Review of “Commercial Banks, Default Insurance and IMF Reforms” by D. Rockerbie and S. Easton

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There are two very commendable elements of this paper. First, it offers a fresh look at the idea of insurance provision as an innovative direction for those pondering how to reform the international financial system generally and the International Monetary Fund specifically. Second, it offers some helpful formal theory for pricing the proposed insurance contract, thus providing a basic analytical framework to support a key aspect of the proposed reform. Of course such an ambitious agenda also carries with it some problems. Overall the paper does not provide enough details to support its core underlying assumptions, and while the insurance contract pricing exposition is interesting it is really just a small portion of any necessary welfare analysis of the suggested reform. Ultimately, then, the paper raises some interesting issues, but does not provide enough substance to persuade me that this direction of reform is really either desirable or feasible.

In terms of reform the paper identifies the serious and perennial problem of how to deal with financial crises arising from sovereign risk. There is a useful but necessarily abbreviated review of some of the contending approaches to financial crisis avoidance and management. The idea of insurance contracts as a possible solution has been identified earlier by others, and the authors acknowledge the earlier contribution by Soros in this regard. Soros suggested a public corporation provide an insurance contract to borrowing countries, who in turn pay premiums in a process overseen by the IMF. In this proposal the details are different: the “burden” of the premium is placed onto the lenders, and the entire arrangement embedded within the Fund. In addition there is the twist of formalizing the relationship between the Fund and private lenders, with the latter potentially taking on some aspects of membership. Having identified a specific form of the insurance arrangements, the second contribution of the paper is to derive some of the premium pricing components of the proposed insurance contract.

These positive features of the paper are pretty self-evident, so at the risk of being overly critical I will focus on some elements that I think need to be challenged in order to move the debate forward. First, while the paper has the desirable virtues of brevity and timeliness, these lead to some problems with the paper that detract from its potential. There are numerous assertions that really need to be supported. For example, on page 2 it is suggested that implicit IMF bailouts will lead to an increase in the risk spread over LIBOR, while on page 3 it is asserted with only marginal support that the deadweight loss of moral hazard is likely to be very small when examining sovereign loans. These are just simple examples chosen from early in the paper, but there are several others that appear. To be persuasive, I think these points need to be examined in more detail if they are critical to the proposal, or deleted if they are extraneous to the core argument. In short there are a lot of contestable assertions that are made without much support, and it is unclear how central many of them are to the argument being made.

Similarly, the domain of the analysis needs to be more strictly identified; the occasional reference to countries at a low stage of development seems unnecessary. For these countries official financing will likely continue to dominate capital inflows, so it is unclear how relevant the proposal for private lender insurance would be for such cases. There are also some confusing aspects of the sequencing of arguments (some discussion of the basics of sovereign lending markets and moral hazard are discussed on page 7, well after the authors have developed more complex arguments about these topics). Some of these difficulties are undoubtedly small and extraneous to the main argument, and while their frequency does detract from the overall paper such problems can probably be attributed to the need for brevity and timeliness. Many readers will not be particularly troubled by these problems if they have closely followed the associated international finance and insurance literatures. While a tightly revised paper would possibly be able to structure the argument in a clearer and more compelling fashion, these are largely problems of cosmetics and, at least to a degree, individual taste.

That leaves me with three core criticisms of the paper. First, while the authors are to be commended for using theory to examine the question of premium pricing, the analysis is only partial and not really convincing. The options valuation approach is interesting but ultimately unsatisfying. Part of the problem is again cosmetic: there are some errors and opacity in presentation. Even with my lack of experience in financial modeling I would have to suggest that equation 2 has a minor problem (isn't "t" supposed to be "t-1"?). More critically, however, I am confused at how an option price can be derived without there being any explicit inclusion of a measure of the probability of good states versus bad states. If this probability is embedded in the risk spread over LIBOR, then it seems to me that a major question has been left begging. Some of the specific calculations seem applicable, and of interest, only to one specific form of the insurance arrangement (the European put version). This focus is also one of those troubling assertions. As far as I am aware, and contrary to the claim on page 5, all the insurance contracts I have allow me to make my claim (exercise my put) at any time, not simply at the end of the contracted period. I expect that in the event of a financial crisis a country and its lenders would also want to exercise any options immediately rather than at the end of a contract. While I am overstating the case, the presentation of the argument as an analogy to the European put option is likely going to confuse many non-experts. The final complaint I have about the formal theoretic component of the paper, and the most problematic one, is that it provides only a partial analysis of what is going on with the proposed insurance arrangement. There are glimpses of the overall solution, but ultimately the exposition does not generate a clear presentation of what the end result of the arrangement will be for the sovereign, the IMF, and the private lenders (even assuming that these lenders are all included in the insured lending syndicates), and what their positions would be in the absence of the insurance scheme or in the presence of some of the competing proposals. Obviously this is asking a lot, but there should at least be an allusion to these matters, an outline of the elements, and a promise of an even more ambitious paper that provides answers to some of these critical questions.

