



DATE DOWNLOADED: Sat May 28 23:59:08 2022

SOURCE: Content Downloaded from [HeinOnline](#)

Citations:

Bluebook 21st ed.

Wally Suphap, Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy, 42 COLUM. J. Transnat'l L. 829 (2004).

ALWD 7th ed.

Wally Suphap, Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy, 42 Colum. J. Transnat'l L. 829 (2004).

APA 7th ed.

Suphap, W. (2004). Toward effective risk-adjusted bank deposit insurance: transnational strategy. Columbia Journal of Transnational Law, 42(3), 829-862.

Chicago 17th ed.

Wally Suphap, "Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy," Columbia Journal of Transnational Law 42, no. 3 (2004): 829-862

McGill Guide 9th ed.

Wally Suphap, "Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy" (2004) 42:3 Colum J Transnat'l L 829.

AGLC 4th ed.

Wally Suphap, 'Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy' (2004) 42(3) Columbia Journal of Transnational Law 829

MLA 9th ed.

Suphap, Wally. "Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy." Columbia Journal of Transnational Law, vol. 42, no. 3, 2004, pp. 829-862. HeinOnline.

OSCOLA 4th ed.

Wally Suphap, 'Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy' (2004) 42 Colum J Transnat'l L 829

Provided by:

Arthur W. Diamond Law Library, Columbia University

-- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at

<https://heinonline.org/HOL/License>

-- The search text of this PDF is generated from uncorrected OCR text.

-- To obtain permission to use this article beyond the scope of your license, please use:

[Copyright Information](#)

## Notes

### Toward Effective Risk-Adjusted Bank Deposit Insurance: A Transnational Strategy

*Following the recent wave of banking crises in Asia, Latin America, and Europe, government regulators worldwide are contemplating the adoption of, or enhancements to, risk-adjusted deposit insurance premium schemes. Despite the promises risk-adjusted premium schemes hold—namely, in curbing the moral hazard problem, ensuring a level playing field among banks of differing risk profiles, bridging the information asymmetries between banks and their depositors, and reducing regulatory costs—myriad difficulties associated with accurately assessing and pricing banking risks severely hinder the implementation of such schemes. As a solution, this Note posits an instrumental role for multilateral financial organizations in directing their unique institutional advantages toward the task of resolving the complexities inherent in risk pricing. The Note outlines a transnational strategy for risk-adjusted premium pricing that entails close collaboration between multilateral organizations and domestic regulators in developing best practices and supervisory guidance, and highlights suggested areas of reform for the rocky, though promising, road toward risk-adjusted premium schemes worldwide.*

## I. INTRODUCTION

In the aftermath of recent banking crises in such countries as Argentina, Mexico, Japan, Russia, South Korea, Sweden, and Thailand,<sup>1</sup> government regulators worldwide are considering far-reaching reforms to their bank deposit insurance systems (“DISs”).<sup>2</sup> One of the most drastic and potentially promising proposals being considered in several countries is the funding of DISs through risk-adjusted premiums.<sup>3</sup> Under a risk-adjusted premium pricing scheme,<sup>4</sup> banking regulators would classify depository institutions into risk

---

1. For analysis of these and other banking crises, see BENTON E. GUP, *INTERNATIONAL BANKING CRISES* (1999); *ECONOMIC AND FINANCIAL CRISES IN EMERGING MARKET COUNTRIES* (Martin Feldstein ed., 2003); BURKHARD DREES ET AL., *THE NORDIC BANKING CRISES* (1998); GEORGE SOROS, *THE CRISIS OF GLOBAL CAPITALISM* 135–74 (1998); WORLD BANK, *MANAGING THE REAL AND FISCAL EFFECTS OF BANKING CRISES* (World Bank, Discussion Paper No. 428, 2002) [hereinafter *WORLD BANK STUDY*]; Jason Furman & Joseph E. Stiglitz, *Economic Crises: Evidence and Insights from East Asia*, 2 *BROOKINGS PAPERS ON ECON. ACTIVITY* 1 (1999); Jeffrey D. Sachs et al., *Financial Crises in Emerging Markets*, 1 *BROOKINGS PAPERS ON ECON. ACTIVITY* 147 (1996); Columbia University’s Initiative for Policy Dialogue website, at [http://www.gsb.columbia.edu/ipd/j\\_banking.html](http://www.gsb.columbia.edu/ipd/j_banking.html) (last visited Feb. 15, 2004).

2. See LUC LAEVEN, *WORLD BANK, PRICING THE ADOPTION OF DEPOSIT INSURANCE* 3 (2002) (“Since end-2000, deposit insurance has been under consideration in . . . Albania, Bolivia, China, Costa Rica, Hong Kong, Kuwait, Russia, and Zambia.”). For country-specific reform efforts, see Ken Belson, *Japan Moves to Expand Cleanup of Banks*, N.Y. TIMES, Dec. 2, 2003, at W1 (Japan); *Deposit Insurance Corporation Plan Still Alive*, INDIAN BUS. INSIGHT, Feb. 20, 2003, available at 2003 WL 15573092 (India); Leyla Boulton, *Regulators Seize Uzans’ Imar Bank*, FIN. TIMES, July 5, 2003, at 8 (Turkey); *Deposit Bill Passes*, MOSCOW TIMES, Nov. 20, 2003, available at 2003 WL 66305369 (Russia); *Lawmakers OK New Insurance, Bank Deposit Insurance Rules*, TAIWAN ECON. NEWS, June 27, 2001, available at LEXIS, Nexis Library, Global News Wire (Taiwan); Rob Blackwell, *Hopes Remain for Overhaul of Deposit Insurance in ‘03*, AM. BANKER, Aug. 18, 2003, at 4 (Australia); Joyce Moullakis & Lisa Murray, *Banks Say Deposit Insurance Unnecessary*, AUSTL. FIN. REV., Nov. 10, 2003, at 59 (Singapore and Hong Kong); Allen T. Cheng, *PBOC Considers Deposit Insurance*, S. CHINA MORNING POST, Feb. 11, 2004, at B3 (China); Jeffrey O. Valisno, *House, Senate Agree to P250,000 Maximum Insured Bank Deposit*, BUS. WORLD, Feb. 5, 2004, at 13 (the Philippines); *Nigeria: NDIC to Insure Community Banks’ Deposits*, AFRICA NEWS, Feb. 4, 2004, LEXIS, Nexis Library, Africa News (Nigeria).

3. See, e.g., *Shift to Risk-Based Premium Awaits Law Draft from RBI*, FIN. EXPRESS, Feb. 18, 2003, LEXIS, Nexis Library, Global News Wire (India); Moullakis & Murray, *supra* note 2, at 59 (Singapore and Hong Kong); Alex T. Magaisa, *Deposit Protection Scheme Contains Risks*, ZIMB. INDEP., Apr. 5, 2003, available at 2003 WL 19809973 (Zimbabwe); *Consensus Emerges on FDIC Reform at House Panel Session*, CONG. DAILY, Mar. 5, 2003, available at 2003 WL 8362642 (United States); JOHN R. LABROSSE & DAVID K. WALKER, *CONFERENCE PROCEEDINGS OF IADI CONFERENCE ON DEPOSIT INSURANCE* 18 (Nov. 30, 2001) [hereinafter *IADI CONFERENCE PROCEEDINGS*] (Uruguay).

4. While this Note uses the term risk-adjusted premium schemes, such schemes have also been referred to as “risk-based,” “risk-sensitive,” “risk-calibrated,” or “differential” premium schemes.

categories and impose higher premiums on those institutions in higher-risk categories. Such a scheme—as distinguished from the alternative flat-rate scheme<sup>5</sup>—has been commended for discouraging the moral hazard of excessive risk-taking,<sup>6</sup> rectifying the inequitable subsidization of riskier banks by safer banks,<sup>7</sup> correcting the information asymmetries between banks and their less-financially-sophisticated depositors,<sup>8</sup> and reducing regulatory and enforcement costs.<sup>9</sup>

Yet, despite near consensus among economists and policymakers concerning the significant benefits of risk-adjusted schemes, a majority of the world's banking systems still operate under flat-rate schemes.<sup>10</sup> According to a World Bank study published in 2000, more than two-thirds of the estimated sixty-eight countries with explicit DISs assess flat-rate premiums.<sup>11</sup> Indeed, depending on the classification criteria, the number may be even greater. For instance, virtually all depository institutions operating in the United States are exempt from risk-adjusted premium charges,<sup>12</sup> although the World Bank (among others) considers the U.S. DIS a risk-adjusted scheme.<sup>13</sup>

What accounts for the prevalence of flat-rate premium schemes in the face of a fairer, more efficient alternative? In large part, the answer lies in the difficulties associated with accurately assessing banking risk.<sup>14</sup> The design and implementation of a risk-adjusted premium scheme is extremely complex, requiring

---

5. See *infra* Part II.C (discussing flat-rate premium schemes).

6. See *infra* Part III.A (discussing the moral hazard problem).

7. See *infra* Part III.B (discussing the free-rider problem).

8. See *infra* Part III.C (discussing the information asymmetries).

9. See *infra* Part III.D (discussing the regulatory savings).

10. See CAN. DEPOSIT INSURANCE CORP. (CDIC), SUMMARY OF THE CDIC INTERNATIONAL DEPOSIT INSURANCE SURVEY RESULTS, at <http://www.iadi.org/html/Default.aspx?MenuID=211> (last visited Feb. 26, 2004) (noting that “flat rate premiums are the most common form of [DIS funding, although] differential premium systems are becoming increasingly prevalent”).

11. ASLI DEMIRGÜÇ-KUNT & TOLGA SOBACI, WORLD BANK, DEPOSIT INSURANCE AROUND THE WORLD 6 (2000). An “explicit” DIS refers to a DIS with “the presence of a formal arrangement establishing a guarantee scheme for deposits through some form of legislation such as the central bank law, banking law, or the constitution. . . . In the absence of such formal arrangements . . . the country has an “implicit” deposit insurance system.” *Id.* at 3. See also *infra* Part II.A.

