LESSONS LEARNED FROM

RECENT U.S. BANKING EXPERIENCE

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By

Stephen C. Swaim and Maja Wessels[1]

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It is with a certain sense of temerity that we address the subject of lessons Europeans can learn from recent U.S. banking experience. When the bills are all paid 30 to 40 years from now, the U.S. will have spent perhaps $500 billion to pay for failed savings and loan institutions. And, in the past 3 years, about $25 billion has been spent by the deposit insurance fund to resolve almost 600 failed commercial banks and savings banks--an amount that has virtually wiped out the fund's reserves. U.S. banks that already pay the highest deposit insurance premiums in the world may have to pay even more to recapitalize the Bank Insurance Fund. Surely there are not too many "how to do it" lessons here!

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[1]Mr. Swaim and Ms. Wessels work for the U.S. General Accounting Office, an independent agency of the legislative branch which conducts studies and audits of the various programs of the United States government. They are, respectively, the project director and a senior evaluator for a recent GAO study on deposit insurance reform.

Moreover, many would say that we could probably learn more from the European banking system than vice versa. We are, for example, at this moment hotly debating issues that have already been resolved in Europe, some of them decades ago--issues concerning the powers of banking organizations and whether banks can branch throughout the market areas that they feel they can profitably serve.

We certainly are no experts on the European banking system, nor do we pretend in any way to be forecasting what may take place as banking throughout the European Community is liberalized beginning in 1993. Yet, based on our recent study of deposit insurance reform in the U.S., we feel that there may well be some important points from which those concerned with the future of European banking can draw.

While it is true that the U.S. system is unique in a number of ways, it can serve as an object lesson on how competition in financial markets affects the government's ability to supervise the safety and soundness of banks. To a great extent, the difficulties experienced by U.S. banks were a direct consequence of increased competition, overcapacity and narrowed profit margins in the financial services sector resulting from deregulation, changes in markets and technology, and other factors. These problems were exacerbated by a system of bank supervision unprepared to handle the increased risk that accompanied banks' attempts to maintain market share.

Obviously, increased competition will also characterize deregulated, post-1992 banking in Europe. The point of this deregulation, after all, is to improve the efficiency of the European financial system and reduce the costs of financial services. However, the corollary of greater efficiency is the need for fewer institutions to provide the same level of services. Indeed, consolidation in the EC is already evident as banks position themselves, both defensively and offensively, to preserve market share. According to KPMG Peat Marwick, around 400 cross-border mergers, acquisitions, and alliances of banks were either executed or announced in 1990 alone.

With further deregulation, greater responsibility will fall on bank supervisors to ensure a smooth transition to increased efficiency and competition. The U.S. system of bank supervision was not up to this challenge and hundreds of banks failed. We trust that the European regulators--in part because of lessons learned from the U.S. experience--will fare much better.

Before proceeding further, I would like to provide a little more background on the perspective that we bring to this topic. In 1989, Congress asked the U.S. General Accounting Office to study the various issues associated with deposit insurance reform and to recommend improvements to the deposit insurance system. GAO's report was issued in March 1991[2], and the agency has already testified several times before Congress on topics discussed in the report. While we have no intent of reiterating the contents of this report, our general conclusions about what needs to be done to reform the system in the United States have a direct bearing on what European regulators may find prudent to undertake in order to avoid similar problems.

BACKGROUND ON THE U.S. BANKING SYSTEM AND DEPOSIT INSURANCE LOSSES

As of June 30, 1990, there were about 29,000 depository institutions in the United States. These institutions held roughly $5 trillion in assets, approximately 2/3 of which are in 12,500 commercial banks. (See table 1.)

Table 1 : Assets Held by Depository Institutions, as of June 30, 1990

Dollars in billions

Type of institution	Number of institutions	Amount of assets	Percent of total depository institution assets
Commercial banks	12,502	$3 360 0	66 7
BIF-insured savings banks	461	233 4	4 6
Other savings banks and thrifts[a]	2,878	1,251 7	24 8
Credit unions	13 102	195 3	3 9
Total	**28,943**	**$5,040.4**	**100.0**

[a]Data are as of December 31, 1989, for SAIF-insured institutions and institutions in RTC conservatorships

Source GAO analysis of call report data

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[2]Deposit Insurance: A Strategy for Reform, GAO/GGD-91-26, March 4, 1991. Copies may be obtained from GAO by writing GAO, P.O. Box 6015, Gaithersburg, MD, 20877, or by calling in the U.S. (202) 275-6241.

These institutions vary greatly in size. Most are relatively small--less than $500 million in assets. Yet, the largest commercial banks rank amount the nation's largest and most complex multinational companies. The 57 largest depository institutions in the U.S., those with assets over $10 billion, control roughly 30 percent of total depository institution assets. (See table 2.)