The problems associated with the partial nature of the formal analysis are manifested at the conceptual level as well. What would be easier than the formal modeling of the problem would be to provide a broad brush portrait of what the sources of inefficiency are in the current system and perhaps some of the more popular proposed alternatives and, more importantly, what are the sources of improved efficiency in the insurance-based approach. The authors perform a valuable service in examining some of these, but the presentation is disjointed and piecemeal rather than comprehensive. Let me provide an example. If the problem is conceived as one of excessive lending to risky sovereigns, it would appear to me that the way this proposal deals with the inefficiency is by limiting how much lending the IMF will underwrite. If that is the case then it seems to me that there are other (possibly more efficient) means by which debt levels could be restricted. There are other potential sources of inefficiency. Curiously moral hazard is apparently not one of interest here, as the authors dismiss this on page 3 as irrelevant to their argument for reform even though they discuss the issue relatively extensively in the paper.

The absence of the larger conceptual problem leads to other difficulties as well. For example, the authors state that there must be some subsidy element to the insurance contract or else the private firms will not bother lending, as they will make zero profit over the riskless rate. I think this is a conceptual difficulty akin to the problem in explaining why any agent would supply a good or service in a perfectly competitive market, as only zero economic profits are available. The source of profit for the lender is, presumably, the difference between the lending rate and the rate paid on acquiring loanable funds from, say, depositors. Let's face it, if the IMF were able to remove the risk of lending to a sovereign, why shouldn't it just conduct the act of financial intermediation itself? Furthermore, if sovereign risk was removed entirely, why should there be a sovereign risk premium at all? If the authors are thinking of other sources of risk, why is the paper focused on sovereign risk? So I think there could be a much clearer discussion of the problems to be addressed by reform, and a much clearer identification of how the proposal avoids these problems efficiently.

The third core criticism I have of the paper must first acknowledge its value in bringing attention to the potential for more ambitious and unconventional IMF reform than is generally contemplated. The authors should be congratulated for shaking up the debate and for reminding us that more than incremental change is possible, and possibly desirable. Thinking outside the traditional box, however, can attract a litany of objections. First are the arguments that in practice organizational innovations do tend to be incremental, and that the problems arising from the financial crises would have to be more far-reaching and more dangerous to the most powerful countries in the international system before reformers will become, as they say, courageous. In this case it is not so much the issue of insurance contracts that will attract the attention of international relations commentators, as it is the notion of private lenders somehow becoming "members" of the IMF. The optics would be bad, though in truth I think the authors could easily finesse this with somewhat less controversial phrasing. Political sensitivities should not cloud the need for clear discussion, however, and clearly the authors are calling for a fundamental shift in relations between private lenders and the IMF. On this point I think that there should be some greater acknowledgement in the paper of the practical difficulties of framing and overseeing this relationship. The governance issues cannot simply be shrugged off. How would the equivalent of regulatory capture be avoided? Other complications are also left aside in the discussion, such as the practicalities of having individual bond owners purchase insurance contracts when holding sovereign bonds and whether the problems being addressed here are relevant to developments in international equity flows as well. In the absence of a more complete analysis addressing the problems outlined above, it is hard to see how the practical complexities of this proposal can be overcome. This review and conclusion should not be read as a criticism of the authors, but rather as an exhortation for them to develop their argument more clearly and in more detail.