12. See *infra* notes 56–57 and accompanying text.

13. See DEMIRGÜÇ-KUNT & SOBACI, *supra* note 11, at 7.

14. See *infra* Part IV (discussing the impediments to the implementation of risk-adjusted premium schemes).

sophisticated risk-pricing methodologies,<sup>15</sup> substantial resource commitments,<sup>16</sup> and cross-border coordination.<sup>17</sup> Banking regulators considering risk-adjusted schemes must also anticipate any unintended negative consequences—for example, the destabilizing effects of imposing high premiums on troubled banks,<sup>18</sup> the leakage of sensitive financial information,<sup>19</sup> and the potential conflict with existing risk-based capital standards.<sup>20</sup> As one government opting for the flat-rate alternative observed, “the decision was taken to commence with a flat-rate premium because it is easier and simpler to apply. . . despite its drawback in terms of applying the same assessment rate for all institutions irrespective of their risk profiles.”<sup>21</sup>

The challenge, then, is to find ways to overcome the impediments to the implementation of risk-adjusted premium schemes. As a remedy, this Note proposes a transnational strategy, one that redirects complementary domestic and international instruments toward the common end of resolving the complexities associated with accurately pricing risk. Specifically, Part II provides a brief introduction to the structure and objectives of DISs. Parts III and IV present the case for risk-adjusted premium schemes and the challenges impeding their implementation. Part V outlines a transnational strategy, which redefines the role of multilateral organizations from passive spectators to indispensable and complementary participants in the design, implementation, and facilitation of effective risk-adjusted premium schemes worldwide. This Note concludes that without such multilateral collaboration, a danger exists that more and more countries considering DIS reforms will opt for the simpler flat-rate alternative—a move that could lead to financial disaster.<sup>22</sup>

---

15. *See infra* Part IV.A.

16. *See infra* Part IV.B.

17. *See infra* Part IV.D.

18. *See infra* Part IV.E.

19. *See infra* Part IV.C.

20. *See infra* Part IV.F.

21. JAM. DEPOSIT INSURANCE CORP., BACKGROUND TO THE DEPOSIT INSURANCE SCHEME 4, at [http://www.jdic.org/docs/insurance\\_sch\\_bg.doc](http://www.jdic.org/docs/insurance_sch_bg.doc) (last visited Feb. 13, 2004) [hereinafter JDIC].

22. The focus of this Note is on transnational coordination in the area of risk-adjusted DIS among international organizations, depository institutions, central banks, deposit insurers, and other government regulators. It does not attempt to detail a plan of action for the design and implementation of risk-adjusted schemes for specific countries. Indeed, the choice of DIS structural design requires consideration of multiple country-specific factors, and therefore, should be left to domestic regulators. *See* FSF, WORKING GROUP ON DEPOSIT INSURANCE, SITUATIONAL ANALYSIS 1 (2001) (noting “the importance of conducting a

## II. CONTEXTUAL ISSUES

### A. Deposit Insurance: Definition and Objectives

Deposit insurance exists in a variety of forms, and the term applies to different situations.<sup>23</sup> Generally, deposit insurance is a guarantee that all or a limited amount of a bank deposit account—and in some cases, interest accrued on the account—will be repaid to the depositor in the event that the bank fails.<sup>24</sup> The term includes within its scope guarantees that are not only *explicit* (those provided by statute, regulation, or written contract),<sup>25</sup> but also those that are *implicit* (those derived from verbal promises and other non-binding norms).<sup>26</sup> In practice, countries often begin with an implicit, *ad hoc* system and later transition into an explicit, more formal system.<sup>27</sup> Today, a great majority of developed countries and a rapidly growing number of developing countries have adopted or are considering some form of an explicit DIS.<sup>28</sup>

---

comprehensive situational analysis” before the adoption or reform of a DIS); LUC LAEVEN, WORLD BANK, *THE POLITICAL ECONOMY OF DEPOSIT INSURANCE* (2003) (examining the importance of a country’s political-economic context to DIS reform).

23. For comprehensive cross-country surveys of DISs, see CDIC, INTERNATIONAL DEPOSIT INSURANCE SURVEY, at <http://www.iadi.org/html/Default.aspx?MenuID=209> (last visited Mar. 1, 2004); DEMIRGÜÇ-KUNT & SOBACI, *supra* note 11.

24. See DEMIRGÜÇ-KUNT & SOBACI, *supra* note 11, at 1.

25. In 1934, the United States became the first country to establish an explicit DIS. By 1999, approximately sixty-eight countries had followed suit. Out of these sixty-eight countries, thirty-three adopted publicly-administered schemes, eleven adopted privately-administered schemes, and twenty-four adopted schemes jointly administered by governmental and private administrators. See DEMIRGÜÇ-KUNT & SOBACI, *supra* note 11, at 8.

26. For example, China maintains an implicit DIS through which the government has initiated three bank bailouts since 1998. See Keith Bradsher, *China Announces New Bailout of Big Banks*, N.Y. TIMES, Jan. 7, 2004, at C1.

27. See, e.g., Curtis J. Milhaupt, *Japan’s Experience with Deposit Insurance and Failing Banks*, 77 WASH. U. L.Q. 399, 408–24 (1999) (detailing Japan’s move from an implicit to an explicit DIS); ASLI DEMIRGÜÇ-KUNT & EDWARD J. KANE, DEPOSIT INSURANCE: HANDLE WITH CARE 2 (Central Bank of Chile, Working Paper No. 227, 2003), available at <http://www.bcentral.cl/esp/estpub/estudios/dtbc/pdf/dtbc227.pdf> (noting that Thailand, Malaysia, and Korea replaced their implicit DISs with explicit blanket guarantees following the 1997–98 Asian financial crisis).

28. See, e.g., ASLI DEMIRGÜÇ-KUNT & EDWARD J. KANE, DEPOSIT INSURANCE AROUND THE GLOBE: WHERE DOES IT WORK? 3 (2001) (noting that “[a]mong safety net policies, the use of explicit deposit insurance has spread rapidly in recent years” and that “during the last 26 years the number of countries offering explicit deposit insurance guarantees has almost tripled”); LAEVEN, *supra* note 2, at 3 (noting that 73 countries had an explicit DIS as of

Two public policy objectives are often cited in support of DISs.<sup>29</sup> On a micro-level, a DIS is intended to protect small, less-financially-sophisticated depositors who may not be in a position to assess the risks of multiple competing depository institutions. As identified in a cross-country study published by the Financial Stability Forum (“FSF”),<sup>30</sup> one of the largest and most active multilateral financial forums, “opaqueness of information on depository institutions makes it difficult, if not impossible, for less-sophisticated depositors to obtain and analyse the financial condition of these institutions.”<sup>31</sup> In this context, several economists have emphasized the information asymmetries that place small depositors at a disadvantage over banks.<sup>32</sup> This asymmetry of information arises from the fact that bank managers inherently know more about the value of their asset portfolios and the motives behind their investment and management decisions than depositors.<sup>33</sup> An effective DIS that guarantees depositors access to their insured deposits can thus protect depositors from the information asymmetries.

On a macro-level, a DIS can potentially assist in the maintenance of financial stability. Without a DIS in place, there is a likelihood that depositors might “run”<sup>34</sup> by withdrawing their deposits from a bank in response to difficulties (either real or perceived) at that bank.<sup>35</sup> As most non-institutional investors and depositors lack the

2000).

29. *But see* FSF, WORKING GROUP ON DEPOSIT INSURANCE, PUBLIC-POLICY OBJECTIVES FOR DEPOSIT INSURANCE SYSTEMS 5 (2001), at <http://www.fdic.gov/deposit/deposits/international/guidance/guidance/publicpolicyobjectives.pdf> [hereinafter FSF, PUBLIC-POLICY OBJECTIVES] (“Although financial stability and the protection of less-financially-sophisticated depositors are the primary objectives of numerous deposit insurers, some countries have identified other public-policy objectives as important to their system.”).

30. *See infra* Part V.B.2 (describing the history and role of the FSF).

31. FSF, PUBLIC-POLICY OBJECTIVES, *supra* note 29, at 5.

32. *See, e.g.*, Richard Cothren, *Asymmetric Information and Optimal Bank Reserves*, 19 J. MONEY, CREDIT & BANKING 68 (1987); Deborah J. Lucas & Robert L. McDonald, *Bank Financing and Investment Decisions with Asymmetric Information about Loan Quality*, 23 RAND J. ECON. 86 (1992); Stewart C. Myers & Nicolas S. Majluf, *Corporate Investment and Financial Decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984); Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, in *ECONOMICS FOR AN IMPERFECT WORLD* 569, 584 (Richard Arnott et al. eds., 2003) [hereinafter *ECONOMICS FOR AN IMPERFECT WORLD*].

33. *See* sources cited *supra* note 32 and *infra* Part III.C.

34. A “bank run” is defined by the FSF as a “rapid loss of deposits precipitated by fear on the part of the public that a bank may fail and depositors may suffer losses.” FSF, WORKING GROUP ON DEPOSIT INSURANCE, GUIDANCE FOR DEVELOPING EFFECTIVE DEPOSIT INSURANCE SYSTEMS 58 (2001) [hereinafter FSF, GUIDANCE FOR DEVELOPING EFFECTIVE DISs].

35. *See id.* at 11 (concluding that “deposit insurance contributes to the maintenance of

information necessary to differentiate between sound and unsound banks, a run at one bank may result in runs at other banks—regardless of their financial condition.<sup>36</sup> In order to meet the unexpected withdrawal demands, all affected banks may be compelled to liquidate their asset portfolios, often at depressed prices.<sup>37</sup> This scenario can lead to the kind of large-scale, contagious banking crises that have devastated almost a hundred countries in the past few decades.<sup>38</sup> Through alleviating the need for withdrawals, deposit insurance can deter bank runs and panics.<sup>39</sup> As Professors Joseph Stiglitz and Carl Walsh aptly put it, “deposit insurance. . .has an enormous impact in increasing the stability of the banking system. Simply because it exists, the threat against which it insures is much less likely to occur. It is as if life insurance somehow prolonged life.”<sup>40</sup>

## B. *Funding Arrangements*

Funding arrangements play a key role in DISs. As the FSF explained:

Sound funding arrangements are critical to the design and operation of an effective deposit insurance system and the maintenance of public confidence. A well-

---

confidence, so that less-financially-sophisticated depositors, or those who find it hard to assess the financial condition of a bank, are less likely to participate in bank runs”).

36. The spread of bank runs to multiple financial institutions is often called the “contagion effect” or “systematic risk.” Professors Scott and Wellons break down the concept of “systematic risk” into two parts: “First, it refers to a financial shock that has simultaneous impact on a number of financial institutions. Second, it refers to the chain reaction problem, the possibility that the failure of one bank will affect others.” HAL S. SCOTT & PHILIP A. WELLONS, *INTERNATIONAL FINANCE* 102 (10th ed. 2003). For a review of the academic literature on systematic risk, see OLIVER DE BANDT & PHILIPP HARTMANN, *EUROPEAN CENTRAL BANK, SYSTEMATIC RISK: A SURVEY* (2000).

37. See SCOTT & WELLONS, *supra* note 36, at 102.

38. See WORLD BANK STUDY, *supra* note 1, at 31–48 (presenting data on 113 systemic banking crises in 93 countries and 50 nonsystemic banking crises in 44 countries during 1970–90); DEMIRGÜÇ-KUNT & KANE, *supra* note 28, at 2 (calculating the costs of a banking crisis to be upwards of 50 percent of a country’s GDP).

