

# INTERNATIONAL DEPOSIT INSURANCE

Max Gillman

*The current banking crisis has highlighted the fragility of the international finance system and the extent to which current system safeguards such as IMF action fall short. Envisioning a fuller banking security system leads naturally to the proposal for an international deposit insurance system based on risk-based premiums. This proposal is outlined here as a replacement for ad hoc action by national governments and the IMF that is designed to avoid moral hazard while providing an efficient means to international banking security as part of our global financial architecture.*

**Keywords:** Deposit insurance, risk-based premiums, IMF, capital requirements, governance.

The G20 have pledged \$1 trillion to the IMF to help resolve the global financial crisis. One use that could be made of such funding is the establishment of an international deposit insurance system for the worldwide bank industry. Similar to how the establishment of the US Federal Deposit Insurance Act of 1933 played a large role in bringing about the turnaround in the US financial system, so could an international deposit insurance system help turnaround and safeguard the global financial system.

Establishing such deposit insurance on an international basis would need to be done within an international body well-designed to that purpose. And certainly either the IMF or the World Bank would be well-suited for this, but perhaps even more the IMF since it has informally been involved in bailing out countries from financial crises. The proposed international deposit insurance fund, or IDF, for International Deposit Fund, would enable the IMF to regulate financial markets on a systematic basis that would enhance global financial competition while minimising moral hazard.

The task of the IMF through an IDF would be to establish an international bank deposit insurance system that is actuarially fair. Each bank would obtain the IMF-IDF insurance coverage by paying a risk-based premium on each dollar of deposits that are insured. Banks with more risky assets would pay a higher deposit insurance premium. This would be a price-based deposit insurance system rather

than one with certain capital-allocation restrictions.

Capital regulations would not be required, but could be used by the IMF-IDF in guidelines that would indicate the pricing structure for the risk-based deposit insurance premiums. Therefore banks could participate voluntarily and in doing so present an acceptable alternative to involuntary capital restrictions that may be required within each nation; and these regulations could be lifted as a part of national participation in the IDF scheme. And at the same time the legal priority of depositors over other creditors would need to be standardised as far as possible.

The central component of such an international deposit insurance system is that banks would have the incentive fully to reveal information on the nature of the structure of their assets and liabilities. This would enable the IMF-IDF to give them the lowest possible deposit insurance premium for their balance sheet structure. Uncertainty of what is really on the balance sheets of a bank, due to incomplete disclosure, would require the IMF-IDF to charge a higher deposit premium.

In determining the deposit insurance premium for each bank, the IMF-IDF would give a rating class to each bank, and on the basis of that class, the price of insurance would be determined. The rating class would be public. Banks that did not choose to get IDF insurance would be unable to advertise their deposits as 'IDF-Insured', similar to

'FDIC Insured', or 'Intel-Inside'. The mark of quality that IDF insurance would bring would induce banks through competition to try to get IDF insurance, and to get the lowest price of insurance and so the highest rating class. Banks would compete to get the best IDF rating class both to increase demand for their bank deposits and to reduce the cost of supplying such deposits.

The IDF could follow best practice in governance, and in particular in determining the pricing of deposit insurance as based on risk. The US FDIC, following a study in 2001, instituted full risk-based pricing of premiums with its Federal Deposit Insurance Reform Act of 2005 that was signed into law in February 2006. This major reform dictates that the Board of Directors of the FDIC determine the risk-based pricing of their Deposit Insurance Fund (DIF), and as of January 2007 there are four risk categories, with different prices for insurance. Private market pricing of such risk could also be followed to some extent, such as with the major bond rating companies (although these ventures can miss aggregate risk). And major banks could hold some portion of the seats on any Board of Directors, along with national government representatives from each global region.

Aggregate risk remains a primary concern with such an IDF, and the pricing of risk premiums so as to add the aggregate risk component into the pricing is a difficult assignment. Surely experience over time would be required. But just as surely such a system would improve upon the existing practice of the IMF acting *ad hoc* as a lender of last resort. Instead of this, the IDF would institutionalise a viable long-term buttress of the international financial system.

Information revelation by banks and the ensuing competition for a good rating class would self-perpetuate the success of the IDF international deposit scheme. And this would mean that the deposit insurance would be able to be appropriately priced so that the system would be actuarially fair. Achieving a balance between receipts through deposit insurance premiums and expenditures through occasional

pay-outs during bank insolvencies, the IDF could then be a successful, self-financing, international deposit insurance system.

Coverage with the IDF could gradually be spread from developed countries to less-developed countries as the banks in the latter became technologically advanced enough to apply for and receive IDF deposit insurance. This would create a natural market-driven way to bring less-developed nations into international capital markets, as such countries gradually achieved coverage through the IDF umbrella. This IDF coverage might even be folded into the WTO structure in time, as part of a condition for WTO membership.

Such an IMF-IDF is a system that could be started up almost immediately. This might entail bold action such as using the US FDIC as the basis of the IMF-IDF system, and then bringing in other national insurance schemes within the IMF-IDF. Funding could start with seed capital from the IMF, as part of the newly pledged \$1 trillion by the G20, for example, along possibly with the funds of the FDIC, which could be the US contribution to the \$1 trillion pledge.

An IMF-IDF international deposit insurance system would be a systematic approach to pricing otherwise uninsurable 'aggregate risk', and so decreasing the moral hazard that the IMF has been accused of causing with its bailouts of the past. The IDF would approximately price aggregate risk and include this in the risk-based premiums. And by the fact that it would be an encompassing international deposit insurance system, it would be able to pool such national aggregate risks and thereby ultimately decrease the residual aggregate risk in the global system. And as the IDF insurance spreads to more banks and nations over time, this process would be partly self-fulfilling as it became more globally encompassing.

Geoffrey Wood will respond to this Economic Viewpoint in a future edition of *Economic Affairs*.

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