Table 2: Asset Size of Depository Institutions, as of June 30, 1990

	Number of Institutions			Percent of deposit industry assets in categories
	Commercial banks	Savings banks and thrifts[a]	Credit unions	
Greater than $50 billion	7	0	0	11 7
$10-$50 billion	38	12	0	19 2
$1-$10 billion	327	268	5	35 5
$500 million -$1 billion	245	245	23	7 0
$50 million -less than $500 million	5,124	1,967	752	21 2
Less than $50 million	6 761	847	12 322	5 4

[a]Data for thrifts are as of December 31 1989

Source GAO analysis of call report data

As a result of mergers, acquisitions, and bank failures some consolidation is taking place within the U.S. banking system. The number of separately capitalized commercial banks has fallen by over 2,000 in the past 5 years, and 75 percent of the industry assets are held by 942 multi-bank holding companies. Multi-bank holding companies, the most common form of organizations for larger U.S. banks, permit limited associations of banking and other financial serving activities, such as underwriting and dealing in corporate securities.

Federal agencies estimate that as of June 30, 1990, deposit insurance agencies--financed through premiums assessed on depository institutions but backed by the full faith and credit of the U.S. government--officially insured just under $3 trillion in deposits and credit union shares. (The maximum limit in any one insured account is $100,000.) Of the total, commercial banks held 58 percent, thrifts and savings banks 36 percent, and credit unions 6 percent.

The U.S. banking system stands in contrast to those in EC countries. It is much less concentrated, for one. According to Moody's Investor Services, the largest five commercial banks in the U.S. hold only 12 percent of all commercial bank deposits. This compares to 31 percent in Germany[3], 32 percent in the U.K., 36 in Italy, and 57 in France. Furthermore, the U.S. averages one depository institution for every 7,300 people compared to one for every 13,700 in Germany, 63,200 in France and 85,900 in the U.K.

[3] All references to the Federal Republic of Germany exclude statistics on eastern Germany.

U.S. banks also play a much smaller role in the economy than do banks in the EC. Again, according to Peat Marwick, the percentage of bank assets as a proportion of GDP is about twice as large in Germany, the U.K., and France as it is in the U.S. U.S. bank assets equal 110 percent of GDP compared to 211 percent in Germany, 248 percent in the U.K and 251 percent in France. Banks' share of financial assets in the U.S. has declined as those of other organizations such mutual funds and pension funds have increased. The assets of the top five banks in the U.S. are equal to only 98 percent of the assets of the top five industrial companies compared to 780 percent in France, 463 percent in Germany, and 313 percent in the U.K.

Bank failures and insurance losses

In the 1980s, losses in the credit union, thrift, and banking industries demonstrated that insuring deposits can be very expensive. From August 1989 through December 1990, a total of 531 thrifts with about $271 billion in assets failed. Roughly 180 more are expected to fail and about 350 may lack sufficient financial resources to avoid insolvency. These failures are expected to cost the American taxpayers about $400 to $500 billion over the next three or four decades.

Bank failures also occurred at record rates during the 1980s. In the decade 1981 through 1990, more than 1,100 FDIC-insured banks were closed or received financial assistance from the FDIC.

Looking ahead, more bank failures can be expected. Just to illustrate the potential magnitude of the problem, there are over one thousand banks with $430 billion in assets (about 12 percent of industry assets) on the FDIC's problem bank list.

GAO'S ANALYSIS OF WHAT WENT WRONG IN THE U.S. BANKING SYSTEM AND WHAT SHOULD BE DONE

When the deposit insurance program in the U.S. was established in 1933, it was designed to be industry financed and expected to be relatively inexpensive. The premium levels were about 0.08 percent (8 basis points) of total domestic deposits, and rebates were given when the fund balance rose above 1.25 percent of insured deposits. Certainly the system was not expected to require taxpayer financing. For decades these expectations were upheld; only in the early 1980s did things begin to unravel.

The banking industry has changed a great deal since deposit insurance was first enacted. Until a generation ago, banking in the U.S. was in many ways a protected industry. Entry was restricted, no interest was paid on demand deposits, and interest rates on other deposits were controlled. The barriers between banking and other financial services were clear and there was little direct competition from out of state or foreign depository institutions. These protections helped deflect risk away from banks and thereby protected the deposit insurance system from loss.

Currently, as is well known, most of these protections have been stripped away or significantly diminished by changed regulations, advances in technology, and other factors. Today, banks not only compete with each other over a much wider geographical area, but virtually every service offered by a bank--whether it involves taking money in or lending it out--has close substitutes offered by non-banking firms.