39. See 149 CONG. REC. H2623 (daily ed. Apr. 2, 2003) (statement of Alan Greenspan, Chairman, Federal Reserve Board) [hereinafter Greenspan] (“Deposit insurance, combined with other components of our banking safety net, has meant that periods of financial stress no longer entail widespread depositor runs on banks and thrift institutions” and “has contributed to the prevention of bank runs that could have destabilized the financial structure in the short run.”).

40. JOSEPH E. STIGLITZ & CARL E. WALSH, *ECONOMICS* 541 (3d ed. 2002).



designed deposit insurance system should include the mechanisms necessary to ensure that adequate funds are available to reimburse depositors promptly in the case of an insured institution's failure and to cover the operating expenses of the system. As the experiences of several countries have shown, inadequate funding can lead to delay in resolving failed institutions and to significant increases in costs.<sup>41</sup>

Funding for DIS purposes can be obtained in various ways. One method is to build a reserve fund on an *ex-ante* basis. Under this method, all member depository institutions, as a precaution against future bank collapses, contribute to the creation and maintenance of the insurance fund. While this arrangement has the advantage of ensuring the existence of a financial safety net, it has been criticized as a potential drain on the liquidity of the banking sector because premiums paid to the deposit insurer cannot be accessed for investment purposes.<sup>42</sup>

A less common alternative funding mechanism entails reserving the power to obtain funds only as necessary.<sup>43</sup> Under such an *ex-post* approach, depository institutions are required to pay insurance premiums only when a failure occurs. There are several advantages to such an approach. First, when the banking industry and economy are healthy, the operating expenses of the DIS are low. Second, an *ex-post* approach avoids the drain on liquidity that occurs when funds have to be advanced to the deposit insurer. Third, such an approach can encourage intra-industry monitoring, as member banks know that their contributions will be minimized if all banks are financially sound.

However, a major disadvantage of an *ex-post* approach is that, because the calculation and collection of assessments occur post-failure, reimbursement of insured depositors may be slower and more difficult than under an *ex-ante* system. Moreover, such an approach raises fairness concerns. Since depository institutions that fail have no assets to contribute to the insurance fund, they escape being charged for the losses they produced.

---

41. FSF, WORKING GROUP ON DEPOSIT INSURANCE, FUNDING 1 (2001) [hereinafter FSF, FUNDING].

42. *See id.* at 2.

43. *See* DEMIRGÜÇ-KUNT & KANE, *supra* note 28, at 8 ("Deposit insurance obligations are typically advance-funded."). For a survey of various funding arrangements, see LUC LAEVEN, PRICING OF DEPOSIT INSURANCE (World Bank Pol'y Research, Working Paper No. 2871, 2002).

It is important to note that the above funding mechanisms are not mutually exclusive. Indeed, it is not uncommon for countries to adopt combinations or variants of these approaches.<sup>44</sup> For example, deposit insurers in several countries charge premiums *ex-ante* to buildup a fund while retaining the power, if required, to impose *ex-post* charges on their member depository institutions.<sup>45</sup>

### C. Premium Pricing

When funding is obtained using *ex-ante* charges on member depository institutions, a crucial decision must be made between flat-rate and risk-adjusted premiums. Flat-rate premium schemes include those arrangements in which premiums are assessed at a uniform rate across all insured depository institutions. As of 1999, a majority of the world's major banking systems—some fifty countries—were operating under a flat-rate premium scheme.<sup>46</sup> The United States, the first country to institute an explicit DIS,<sup>47</sup> employed a pure flat-rate system for almost 60 years, during which time member depository institutions were charged a given rate per dollar of total domestic deposits.<sup>48</sup>

In contrast, under a risk-adjusted premium scheme, assessments of individual banks are linked in some way to the risks they pose to the insurance fund. This approach is analogous to that of conventional types of insurance. The classic example is auto insurance, where auto insurance companies generally assess premium rates based on a driver's age, residence, driving history, and other factors correlated to the driver's risk of being involved in a car accident.

As with auto insurance, a risk-adjusted deposit insurance scheme assesses premium rates in relation to a set of defined determinants of a bank's risk of collapse. For example, under the French explicit DIS adopted in June 1999, the risk profiles of member banks are scored according to a number of criteria, including "the amount insured, estimated risk rating, solvency, profitability, and

---

44. See FSF, FUNDING, *supra* note 41, at 3 ("In practice, deposit insurance systems often are funded on a combined *ex-ante* and *ex-post* basis.").

45. See *id.*

46. See DEMIRGÜÇ-KUNT & SOBACI, *supra* note 11, at 14.

47. See DEMIRGÜÇ-KUNT & KANE, *supra* note 28, at 4.

48. For a succinct history of the U.S. DIS, see Lawrence J. White, *The Reform of Federal Deposit Insurance*, 3 J. ECON. PERSPS. 11, 12 (1989).

transformation and granularity measures.”<sup>49</sup> The score is then used to classify each institution into one of three categories, with those banks in higher-risk categories being assessed higher premiums.<sup>50</sup>

Some countries, such as Sweden, have adopted pricing schemes that fall somewhere in between flat-rate and risk-adjusted. According to the Swedish DIS regulations adopted in 1996 in the aftermath of a devastating banking crisis,<sup>51</sup> the Swedish Deposit Guarantor imposes risk-adjusted premiums (between a minimum of 0.06 percent and a maximum of 0.14 percent) only if the net aggregated charges are less than 2.5 percent of the total deposits.<sup>52</sup> Otherwise, member depository institutions in Sweden are charged only an annual flat-rate base fee.

The case is similar to DIS in the United States. While the U.S. Federal Deposit Insurance Corporation Improvement Act of 1991 explicitly required the Federal Deposit Insurance Corporation (“FDIC”) to adopt a “risk-based assessment system,”<sup>53</sup> the FDIC’s current authority to charge risk-adjusted premiums has been heavily curtailed by the Deposit Insurance Funds Act of 1996 (“DIFA”), which prohibits such charges when the fund’s deposit reserve ratio (“DRR”)<sup>54</sup> is above a 1.25 percent minimum.<sup>55</sup> As a result of this threshold, over 90 percent of depository institutions operating in the United States have avoided paying risk-adjusted premiums.<sup>56</sup> This

---

49. IADI CONFERENCE PROCEEDINGS, *supra* note 3, at 15 (statement of Sylvie Math  rat, Chef du Service des   tudes bancaires, Secr  tariat g  n  ral de la Commission bancaire, France). See also CRBF Regulation No. 99-06 (July 9, 1999) (Fr.), amended by CRBF Regulation No. 2000-07 (Sept. 6, 2000), available at [http://www.garantiedesdepots.fr/spip/reglements\\_99\\_06.php](http://www.garantiedesdepots.fr/spip/reglements_99_06.php).

50. See CRBF Regulation No. 99-06, *supra* note 49.

51. See BURKHARD DREES ET AL., IMF OCCASIONAL PAPER NO. 161, THE NORDIC BANKING CRISES: PITFALLS IN FINANCIAL LIBERALIZATION (1998).

52. The Act (1995:1571) on the Deposit Guarantee Scheme    12, available at <http://www.ign.se>.

53. 12 U.S.C.    1817(b) (2003).

54. DRR is computed as the insurance fund balance divided by insured deposits.

55. 12 U.S.C.    1821 (2003). See also James A. Wilcox, *MIMIC: A Proposal for Deposit Insurance Reform*, 9 J. FIN. REG. & COMPLIANCE 338 (2001).

56. See 149 CONG. REC. 2,609 (daily ed. Apr. 2, 2003) (statement of Hon. Michael G. Oxley) (“Under the current system, 91 percent of financial institutions do not pay deposit insurance premiums even though there are clear differences in their risk profiles.”); Clyde Mitchell, *Banking Federal Deposit Insurance—Recent Developments*, N.Y. L.J., July 16, 2003, at 3 (observing that the U.S. DIS “does not permit the FDIC to establish premiums based on an insured institution’s risk profile, with the effect that more than 90 percent of the industry does not pay for deposit insurance”); Wilcox *Discusses Deposit Insurance Reform*, OCC News Release 2000-100 (Dec. 12, 2000), at 6, available at <http://www.occ.treas.gov/00rellst.htm> (noting that “while measuring risk at individual banks may be challenging, we can surely do better than charging nearly every bank the same zero

predicament has sparked calls from several economists and policymakers—most notably, the Chairman of the Federal Reserve Board as well as past and present chairmen of the FDIC—for the government to adopt a fully risk-adjusted scheme.<sup>57</sup>

### III. THE CASE FOR RISK-ADJUSTED PREMIUM SCHEMES

This Part lays out the case for fully risk-adjusted premium schemes. Risk-adjusted premium schemes have at least four significant benefits over flat-rate schemes—namely, (1) mitigating the moral hazard for excessive risk-taking, (2) providing a fair method of premium assessment, (3) rectifying banking-related information asymmetries, and (4) reducing regulatory and enforcement costs.

---

premium”); Craig Linder, *No Premiums: Bank Fund Ratio Up*, AMER. BANKER, Nov. 5, 2003, at 4 (explaining that the majority of U.S. banks have not been assessed premiums because DRR levels were maintained); Donna Tanoue, Remarks at the Annual Convention of the American Bankers Association (Sept. 27, 1998) (transcript available at <http://www.fdic.gov/news/news/speeches/archives/1998/sp27sept98.html>) (noting that “there has been no increase in the percentage of institutions classified into the riskier categories of [the U.S.] premium system”).

57. See Greenspan, *supra* note 39, at 2623 (noting that the “current statutory requirement that free deposit insurance be provided to well-capitalized and highly rated institutions when the ratio of FDIC reserves to insured deposits exceeds a predetermined ratio maximizes the subsidy provided to these institutions and is inconsistent with efforts to avoid inducing moral hazard” and that “the [Federal Reserve] Board endorses the FDIC recommendations that would eliminate the statutory restrictions on risk-based pricing and allow a premium to be imposed on every insured depository institution, no matter how well capitalized and well rated it may be or how high the fund’s reserves”); Tanoue, *supra* note 56 (singling out risk-adjusted premium schemes as a “tool to help persuade banks to avoid excessive risk”); *Deposit Insurance Oversight: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (Feb. 26, 2003) (statement of Donald E. Powell, Chairman, FDIC), available at [http://banking.senate.gov/\\_files/powell1.pdf](http://banking.senate.gov/_files/powell1.pdf) [hereinafter Powell] (emphasizing the “pricing [of] premiums properly to reflect risk” as one of the “elements of deposit insurance reform that the FDIC regards most critical”); 149 CONG. REC. H2,621–22 (daily ed. Apr. 2, 2003) (statement of Hon. Peter R. Fischer, Undersecretary for Domestic Finance, Dept. of the Treasury) (calling for Congress to “remove the current restrictions on FDIC premium-setting” and move toward “full risk-based shared funding”); *Wilcox Discusses Deposit Insurance Reform*, *supra* note 56 (calling for the FDIC to charge member banks risk-adjusted premiums); Jonathan R. Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277, 1278 (1989) (arguing that the FDIC’s “policies for administering bank failures, and its refusal to price deposit insurance so as to penalize excessive risk-taking by insured banks, defy explanation on public policy grounds”); White, *The Reform of Federal Deposit Insurance*, *supra* note 48, at 22 (arguing that “risk-based premiums are a necessary part of the reform of deposit insurance”); Eric W. Bond et al., *Bank Capitalization, Deposit Insurance, and Risk Categorization*, 60 J. RISK & INSURANCE 547, 566 (1993) (concluding that “the optimal [deposit] insurance plan assesses premiums based upon bank riskiness”).

