"BANK RISK AND DEPOSIT INSURANCE" BY LUC LAEVEN THE WORLD BANK ECONOMIC REVIEW, VOL. 16 NO 109-137,NOVEMBER 2002

G. K. Sanni*

1.0 INTRODUCTION

The paper attempts to establish relationship between bank risk and deposit insurance. This is because banks perform crucial roles in economic development of a country, during which they undertake many risks in the process of performing these roles, which if not well managed might lead to bank crises. Enquiries into bank crises have shown that, not only do banks often take excessive risks,but also, they often failed to carry out extensive risk analysis of their short-term portfolio investments. Therefore, some banks engage in more risks than their capital could bear.

The article estimated the cost of deposit insurance for a large sample of banks in fourteen different economies and assessed the relationship between the risk-taking behavior of banks and their corporate governance structure.

It noted that there is a positive correlation between bank risk and cost of deposit insurance. For instance, it argued that a relatively high cost of deposit insurance indicates that a bank takes excessive risks..

2.0 HIGHLIGHTS OF THE PAPER

The major highlights of the paper are as follows:

- the cost of deposit insurance is closely related to degree of risk taken by banks.
- implicit deposit insurance premiums are higher for banks in crisis countries and have some power in predicting bank distress.

***G. K. Sanni** is a Senior Economist in the Research Department Central Bank of Nigeria

- the average cost of deposit insurance is higher during the crisis period 1997-98 in the sampled economies than during pre-crisis years.

- risk taking also differs across forms of ownership. In other words, concentrated ownership increase risk taking by banks while dispersed ownership is associated with lower risk.

- the cost of deposit insurance is lower in economies with low inflation rate, adequate security and enforcement of the rule of law. In other words, banking systems are expected to be less risky in economies with high GDP per capital and lower rate of inflation.

- banks with a high cost of deposit insurance have a higher chance of failing or being subject to intervention than banks with a low cost of deposit insurance.

- the cost of deposit insurance has some predictive power about the level of risks taken by banks and the possibility of being distressed.

- the cost of deposit insurance is highest for banks with concentrated private ownership especially those predominantly owned by a single person and to a lesser extent, the state or family owned banks. This indicate that these banks tend to take the greatest risks. In contrast, banks with dispersed ownership engage in a relatively low level of risk taking.

3.0 COMMENTS

The strength of this paper lies in the depth of its analysis. The article analyzed a large sample of banks in different economies and measured the degree of a bank's risk taking, the value of its deposit insurance services costs. The implicit deposit insurance cost was calculated by applying a well-known technique that models deposit insurance as a put option in the bank's assets. The put option approach to valuing deposit insurance assumes that stock markets are efficient. The sample was limited to economies that had relatively large and liquid stock markets. The sample was also limited by excluding countries with heavily regulated financial sectors. In order words, countries that had not liberalized their financial sectors before 1990 were excluded from the study. However, the paper failed to examine other causes of bank risks which include non-compliance with the banking regulations, portfolio mismatch, failure to appreciate the environmental factors governing their operations, conflicts between profitability and security goals of the bank as well as poor operational strategies. These factors as well as conflict of interests between the management and shareholders often culminate in the failure of the banks rather than the payment of high deposit insurance. The payment of high deposit insurance therefore represents only a symptom but not a cause of bank failure. Also, the author did not address the impact of government fiscal and monetary operations on the activities of banks.

4.0 RELEVANCE TO POLICY

The findings of this paper are useful for policy considerations. First, the findings support the view of many policy makers that one of the keys to a sound financial system is a dispersed private ownership of banks. Second, the findings indicate that dispersed ownership is important for the stability of financial systems, especially, where corporate governance systems, and institutional environment in general are weak such as in many developing countries. Finally, as a proxy for bank risk, the cost of deposit insurance could be a useful additional tool for identifying troubled financial institutions and providing early warning of bank crises.

A major insight that could be gleaned from the paper is that widespread ownership of banks is more advantageous than concentrated ownership where a single individual owns the majority, which confers automatically sole control. This is because, the widespread ownership of banks provides the advantage of diverse opinions on the management of the business, and hence improve the quality of decisions. It is in this regards, that bank regulatory agencies should encourage greater dilution of ownership of banks through public quotation on the stock market. This would help to forestall financial distress and guarantee confidence in the banking industry.