurance and explores how balancing these benefits and costs can produce an optimal deposit insurance system. Starting from the premise that the main benefit of deposit insurance is to prevent

wasteful liquidations of bank assets caused by deposit runs, the theoretical debate centers on the question of how effectively hypothetical variations in deposit insurance arrangements can curtail voluntary risk taking (i.e., moral hazard). In contrast, cross-country empirical evidence on the efficiency of existing deposit insurance systems has been scarce and analysis has been limited to developed country experiences. Due to lack of data, there has been very little empirical evidence on what factors determine DI adoption and design, or the impact of DI and its design on bank stability, market discipline, and financial development.

This book brings together a unified collection of papers that mitigates some of the existing weaknesses in the literature by (1) constructing and analyzing a broad cross-country dataset on deposit insurance, and (2) assessing the impact of DI and its design in individual developing countries.

Deposit insurance is strong medicine. Whether it benefits or harms a country depends on how well it is designed and administered. For countries in the process of adopting DI, this volume provides advice that identifies six guiding principles of good design: limited insurance coverage, compulsory membership, private-sector participation in overseeing the scheme, appropriate pricing, restrictions on the ability of the fund to shift losses to the taxpayer, and assigning explicit responsibility for bank insolvency resolution.

In the summer of 2007, bank runs on loss-making banks in Germany and in the United Kingdom underscored inadequacies in European safety nets and in arrangements for supporting securitized loans. Delays in verifying and resolving the insolvency of Northern Rock and other troubled banks revealed worldwide defects in credit ratings and gaps in the enforceability of securitized bank liabilities. The unanticipated return to bank balance sheets of loss exposures that such liabilities were designed to transfer to others pushed the issues of deposit insurance coverage and safeguards back to the center of debates on regulatory policy in both developing and industrialized countries. The guiding principles identified in this book can contribute mightily to this debate.

The book is aimed at academics working in the area of finance, development, and international economics along with public policy professionals working at international institutions, central banks, and ministries of finance. We sincerely believe that this book belongs on the bookshelf of every policymaker who hopes to contribute to a national and cross-country debate on the wisdom of adopting or the need to redesign a deposit insurance system.