### A. *Moral Hazard*

In a world without deposit insurance, market mechanisms constrain excessive risk-taking by banks. In particular, the threat of a mass deposit withdrawal in case of bank failure stimulates prudent risk management.<sup>58</sup> The fear of a contagion effect also induces banks to monitor each other.<sup>59</sup> But when deposit insurers step in to guarantee reimbursement of deposits, depositors know that their deposits are guaranteed and no longer rush to make withdrawals during a banking crisis.<sup>60</sup> At the same time, insured banks have less of an incentive to monitor their risks and those of other banks.<sup>61</sup> This reduced vigilance on the part of both depositors and banks to monitor and curb excessive risk-taking, in turn, allows banks greater freedom to take on more risks without incurring significant negative consequences. This perverse risk-taking incentive is known as the problem of “moral hazard.”<sup>62</sup> As a group of economists explained:

The creation of such a safety net comes at a cost, namely moral hazard. Depositors no longer have an incentive to monitor (or pay to monitor) banks since their deposits are guaranteed up to the coverage limit . . . . Banks have an attendant incentive to increase risk. Hence the name of the game in designing a safety net has been to balance the need to prevent bank panics (and other social costs to bank failure such as credit crunches) with the moral hazard brought on by the very presence of the safety net.<sup>63</sup>

---

58. See FSF, GUIDANCE FOR DEVELOPING EFFECTIVE DISS, *supra* note 34, at 3, 5.

59. See *id.* at 3.

60. See *id.*; Greenspan, *supra* note 39, at 2623.

61. FSF, GUIDANCE FOR DEVELOPING EFFECTIVE DISS, *supra* note 34, at 6; Greenspan, *supra* note 39, at 2623.

62. See, e.g., Robert C. Merton, *An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees*, J. BANKING & FIN. 1, 3–11 (1977) (introducing the notion of risk-taking incentives created by deposit insurance); Greenspan, *supra* note 39, at 2623 (noting that the “incentive to take excessive risks at the expense of the insurer, and potentially the taxpayer, is the so-called moral hazard problem of deposit insurance”); Michael C. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 AMER. ECON. REV. 1183, 1183 (1990) (noting that DIS poses a moral hazard because “banks or thrifts can borrow at or below the risk-free rate by issuing insured deposits and then investing the proceeds in risky assets with higher expected yields”); Luc Laeven, *Bank Risk and Deposit Insurance*, 16 WORLD BANK ECON. REV. 109, 135 (2002) (finding that “government deposit insurance schemes create moral hazard for banks”). *But see* Gary Gorton & Richard Rosen, *Corporate Control, Portfolio Choice, and the Decline of Banking*, 50 J. FIN. 1377 (1995) (questioning the degree of moral hazard associated with deposit insurance).

63. Andrew Kuritzkes et al., *Deposit Insurance and Risk Management of the U.S.*

One solution to the moral hazard problem, as many commentators have pointed out, is risk-adjusted premium schemes.<sup>64</sup> Given the increasing degree of competition faced by insured institutions and the increasing opportunities for risk-taking as a result of rapid financial innovation,<sup>65</sup> banks would have a strong incentive to take on risks if they did not have to pay a premium for it. Because flat-rate deposit insurance premiums by definition do not reflect the level of risk that a depository institution poses to the DIS, banks can increase the risk to their portfolios without incurring any additional insurance expenses.<sup>66</sup> The costs for increased risk-taking are borne entirely by deposit insurers and depositors. As Federal Reserve Chairman Greenspan noted, “a closer link between insurance premiums and the risk of individual institutions would reduce moral hazard and the distortions in resource allocation that accompany deposit insurance.”<sup>67</sup>

## B. Free Riding

Apart from mitigating the moral hazard problem, risk-adjusted premium schemes can also contribute to establishing a fair and level

---

*Banking System* (2002).

64. See, e.g., Kenneth E. Scott & Thomas Mayer, *Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform*, 23 STAN. L. REV. 857, 886–95 (1971) (making the case for risk-adjusted premiums); Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 316 (1987) (providing for “risk-related insurance premiums” as a method “to strengthen market discipline on risk-taking by banks”); Sudipto Bhattacharya et al., *The Economics of Bank Regulation*, 30 J. MONEY, CREDIT & BANKING 745, 765 (1998) (concluding that “risk-calibrated deposit insurance premia are potentially useful regulatory tools in coping with moral hazard”); FSF, WORKING GROUP ON DEPOSIT INSURANCE, OPTIONS FOR ADDRESSING MORAL HAZARD 10 (2001), at <http://www.fdic.gov/deposit/deposits/international/guidance/guidance/moralhazard.pdf> [hereinafter FSF, MORAL HAZARD] (noting that “differential insurance premiums based on variations in risk” are among the options for addressing moral hazard” and that “[p]roperly structured, differential premium systems may discourage excessive risk-taking by institutions by increasing their premium assessments”); Powell, *supra* note 57, at 4 (“The current system does not charge appropriately for risk, which increases the potential for moral hazard.”).

65. See RAMESH F. RAMSARAN, AN INTRODUCTION TO INTERNATIONAL MONEY AND FINANCE 127–54 (1998) (noting the increased competition and rapid financial innovation in global banking).

66. See Greenspan, *supra* note 39, at 2623 (noting that “the current levels of deposit insurance [in the United States] may have already increased risk-taking at insured depository institutions to such an extent that future systemic risks have arguably risen” and that a flat-rate DIS “misallocates resources by breaking the link between risks and rewards for a select set of market competitors”).

67. See Greenspan, *supra* note 39, at 2623.

playing field among banks.<sup>68</sup> Basic principles of fairness dictate that “similar institutions operating under similar circumstances, and representing similar risks of failure and magnitude of potential loss to the insurance fund, [should] generally incur similar insurance costs.”<sup>69</sup> The corollary to this principle is that, all other things being equal, a higher-risk bank should contribute more to the insurance fund than a lower-risk bank. In this sense, a flat-rate insurance scheme, in which weaker banks “free ride” on healthier banks, is inherently unfair<sup>70</sup> and is analogous to the case of imposing a uniform set of auto insurance premiums on all automobile drivers, regardless of their safety record. As James Wilcox, the first-ever appointed chief economist of the Comptroller of the Currency, noted, “among the vast majority of banks that pay zero premiums, safer banks subsidize riskier banks via the latter’s greater likelihood of drawing down the Fund’s reserves and triggering increased premiums on all banks sooner.”<sup>71</sup> “A promising approach that seeks to simulate market discipline with minimal stability implications,” explained Greenspan, “is the application of risk-based deposit insurance premiums. The idea is to make the price of insurance a function of the bank’s risk, reducing the subsidy to risk-taking and spreading the cost of insurance more fairly across depository institutions.”<sup>72</sup>

### C. *Information Asymmetries*

In addition to curbing the moral hazardous tendencies induced

---

68. See, e.g., John P. LaWare, Remarks to the House of Representatives Subcommittee on Financial Institutions Supervision (June 23, 1992), available at 78 FED. RESERVE BULL. 607 (“Risk-based deposit insurance premiums will distribute the cost of deposit insurance more fairly among healthy and riskier banks. . . .”); Powell, *supra* note 57, at 4 (arguing that the current non-risk-adjusted system “makes safer banks unnecessarily subsidize riskier banks” and that “as a matter of fairness, riskier banks should shoulder more of the industry’s deposit insurance assessment burden”).

69. Assessments, 59 Fed. Reg. 50,710, 50,713 (FDIC proposed Oct. 5, 1994).

70. See, e.g., Clyde Mitchell, *Banking Federal Deposit Insurance—Recent Developments*, N.Y. L.J., July 16, 2003, at 3 (noting that, under the current U.S. DIS system, “safe banks may be subsidizing risky banks and slower-growing banks may be subsidizing new banks and faster-growing banks [i.e., ‘free riders’]”); *Powell Presses for Merger of Funds, Risk-Based System*, BANK BAILOUT LITIG. NEWS, June 11, 2003, available at LEXIS, News Library (noting that FDIC Chairman Donald Powell is proposing a risk-adjusted scheme to combat the free-rider problem); Kenneth H. Thomas, *Letter to Editor: Some Free Advice for FDIC: Make Everybody Pay*, AMER. BANKER, May 9, 2003, at 6 (proposing that “[a]ll banks pay a risk-adjusted premium at all times, so there are no ‘free riders’”).

71. *Wilcox Discusses Deposit Insurance Reform*, *supra* note 56, at 4.

72. Alan Greenspan, Statement to the Senate Committee on Banking, Housing, and Urban Affairs (July 12, 1990), available at 76 FED. RESERVE BULL. 731.

by deposit insurance and ending the unfair free riding by riskier banks, an effective risk-adjusted scheme could also rectify information asymmetries inherent in the banking context. As explained above, information asymmetries in banking arise from the fact that banks know more about their risk profiles than their depositors.<sup>73</sup> As such, healthier banks may wish to “signal” their credibility to depositors through greater disclosure or through better interest rates—what Stiglitz calls “conveying information through actions.”<sup>74</sup> On the other hand, weaker banks may choose to deceive depositors. They may choose not to disclose voluntarily certain types of information, or worse, they may provide the same signals as healthy banks do, confusing and deceiving depositors about the differences between themselves and healthier banks.<sup>75</sup> Risk-adjusted schemes can potentially solve this signaling problem—the premium rate that each bank would pay under such schemes represents an accurate and credible signal of their risk profile to potential and existing depositors. For example, the fact that Bank A paid a higher premium than Bank B, even if Bank A attempted to confuse depositors by mimicking the signals of Bank B, would effectively signal to the market that Bank B is safer than Bank A.

#### D. *Regulatory Savings*

To the extent that a risk-adjusted premium scheme is perfectly priced, it can also result in significant reductions in regulatory costs. As Professors Macey, Miller, and Carnell point out, “the unwieldy and costly system of examination and enforcement could be considerably reduced under [a perfectly risk-adjusted] system.”<sup>76</sup> Specifically, they note that perfectly risk-adjusted schemes “could potentially replace a large portion of existing bank regulation” and “obviate the need for capital adequacy standards.”<sup>77</sup> Regulators would thus no longer need to impose significant limitations on bank assets or activities (and waste valuable resources in monitoring and enforcing those limitations) as banks themselves would be responsible for determining which assets and/or activities are in their best

---

73. See *infra* note Part II.A.

74. Stiglitz, *Information and the Change in the Paradigm in Economics*, *supra* note 32, at 588.

75. See *id.*

76. JONATHAN R. MACEY ET AL., *BANKING LAW AND REGULATION* 258 (3d ed. 2001).

77. *Id.*



interests. This self-assessment could yield resource-allocative benefits as well, they argue, as it would result in banks “act[ing] as more efficient financial intermediaries and contribut[ing] to social wealth by directing capital to higher valued uses.”<sup>78</sup>

In the end, however, the effectiveness of such schemes depends on the accuracy of the risk pricing methodology.<sup>79</sup> The following Part explores in greater detail this and other related challenges to the implementation of risk-adjusted premium schemes.

#### IV. IMPEDIMENTS TO IMPLEMENTATION

Despite consensus on the advantages of a fully risk-adjusted premium scheme,<sup>80</sup> a host of obstacles to risk pricing hinder the effective design and implementation of such schemes worldwide. This Part briefly surveys six major obstacles: risk pricing difficulties, operational costs, confidentiality issues, cross-border complexities, political opposition, and potential conflicts with existing risk-based capital adequacy standards.

##### A. Pricing risks

Perhaps the greatest impediment to the effective implementation of risk-adjusted premium system lies in determining the appropriate standards for risk assessment.<sup>81</sup> As the FSF explained, “[a]lthough there is general agreement that relating deposit insurance premiums to the risk an institution poses to the insurance fund is a good idea, the information-intensive nature of the intermediation process in which banks specialise makes risk measurement a difficult task.”<sup>82</sup>

Risk pricing is fraught with many complexities. First, risk pricing is still, and will surely continue to be for some time, an

---

78. *Id.*

79. See Laurie S. Goodman & Sherrill Shaffer, *The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reforms*, 2 YALE J. ON REG. 145, 153–54 (1984) (“To be effective, . . . a risk-based premium system must employ accurate measures of the riskiness of a bank’s activities and impose premiums with significant risk differentials.”)

80. See *supra* Part III (outlining the case for risk-adjusted premium schemes).

81. See Scott & Mayer, *supra* note 64, at 889 (commenting that “[t]he strongest criticism of the variable premium proposal is that it is not feasible to classify assets or institutions accurately by degree of risk”).

82. FSF, FUNDING, *supra* note 41, at 8.

inexact science. Myriad variables—e.g., credit risks, interest rate risks, market risks, liquidity risks, operational risks, foreign exchange risks, and country risks—factor into banking risks,<sup>83</sup> and the difficulty lies not only in selecting the appropriate variables for the risk-pricing formula but also in determining the coefficients commensurate with each risk variable. Second, even if agreement can be reached on a formula, many of the risk factors are hard to gather information on and quantify. As one commentator described it, banking risks are “intangible and invisible until they materialize into losses.”<sup>84</sup> Third, banking risks are not fixed variables, but change over time. Consequently, the formula—to the extent that agreement can be reached on one—would have to be revised continuously to account for new and unanticipated sources of risk.<sup>85</sup> Given the complexities of risk pricing, it is not surprising that many countries confronting the decision between flat-rate and risk-adjusted premium schemes choose the former, less-complicated scheme in spite of the promise the latter holds for financial stability.<sup>86</sup>

## B. Operational Costs

Even if the problem of risk pricing can be overcome, countries designing a risk-adjusted scheme may lack adequate resources to implement such a scheme successfully. While the estimated operating costs will depend on the specific method of risk pricing adopted, the undeniable fact is that such costs will be considerably high.<sup>87</sup> Indeed, an effective risk-adjusted scheme requires highly sophisticated actuarial expertise, human resources, and other capital

---

83. For an explanation of the major components of banking risks, see JOËL BESSIS, *RISK MANAGEMENT IN BANKING* 11–22 (2d ed. 2002).

84. *Id.* at xi; FSF, *GUIDANCE FOR DEVELOPING EFFECTIVE DISS*, *supra* note 34, at 29 (emphasizing the “information-intensive nature” of risk measurement).

85. See Scott & Mayer, *supra* note 64, at 892 (pointing out that the drawbacks to implementation of a system of variable premiums based on risk classes are the cost of designing such a system and obtaining the information needed); IADI CONFERENCE PROCEEDINGS, *supra* note 3, at 19 (statement of Luis Javier García Macarrón, Sociedad Gestora de los Fondos de Garantía de Depósitos Entidades de Crédito, Spain) (stating that risk-adjusted premiums require substantial resources in the collection and analysis of information).

86. See FSF, *FUNDING*, *supra* note 41, at 7 (“Most newly established or transitional deposit insurance systems initially have adopted flat-rate deposit insurance assessments.”); JDIC, *supra* note 21.

87. See FSF, *GUIDANCE FOR DEVELOPING EFFECTIVE DISS*, *supra* note 34, at 29. *But see* Powell, *supra* note 57, at 7 (“The goals of risk-based premiums can be accomplished with relatively minor adjustments to the FDIC’s current assessment system.”)

expenditures.<sup>88</sup> Such a scheme also entails significant monitoring costs.<sup>89</sup> These costs explain in large part why certain countries contemplating reforms to their DIS have adopted a two-step approach to DIS reform, beginning with a temporary, transitional flat-rate premium scheme and adopting a fully risk-adjusted premium system only after the necessary infrastructure is in place.<sup>90</sup>

Here, an analogy can be drawn to proposals for per-mile premiums on auto insurance. While economists have highlighted the advantages of such per-mile premiums—noting that, for instance, “an ideal tort and insurance system would charge each driver the full social cost of her particular risk exposure on the marginal mile of driving”—the high costs associated with monitoring compliance to per-mile premiums have thwarted efforts toward their successful implementation.<sup>91</sup>

### C. *Confidentiality and Transparency*

Issues related to confidentiality and transparency also hinder the effective implementation of risk-adjusted premium schemes. The problem here is that certain types of information needed in risk calculations are confidential or proprietary, and disclosure of such information may seriously prejudice the position of the depository institution. As the Basel Committee on Banking Supervision (an international body that has recently faced this issue in the process of devising supervisory standards on capital adequacy) explained the problem:

Proprietary information encompasses information (for example on products or systems), that if shared with competitors would render a bank's investment in these products/systems less valuable, and hence would undermine its competitive position. Information about customers is often confidential, in that it is provided under the terms of a legal agreement or counterparty relationship. This has an impact on what banks should

---

88. See FSF, GUIDANCE FOR DEVELOPING EFFECTIVE DISS, *supra* note 34, at 29.

89. See *id.*

90. See IADI CONFERENCE PROCEEDINGS, *supra* note 3, at 17 (statement of Pacharapan Roehrl, Legal Officer, Bank of Thailand) (explaining the two-step process with respect to the Thai DIS).

91. See Aaron S. Edlin, *Per-Mile Premiums for Auto Insurance*, in ECONOMICS FOR AN IMPERFECT WORLD, *supra* note 32, at 53, 73.

reveal in terms of information about their customer base, as well as details on their internal arrangements, for instance methodologies used, parameter estimates, data, etc.<sup>92</sup>

Given the need for an appropriate balance between meaningful disclosure and the protection of confidential information, what becomes clear is that the objectives are not all achievable at once: trade-offs exist and choices have to be made between the competing goals of preserving confidentiality and ensuring transparency.<sup>93</sup>

#### D. Cross-border Complexities

The impediments to risk-adjusted premium schemes are further compounded by cross-border complexities. Over the past three decades, the world has witnessed the globalization of banking.<sup>94</sup> Several countries have experienced significant banking-related reforms, including the privatization of state-controlled banks, deregulation and liberalization, removal of exchange controls, and the opening up of domestic banking sectors to foreign banks. At the same time, advances in technology have paved the way for financial institutions to manage larger information flows across more locations and to evaluate and manage risks at lower costs than ever before.<sup>95</sup> In the third quarter of 2003, the total foreign claims<sup>96</sup> of the Bank of International Settlements (“BIS”) reporting banks was US\$14.7 trillion. With respect to the United States in 2002, foreign banks represented 25% and 18% of the market shares in commercial loans and commercial assets, respectively.<sup>97</sup>

---

92. BANK OF INTERNAT'L SETTLEMENTS, THE NEW BASEL ACCORD 156 (Apr. 2003).

93. The tradeoff between these competing goals is perhaps most apparent in the context of securities disclosure regulation. See Wally Suphap, Note, *Getting It Right versus Getting It Quick: The Quality-Timeliness Tradeoff in Corporate Disclosure*, 2003 COLUM. BUS. L. REV. 661, 697 (2003).

94. See RAMSARAN, *supra* note 65, at 127–54 (1998); Art A. Hall, *International Banking Regulation into the 21st Century*, 21 N.Y.L. SCH. J. INT'L & COMP. L. 41, 45–46 (2001).

95. See RAMSARAN, *supra* note 65, at 151 (“Technology has not only revolutionized the operations of banks, but has changed the whole environment in which these institutions function.”).

96. Foreign claims refer to those claims on borrowers resident outside the country in which the bank is headquartered.

97. See SCOTT & WELLONS, *supra* note 36, at 96–97; see also Robert DeYoung & Daniel E. Nolle, *Foreign-Owned Banks in the United States*, 28 J. MONEY, CREDIT & BANKING 622 (1996).

The growth of cross-border banking activities has many implications for the design and implementation of risk-adjusted premium schemes. First, related to the issues of confidentiality and transparency discussed above, the cross-border nature of banking imposes difficulties for deposit insurers in their information gathering and research efforts, especially as certain home countries of foreign banks impose restrictions on information access.<sup>98</sup> Second, even if information disclosure regulation were relaxed, there is the further difficulty of standardizing cross-border information to enable comparisons between domestic and foreign banks. This is especially problematic given that countries have different regulatory and accounting standards.<sup>99</sup> Third, cross-border banking presents the question of whether to adopt a standard of equal or disparate treatment between domestic and foreign banks. Indeed, several countries impose a different, stricter set of rules on foreign banks, while others have tried to maintain a policy of equal treatment.<sup>100</sup> Fourth, potential exists for the double charging of premiums by the regulatory authorities in the home country and the host country. In this context, the determination of the “home country” is of critical importance, and the fact that there may be two foreign bank parents means that a single depository institution could be assessed insurance premiums by two deposit insurers.<sup>101</sup>

### E. Political Opposition

A major set of impediments to the effective implementation of risk-adjusted premium schemes arise from the political context. While a shift to fully risk-adjusted premiums would be advantageous

---

98. FSF, WORKING GROUP ON DEPOSIT INSURANCE, CROSS-BORDER AND REGIONAL ISSUES 5 (2001), at <http://www.fdic.gov/deposit/deposits/international/guidance/guidance/crossborder.pdf>.

99. See Chantal Thomas, *Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method*, 14 BERKELEY J. INT'L L. 99 (1996) (discussing different domestic accounting and tax standards).

100. See Frank A. Misuraca, *Foreign Banking in the United States: An Objective Study of the International Banking Act of 1978*, 4 D.C.L. J. INT'L L. & PRAC. 539, 543 (1995) (noting that the U.S. International Banking Act of 1978 “served to severely limit the activities of foreign banks in the United States”); Raj Bhala, *Hegelian Reflections on Unilateral Action in the World Trading System*, 15 BERKELEY J. INT'L L. 159, 211 (1997) (presenting evidence of unequal treatment of foreign banks in Japan); Lawrence L. C. Lee, *Taiwan's Current Banking Development Strategy*, 17 UCLA PAC. BASIN L.J. 166, 222–23 (1999) (noting increased equality in Taiwan's treatment of its foreign banks).

101. See SCOTT & WELLONS, *supra* note 36, at 106–07 (linking the failure of BCCI Holdings to the existence of two foreign bank parents).

for most affected parties, one group that may be hurt initially by such reforms is, of course, the higher-risk banks that would be required to pay higher premiums. To the extent that these banks are effective in banding together to lobby the government, they could potentially derail the entire reform process.

Another potential political obstacle stems from the fear that risk-adjusted schemes may chill socially desirable risk-taking.<sup>102</sup> As one commentator put it, “a risk-based system would force banks to pay higher premiums only when they encountered difficulty and consequently became more risky.”<sup>103</sup> And, as the FSF similarly cautioned, “regulatory discipline can be intrusive from the standpoint of institutions and can inhibit moderate risk-taking if unduly stringent.”<sup>104</sup> Governments of developing countries, especially those in the midst of an economic expansion period, likely would not be receptive to any reform effort that could be seen as significantly curbing financial risk-taking. Finding the right pricing formula thus takes on great importance, and will undoubtedly require a delicate balance between limiting banking risks and maximizing business objectives.<sup>105</sup>

#### F. *Conflict with Risk-Based Capital Standards*

Another potential complication is the potential inconsistency of risk-adjusted schemes with other risk-based standards—most notably, risk-based capital adequacy standards.<sup>106</sup> Under international risk-based capital adequacy standards, banks are required to maintain minimum capital reserves in relation to the risks posed by their assets.<sup>107</sup> While both risk-adjusted premiums and capital adequacy requirements share the same objectives of promoting safety and soundness in financial systems, there is the potential that the two may conflict in practice. For example, suppose that a DIS treated a certain type of asset as high risk, but the capital adequacy standards treated

---

102. See Powell, *supra* note 57, at 3 (“High premiums at . . . a [distressed] point in the business cycle would be pro-cyclical and result in a significant drain on the net income of depository institutions, thereby impeding credit availability and economic recovery.”).

103. Goodman & Shaffer, *supra* note 79, at 154.

104. FSF, MORAL HAZARD, *supra* note 64, at 9.

105. See BESSIS, *supra* note 83, at 53 (“Modern best practices consists of setting risk limits based on economic measures of risk while ensuring the best risk-adjusted performances.”).

106. See *infra* Part V.B (discussing the Basel capital adequacy standards).

107. *Id.*

the asset as low risk. Banks would consequently be in a dilemma as to the choice of whether to hold the asset. As the FSF cautioned, “[c]areful consideration should be given to the balance between risk-based capital standards and risk-based/differential insurance premiums so that they do not operate at cross-purposes.”<sup>108</sup>

To the extent that the two standards need to be consistent, a related issue is whether to superimpose the risk-weight assessments used in the capital adequacy standards directly on risk-adjusted premium schemes. This undoubtedly would be an easier method logistically than developing a completely new rating system for risk-adjusted premium pricing. However, in this respect, one cannot ignore the possibility that the two sets of standards may differ in some significant ways so as to justify imposing different (albeit consistent) risk assessments. Indeed, an obvious difference that might justify applying differing risk calculations is that the capital adequacy standards affect how much capital a bank is required to hold, while the insurance premium schemes affects how much a bank is required to pay.

## V. A TRANSNATIONAL STRATEGY

### A. *The Need for International Coordination*

In recent years, international organizations have played an increasingly active role in banking regulation, with implications at the international and national levels.<sup>109</sup> Their activities have focused on banking-related areas previously not addressed by international cooperation—for example, security and privacy issues, technology and the internet, terrorist financing, and capital adequacy requirements.<sup>110</sup> These and other developments bear witness to the

---

108. FSF, MORAL HAZARD, *supra* note 64, at 8.

109. See Hall, *supra* note 94, 60–71 (surveying recent international coordination efforts in banking).

110. For a comprehensive list of international standards (including good principles, practices, and guidelines) issued by international organizations, see FSF, COMPENDIUM OF STANDARDS, at <http://www.fsforum.org/compendium/about.html> (consisting of, *inter alia*, BASEL COMM. ON BANKING SUPERVISION, SUPERVISORY GUIDANCE ON DEALING WITH WEAK BANKS (2002); BASEL COMM. ON BANKING SUPERVISION, SOUND PRACTICES FOR THE MANAGEMENT AND SUPERVISION OF OPERATIONAL RISK (2002); FIN. ACTION TASK FORCE, SPECIAL RECOMMENDATIONS ON TERRORIST FINANCING (2002); BASEL COMM. ON BANKING SUPERVISION, RISK MANAGEMENT PRINCIPLES FOR ELECTRONIC BANKING (2001); ORG. FOR

great changes which have occurred in the field over the past few decades. In particular, they suggest that the international community has become more or less aware that banking crises are costly and contagious, and thus, have enhanced the role of international organizations in banking. As a result, virtually all existing multilateral financial institutions find themselves with an increase in the breadth and nature of their activities.<sup>111</sup>

Despite these positive developments, a coordinated multilateral push for risk-adjusted premium schemes is still lacking. As the survey of existing banking-related institutions demonstrates below, there exists a plethora of international organizations related to banking issues—indeed, one entirely devoted to DIS-related issues—yet, a vital transnational strategy that links their efforts for risk-adjusted premium schemes together is still needed. To fill this void, this Note proposes a transnational strategy—one that combines the largely untapped institutional advantages of international organizations with the existing network of domestic regulatory agencies to overcome the myriad challenges to their implementation.

## *B. Overview of Existing Banking-Related International Institutions*

### 1. The Bank of International Settlements and the Basel Committee

The principal organization for banking coordination is the Bank of International Settlements (“BIS”). Created in 1930, the BIS is the world’s oldest international financial institution.<sup>112</sup> Initially established to manage German reparations,<sup>113</sup> its activities presently

---

ECON. COOPERATION AND DEVELOPMENT (OECD), PRINCIPLES OF CORPORATE GOVERNANCE (1999); INT’L MONETARY FUND (IMF), CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES (1999); GROUP OF SEVEN, TEN KEY PRINCIPLES FOR THE IMPROVEMENT OF INTERNATIONAL CO-OPERATION REGARDING FINANCIAL CRIMES AND REGULATORY ABUSE (1999).

111. See *infra* Part V.B (providing an overview of banking-related international organizations and their works).

112. See BIS website, at <http://www.bis.org/bcbs/aboutbcbs.htm> (last visited Apr. 8, 2004).

113. See GIUSEPPE U. PAPI, THE FIRST TWENTY YEARS OF THE BANK FOR INTERNATIONAL SETTLEMENTS 95–99 (1951) (discussing the duties of the BIS during its initial years).



focus on two broad areas.<sup>114</sup> First, it assists central banks and other financial authorities in their efforts to promote improved monetary and financial stability through promoting international cooperation and through its various committees and task forces.<sup>115</sup> Second, the BIS acts as a bank for central banks, providing services related to their financial operations. In this latter role, it holds on deposit a significant portion of the world's foreign exchange reserves.<sup>116</sup>

The institutional structure of the BIS consists of a seventeen-member Board of Directors ("the Board"), presently chaired by the President of the Netherlands Bank, Nout Wellink. The Board has six *ex officio* directors, including the governors of the central banks of Belgium, France, Germany, Italy, and the United Kingdom and the Chairman of the Board of Governors of the U.S. Federal Reserve. Each *ex officio* member appoints another member of the same nationality to the Board. The Statutes also provide for the election to the Board of not more than nine Governors from among the other thirty-eight member central banks.<sup>117</sup> Those central banks not on the Board are entitled to be represented in the General Meetings, and their voting power is proportionate to the number of BIS shares issued in their respective countries.<sup>118</sup>

A number of committees and organizations focusing on financial stability have their secretariats at the BIS. The most important of such committees in the area of banking regulation is the Basel Committee on Banking Supervision ("the Basel Committee" or "the Committee"). Established in 1975 by central bank Governors of the G10 countries,<sup>119</sup> the Basel Committee provides a forum for regular cooperation on banking supervisory matters.<sup>120</sup> Over recent years, it has developed increasingly into a standard-setting body on various aspects of banking supervision. As the Basel Committee explained its standard-setting role:

The Committee does not possess any formal supranational supervisory authority, and its

---

114. See BIS website, *supra* note 112.

115. *Id.*

116. *Id.*

117. The Governors of the central banks of Canada, Japan, the Netherlands, Sweden, and Switzerland are the current elected members of the Board. *Id.*

118. *Id.*

119. The G10 actually consists of *eleven* central banks: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. *Id.*

120. *Id.*

conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries’ supervisory techniques.<sup>121</sup>

Among the most significant works of the Committee is the capital measurement system commonly known as the “Basel Capital Accord” or “Basel I.”<sup>122</sup> Entered into in 1988, the Basel Capital Accord sets down the agreement among the G10 countries plus Luxembourg to apply common minimum capital standards to their banking industries.<sup>123</sup> The standards were meant primarily to address “the concern of the Governors of the G10 central banks that the capital of the world’s major banks had become dangerously low after persistent erosion through competition.”<sup>124</sup> Capital was deemed “necessary for banks as a cushion against losses” and, as such, capital requirements were seen as a way to provide “an incentive for the owners of the business to manage [capital] in a prudent manner.”<sup>125</sup>

The basic idea behind the Basel Accord was to assign each asset owned by a bank, or accounted for on an off-balance-sheet basis, to risk categories.<sup>126</sup> Each risk category was assigned a “risk weight,” which was used to multiply the amounts in each risk category to determine the amount of “capital” required by the bank. Capital was divided broadly into “tier 1” or “core” capital (consisting of retained earnings, common stock, and qualifying perpetual preferred stock and minority interests in equity accounts of consolidated subsidiaries, minus goodwill) and “tier 2” capital

---

121. *Id.*

122. BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988).

123. BASEL COMM. ON BANKING SUPERVISION, MINIMUM STANDARDS FOR THE SUPERVISION OF INTERNATIONAL BANKING GROUPS AND THEIR CROSS-BORDER ESTABLISHMENTS (1992).

124. BASEL COMM. ON BANKING SUPERVISION, THE NEW BASEL ACCORD: AN EXPLANATORY NOTE 11 (2001), available at <http://www.bis.org/publ/bcbsca01.pdf>.

125. *Id.*

126. BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988).

(various forms of “supplementary” capital, such as loan-loss reserves).<sup>127</sup>

In recent years, Basel I has faced staunch criticism from the international community as well as from the Committee itself.<sup>128</sup> Subsequently, preparations have been underway for the implementation of a new set of capital adequacy standards, the so-called “New Basel Capital Accord” or “Basel II.”<sup>129</sup> The New Basel Capital Accord attempts to expand the basket of risk factors and replace the one-size-fits-all approach of Basel I with a menu of options and flexibility for banks.<sup>130</sup> Negotiations are expected to be completed in 2004, and its final implementation is tentatively set for year-end 2006.<sup>131</sup>

## 2. The Financial Stability Forum

Another important forum for international cooperation in DIS reform is the Financial Stability Forum (“FSF”). Convened in 1999 by the Finance Ministers and Central Bank Governors of the G7 countries,<sup>132</sup> the FSF brings together national authorities responsible for financial stability, international financial institutions, international supervisory and regulatory bodies, and central bank expert groups. The FSF defines its purpose broadly as “promot[ing] international financial stability through information exchange and international co-

---

127. *Id.* at 3–8.

128. As the Basel Committee acknowledged:

The current [Basel Accord] risk weighting of assets results, at best, in a crude measure of economic risk, primarily because degrees of credit risk exposure are not sufficiently calibrated as to adequately differentiate between borrowers' differing default risks. Another related and increasing problem with the existing Accord is the ability of banks to arbitrage their regulatory capital requirement and exploit differences between true economic risk and risk measured under the Accord.

BASEL COMM. ON BANKING SUPERVISION, A NEW CAPITAL ADEQUACY FRAMEWORK 9 (1999).

129. BASEL COMM. ON BANKING SUPERVISION, THE NEW BASEL CAPITAL ACCORD: THIRD CONSULTATIVE PAPER (2003), at <http://www.bis.org/bcbs/bcbscp3.htm>.

130. See BASEL COMM. ON BANKING SUPERVISION, OVERVIEW OF THE NEW BASEL CAPITAL ACCORD (2003), at <http://www.bis.org/bcbs/cp3ov.pdf>. The New Basel Accord consists of three pillars: (1) minimum capital requirements, (2) supervisory review of capital adequacy, and (3) public disclosure. With respect to minimum capital requirements, a major innovation of the New Basel Accord is the introduction of three distinct options for the calculation of credit risk and three others for operational risk.

131. See Press Release, BIS, Basel II: Significant Progress on Major Issues (Apr. 29, 2003), at <http://www.bis.org/press/p031011.htm>.

132. The G7 consisted of seven industrialized countries: Canada, France, Germany, Japan, Italy, the United Kingdom, and the United States.

operation in financial supervision and surveillance.”<sup>133</sup>

One year after its establishment, the FSF created the Working Group on Deposit Insurance (“WGDI”), a subdivision charged with the task of establishing a set of guidelines on deposit insurance for countries considering the initiation or reform of their DIS.<sup>134</sup> Today, the sixteen-member working group consists of the Chairman (Roger W. Ferguson, Jr., Vice Chairman of the Federal Reserve Board), representatives from twelve member countries,<sup>135</sup> as well as representatives from the FSF, the International Monetary Fund (“IMF”), and the World Bank.<sup>136</sup>

Among the WGDI’s most notable projects in the area of DISs is the drafting of the *Guidance for Developing Effective Deposit Insurance Systems*, the first-ever comprehensive attempt at international guidance on the design and implementation of DISs.<sup>137</sup> The FSF has endorsed the WGDI’s report, along with its discussion papers on various DIS-related topics,<sup>138</sup> and recommended its application worldwide, especially for countries transitioning from implicit or blanket guarantees to a DIS of explicit, more limited coverage.<sup>139</sup>

### 3. The International Association of Deposit Insurers

While there is no global deposit insurer (despite proposals for one),<sup>140</sup> there are international organizations comprised of deposit insurers. The largest deposit insurer organization is the International Association of Deposit Insurers (“IADI”). Founded on October 2002 at the initiative of the Canadian Deposit Insurance Corporation (the “CDIC”), the IADI is a non-profit organization aimed at “enhanc[ing]

---

133. FSF website, at <http://www.fsforum.org> (last updated Dec. 10, 2003).

134. See FSF, WORKING GROUP ON DEPOSIT INSURANCE, PROGRESS REPORT (2001), at [http://www.fsforum.org/publications/publication\\_19\\_20.html](http://www.fsforum.org/publications/publication_19_20.html).

135. As of March 2004, these countries included Argentina, Canada, Chile, France, Germany, Hungary, Italy, Jamaica, Japan, Mexico, the Philippines, and the United States.

136. See FSF website, at <http://www.fsforum.org> (last updated Dec. 10, 2003).

137. See FSF, GUIDANCE FOR DEVELOPING EFFECTIVE DISs, *supra* note 34.

138. See FSF/WGDI Discussion Papers, at <http://www.fdic.gov/deposit/deposits/international/guidance/guidance/index.html>.

139. See FSF website, at <http://www.fsforum.org> (last updated Dec. 10, 2003).

140. See GEORGE SOROS, THE CRISIS OF GLOBAL CAPITALISM 182–83 (1998) (advocating the establishment of an international institution to “guarantee international loans and credits up to defined limits”); Kenneth Rogoff, *International Institutions for Reducing Global Financial Instability*, in AN INTERNATIONAL FINANCE READER 159, 170 (Dilip K. Das ed., 2003) (discussing and critiquing Soros’ proposal).

the effectiveness of deposit insurance by promoting guidance and international cooperation among deposit insurers and other interested parties.”<sup>141</sup>

The IADI’s institutional structure consists of the Executive Council at the apex, which governs its main business affairs. Its membership includes thirty-four deposit insurers and seventeen associated central banks and financial companies. Its Secretariat is located at, but is independent of, the FSF in Basel, Switzerland.

The IADI is comprised of several standing committees, including the Training and Conference Committee, the Research and Guidance Committee, the Membership and Communications Committee, the Finance and Planning Committee, and the Governance Committee. Separate regional committees also exist for Africa, Asia, the Caribbean, Eurasia, and Latin America in order to “reflect regional interests and common issues through the sharing and exchange of information and ideas.”<sup>142</sup> The chairs of the regional committees are responsible for recommending action and communicating their plans and activities to the Executive Council.<sup>143</sup>

Despite its very recent establishment, the IADI has been active on a variety of fronts. Specifically, it recently completed a detailed guidance on the design and implementation risk-adjusted premiums.<sup>144</sup> The guidance addressed such issues as the pricing of risk-adjusted premiums and the effects of high premiums on weak and troubled banks. In recent months, the IADI, in conjunction with the CDIC, also has been developing a database of DISs worldwide, gathering information via survey questionnaires distributed to DIS regulators worldwide.<sup>145</sup> The IADI intends to update the survey regularly “to facilitate practitioner-focused research aimed at identifying good and effective deposits insurance practices.”<sup>146</sup>

---

141. See IADI website, at <http://www.iadi.org>.

142. *Id.*

143. *Id.*

144. IADI, GUIDANCE PAPER ON THE ESTABLISHMENT AND DESIGN OF DEPOSIT INSURANCE SYSTEMS (Feb. 2004), at [http://www.iadi.org/html/App/SiteContent/Design\\_Paper\\_Final%20feb%202004.pdf](http://www.iadi.org/html/App/SiteContent/Design_Paper_Final%20feb%202004.pdf).

145. IADI & CDIC, INTERNATIONAL DEPOSIT INSURANCE SURVEY, at <http://www.iadi.org/html/Default.aspx?MenuID=209>.

146. *Id.*

### C. Institutional Advantages

This Part explores the institutional advantages that multilateral banking organizations possess, and how these advantages can be exploited to overcome the impediments to risk pricing.

First and foremost, these organizations can provide invaluable forums for information exchange. Because of their international membership, they are ideally placed to foster the development of risk-adjusted premium schemes through enhanced sharing of information and best practices in risk-pricing methodologies and monitoring. As one commentator put it, cross-border institutional mechanisms have the potential “to promote more open-ended, creative discussions among governments, as well as to provide effective channels for citizen input, both domestically and at the level of the international institution.”<sup>147</sup> This does not, however, suggest that countries need to think the same way or adopt the same scheme. Indeed, the FSF has advocated that countries should develop schemes that reflect their respective political, economic, and social contexts.

Second, international organizations can be instrumental in developing and enforcing international norms. While existing international banking organizations have no formal legislative or enforcement power, they do have the authority to issue and promote supervisory guidelines and best practices. These guidelines and best practices, though far from being legally binding, can assume the status of “soft law”<sup>148</sup> and help guide countries struggling with design and implementation problems to establish cooperative arrangements.<sup>149</sup> Indeed, given that the precise risk-pricing

---

147. Lyuba Zarsky, *Environmental Norms in the Asia-Pacific Economic Cooperation Forum*, in COMMITMENT AND COMPLIANCE: THE ROLE OF NON-BINDING NORMS IN INTERNATIONAL LEGAL SYSTEM 303, 327 (Dinah Shelton ed., 2000) [hereinafter COMMITMENT AND COMPLIANCE].

148. For a discussion of the concept of “soft law,” see Dinah Shelton, *Introduction: Law, Non-Law and the Problem of ‘Soft Law,’* in COMMITMENT AND COMPLIANCE, *supra* note 147, at 10–13 (distinguishing between hard and soft international law, and noting that: “Soft law generally can be adopted more rapidly because it is non-binding. It can also be quickly amended or replaced if it fails to meet current challenges. Its flexibility extends to implementation and compliance where the dynamic interaction of the various actors can play a crucial role.”) [hereinafter Shelton, *Soft Law*]; see also Christine Chinkin, *The Challenge of Soft Law*, 38 INT’L & COMP. L.Q. 850, 854–55; Francesco Francioni, *International “Soft Law”*: A Contemporary Assessment, in VAUGHAN LOWE & MALGOSIA FITZMAURICE, FIFTY YEARS OF THE INTERNATIONAL COURT OF JUSTICE 167 (1996); Harold H. Koh, *Why Do Nations Obey International Law*, 106 YALE L.J. 2599, 2631 (1997); Prosper Weil, *Towards Relative Normativity in International Law?*, 77 AM. J. INT’L L. 413, 414 (1983).

149. See Richard B. Bilder, *Beyond Compliance: Helping Nations Cooperate*, in COMMITMENT AND COMPLIANCE, *supra* note 147, at 65 (arguing that international organizations are key in helping countries cooperate).

methodologies have yet to be clearly identified, supervisory guidelines and other recommendations are particularly appropriate, as they are easier to amend than binding standards.<sup>150</sup>

Third, international organizations have the benefit of political legitimacy and impartiality. For example, as the world's central international banking organization, the BIS embodies world opinion, or at least the opinions of its member states. When the BIS adopts a particular set of standards—as it did through the Basel Capital Accord—it is seen as embodying the interests of the international banking community as a whole. In doing so, the BIS, along with a handful of other supranational bank-related organizations, maintains a legitimacy and neutrality respected by bank supervisory authorities worldwide.

Fourth, international organizations, by their very nature, are best equipped to deal with cross-border issues. Here, international organizations can resolve the myriad impediments that stem from cross-border complexities.<sup>151</sup> Specifically, they can promote initiatives to relax restrictions on cross-border information access, foster standardization of the cross-border information to enable comparisons, ensure competitive but equal treatment of local and foreign banks, and prevent the double charging of premiums. As these cross-border complexities may require reciprocity and compliance, international organizations can serve as “a focal point for maximizing compliance and reducing the likelihood of defection.”<sup>152</sup>

Finally, and perhaps most importantly, multilateral institutions have a proven track record in the area of international banking standards. The prime accomplishment of international banking organizations is the Basel Capital Accord, which has been successful at offering internationally-accepted supervisory guidelines on capital adequacy standards.<sup>153</sup> In fact, these capital adequacy standards have become “accepted as the de facto standard that is applied by most supervisors around the world” and have acquired a status as “the

---

150. See Shelton, *Soft Law*, *supra* note 148, in COMMITMENT AND COMPLIANCE, *supra* note 147, at 13 (“Soft law generally can be adopted more rapidly because it is non-binding. It can also be quickly amended or replaced if it fails to meet current challenges.”)

151. See *supra* Part IV.D.

152. Shelton, *Soft Law*, *supra* note 148, in COMMITMENT AND COMPLIANCE, *supra* note 147, at 2.

153. See Chris Matten, *Basel Accord No Simple Fix*, BANGKOK POST, July 15, 2003, at 3 (noting that “more than 100 countries have adopted the Basel Accord as the basis for capital-adequacy assessment”); Lawrence L. C. Lee, *The Basle Accords as Soft Law: Strengthening International Banking Supervision*, 39 VA. J. INT’L L. 1, 2 (1998).

international standard for bank capital adequacy.”<sup>154</sup> Given their experience and expertise, these institutional organizations will be indispensable in establishing international guidelines for risk pricing and addressing the potential conflict between risk-adjusted schemes and risk-based capital adequacy standards.<sup>155</sup>

#### D. *The Road Ahead*

As demonstrated above, international organizations such as the BIS, FSF, and IADI are uniquely situated to facilitate in the development of risk-adjusted DISs. Yet, despite their institutional advantages, several reforms are needed to ensure the schemes’ effectiveness. Accordingly, this Part presents several recommendations aimed at building on the previous works of these organizations.

To be effective, international organizations need to provide good institutional and discursive mechanisms to ensure coordination, oversight, strategic direction, and continuing dialogue among the relevant parties. During the past few decades, domestic and international actors have carried out their DIS-related work primarily on an *ad hoc* and isolated basis. In this regard, international organizations can serve as vital intermediaries between various domestic policymakers and among themselves, providing for coordination in all areas of premium pricing and monitoring.

Multilateral financial organizations must also push for greater inclusiveness and participation. At the present, the BIS maintains only a quarter of the United Nations membership,<sup>156</sup> and the IADI’s membership list is even shorter.<sup>157</sup> Increased membership and involvement in the design and implementation processes are necessary to enhance the legitimacy of international organizations in their standard-setting role. Such legitimacy can ensure compliance that otherwise may be unobtainable given political opposition, lack of

---

154. CEM KARACADAG & MICHAEL W. TAYLOR, *THE NEW CAPITAL ADEQUACY FRAMEWORK 13* (2000), available at <http://www.suerf.com/download/studies/study8.pdf>.

155. See *supra* Part IV.F.

156. As of February 2004, the BIS has fifty-five member central banks, compared to the United Nations with 191 member-states. See BIS website, at <http://www.bis.org/about/orggov.htm> (last updated Oct. 2003); U.N. website, at <http://www.un.org/Overview/unmember.html> (last updated Apr. 2003).

157. As of February 2004, the IADI has thirty-four members. See IADI website, at <http://iadi.org>. Its low membership can be explained in large part by the Organization’s very recent founding.



resources, or disagreements with aspects of the proposed reforms.<sup>158</sup> As Professor Dinah Shelton commented, “the greater the consensus in the international community for the norms and the more compliance, the greater the likelihood that any single state will comply.”<sup>159</sup>

Given the multiplicity of organizations and programs in the area of banking and finance, action must be taken to avoid duplication and waste of resources. In spite of various mechanisms to guarantee efficiency within the international system,<sup>160</sup> it is obvious that coordination problems persist. One possible solution is to establish an umbrella organization to coordinate the various DIS-related projects of international organizations, central banks, and governments. Yet, care must be taken to ensure that such an umbrella organization avoids the bureaucratic red tape and inefficiencies.

In-depth research is needed into complex and highly contentious issues related to deposit insurance. The proliferation of international conferences and comparative studies throughout the past decade are positive steps toward this end,<sup>161</sup> but detailed and comprehensive guidance in this area is still largely lacking. A key area for exploration is the availability of acceptable methods for the assessment, review, and updating of risk-adjusted premium schemes. Indeed, risk-adjusted premium schemes would be counterproductive if premiums were inaccurately assessed such that banks with vastly different risk profiles are charged the same premium rates. Further research is also needed into the possible negative impact of a conversion to risk-adjusted schemes on interested parties, and whether, for instance, investors will suffer from higher spreads or fees that banks may charge its customers in order to recover the incremental increases in insurance premiums.

Above all, a transnational strategy must ensure that research is both *translatable* and *translated* into workable and effective policies. While international organizations cannot and should not impose mandates on member states, they can be instrumental in establishing clear supervisory guidelines, best practices, and other “soft law” instruments,<sup>162</sup> working together with government regulators to push

---

158. See Shelton, *Soft Law*, *supra* note 147, in COMMITMENT AND COMPLIANCE, *supra* note 147, at 12.

159. *Id.* at 14.

160. See, e.g., U.N. GAOR, 50th Sess., U.N. Doc. A/RES/50/1 (1995) (aimed at remedying the lack of communication and coordination with respect to development programs in the U.N. system).

161. See, e.g., DEMIRGÜÇ-KUNT & SOBACI, *supra* note 11; IADI CONFERENCE PROCEEDINGS, *supra* note 3; FSF/WGDI Discussion Papers, *supra* note 138.

162. See sources cited and discussion of soft law instruments *supra* note 148.

for positive domestic reforms. In this respect, any guidelines or policy recommendations adopted by international organizations should not suggest a one-size-fits-all approach for all countries, but should strive to take country-specific contexts into account.<sup>163</sup> In drafting these supervisory guidelines, a delicate balance also needs to be struck between *overregulation*, which can lead to ineffective allocation of capital to the detriment of participants in the financial system and overall economic performance, and *underregulation*, which can promote financial collapse or create market inequities that endanger the prospects for fair competition.

## VI. CONCLUSION

The task and challenges of risk-adjusted premium pricing are immense and should not be underestimated. There are no easy answers to the problems inherent in the assessment of banking risk. As illustrated by the long and often rocky roads to the two Basel risk-based capital standards<sup>164</sup> and other international financial regulatory efforts,<sup>165</sup> the process at times can present a host of unsolvable dilemmas and irresolvable contradictions. But our gravest mistake would be to abandon such efforts and discount their potential for sustained and meaningful financial stability.

In this endeavor, a collaborative, transnational approach toward risk-adjusted schemes worldwide holds out hope for both developing and developed economies. As underscored above, international organizations such as the BIS, the FSF, the IADI, the Basel Committee and others should be courted for their unparalleled institutional mechanisms to promote complementarities, synergies, and collaboration among the various relevant domestic and international actors. Such a transnational approach to risk-adjusted premium pricing would go a long way to mitigate the moral hazard for excessive risk-taking, level the playing field between high and low risk banks, and reduce information asymmetries between banks and their depositors.

---

163. See sources cited *supra* note 22.

164. See, e.g., John J. Duffy, *Central Bankers to Seek 8% Capital Ratio*, AMER. BANKER, Dec. 10, 1987, at 1 (noting disagreement among countries in defining banking capital in Basel I); *Basel Brush*, ECONOMIST, Mar. 29, 2003, at 65–66 (commenting on the “sweat and horse-trading” during the Basel II process).

165. See, e.g., Beth Simmons, *International Efforts Against Money Laundering*, in COMMITMENT AND COMPLIANCE, *supra* note 147, at 244 (pointing out the difficulties encountered in international anti-money laundering efforts).

While the above analysis has sought to identify the ways in which risk-adjusted premium schemes can contribute meaningfully and dramatically to financial stability, information asymmetries, regulatory savings, and equity concerns, preclusion of other measures is undoubtedly not its intention. Indeed, the opposite needs to be stressed: risk-adjusted premium schemes are not the magic cure to the world's banking crises, and countries considering the adoption of risk-adjusted premium schemes or their enhancement<sup>166</sup> would be naïve to focus exclusively on deposit insurance reform without contemplating other complementary safeguards. In the end, risk-adjusted schemes will be the most effective—and their potential benefits over flat-rate schemes will have the best chance at full realization—when integrated into a structured and comprehensive framework that includes sound macroeconomic policies, legal and regulatory schemes, and other financial safety net measures.<sup>167</sup>

*Wally Suphap\**

---

166. See sources cited and countries listed *supra* notes 2–3.

167. As the FSF stated: “Among the various tools of regulatory discipline [are] . . . minimum capital requirements, differential insurance premiums based on variations in risk, early intervention and prompt corrective action, and personal-liability incentives . . . [R]egulatory discipline requires a well-developed legal system and substantial human and technological resources.” FSF, *MORAL HAZARD*, *supra* note 64, at 10. See also *BASEL COMM. ON BANKING SUPERVISION, CORE PRINCIPLES METHODOLOGY* (1999) (offering a set of guidelines for a sound banking supervisory system); *DEMIRGÜÇ-KUNT & SOBACI*, *supra* note 11, at 2 (“[DIS] is a complementary element of an extensive financial safety net that includes banking law and regulations, central bank lender of last resort facilities, and banking supervision.”).

\* J.D. Candidate, 2004, Columbia University School of Law; B.A., 2001, Columbia College, Columbia University. The author is grateful to Professors David Barnard and Curtis Milhaupt for their insightful comments on earlier drafts. The author would also like to thank the editors and staff of the *Columbia Journal of Transnational Law* for their editorial assistance.