Banking has become riskier as profits have been squeezed due to increased competition. In this environment a significant portion of banking institutions has been willing to take on increasing levels of interest rate, credit, and other types of risk to improve profitability. Instead of shrinking, merging, or retrenching, many banks have sought to grow their way out of a problem of industry overcapacity. They have been abetted in these strategies by their ability to offer government guaranteed liabilities--insured deposits--which has sheltered them from market discipline generally and particularly from the need to reduce risk-taking in order to satisfy risk averse creditors. One consequence of increased competition in a system that does not discipline excessive risk-taking has been costly bank failures that have strained the financial system in the U.S., the ability of healthy banks to pay for the resolution of failed banks, and the wallets of U.S. taxpayers.

Given this environment, what can be done to protect healthy banks and the taxpayers from further losses in the deposit insurance system? In our study, we considered what seem to us to be the three main options:

-- Make structural changes by cutting back what banks can do with insured deposits.

-- Reduce deposit insurance coverage to increase market discipline.

-- Make the supervisory safety net that protects the taxpayers more effective.

The first two of these strategies are perhaps more straightforward and are most frequently discussed as solutions to the problems facing the deposit insurance system. We concluded, however, that the third approach--improving supervision--was the most urgently needed and a prerequisite for either of the other two approaches.

The first option would require that all insured deposits be placed in what are often termed narrow banks that are not permitted to make commercial loans. Under many narrow bank proposals, insured deposits could only be invested in short-term, low-risk assets that earn relatively low rates of interest and can be market-to-market on a daily basis. This would, of course, greatly reduce the risk to the deposit insurance system. We questioned this approach, however, because it would destroy key elements of bank intermediation activities and because we did not believe that forcing all risk-taking activities out of the banking system is a desirable objective. The public is well served by having banks make loans that support job creation, provided that these activities are conducted in a safe and sound manner. Furthermore, it is likely that stability problems would become more acute outside of the banking system because many depositors, seeking higher yields, would place their money in uninsured institutions, potentially returning the U.S. to a pre-deposit insurance environment. In this connection, it is important to note that problems in the financial sector that could potentially affect market stability are obviously not confined to banking.

Another option is designed to reduce bank risk-taking through increased market discipline by significantly reducing deposit insurance coverage. We did not believe that this approach could serve as the centerpiece for reform because it would heighten the probability of widespread bank runs. Most depositors have no means of knowing the true condition of a bank and therefore are likely to withdraw money at the first sign of trouble. In addition, cutting back coverage might have very little impact on the actual cost of failed bank resolutions because most uninsured depositors are likely to withdraw their funds before a bank fails.

Given the drawbacks of these reform options, we reached the conclusion that the most practical and effective strategy was to strengthen the supervisory safety net and the incentives of banks to curtail excessive risk. We also concluded that major changes to the current banking and deposit insurance systems are not feasible until the supervisory system has been improved significantly.

Discussion of deposit insurance reform also often includes proposals to deregulate further by giving banks new powers to earn more profits. Again, however, we reached the judgment that further deregulation could prove too risky unless supervisory reforms had first been implemented.

The Problems in Supervision that We Reported

In 1990, GAO studied a sample of 72 banks with capital deficiencies and another sample of 39 banks that failed in 1989 to determine the adequacy of bank supervision, internal controls and other factors relevant to bank safety and soundness. We found that the regulatory process often does not result in the correction of the underlying causes of bank capital problems because bank regulators have wide discretion in choosing among enforcement actions of varying severity. Furthermore, they share a common philosophy of trying to work informally with banks to promote cooperation with those having difficulties. This combination of wide discretion and a cooperative philosophy often did not resolve problems that regulators had identified. We also found that bank capital was typically a lagging indicator of bank problems. Nevertheless, regulatory enforcement actions tended to focus on capital inadequacy, rather than on the underlying problems.

We also determined that the information provided by bank call reports--reports to regulators on bank financial condition--did not adequately reflect deterioration in banks' financial conditions. In addition, 33 of the 39 failed banks we studied had serious internal control problems, such as poor underwriting policies or lack of oversight by the bank boards of directors. Had these been corrected, the banks might not have failed or their failure could have been less expensive to the bank insurance fund.

GAO's Recommendations to Improve Supervision and Economic Incentives to Reduce Risk

Our work demonstrated that earlier and more forceful intervention by bank regulators is necessary to correct problems in banks. Furthermore, because we found that capital is a lagging indicator of bank problems, we proposed a regulatory approach that emphasized earlier intervention by regulators based on management problems, asset quality, and other related areas. Our proposal required regulatory intervention before capital deterioration, as well as after certain threshold levels of capital sufficiency had been breached.

We also found that the success of an early intervention strategy depends on good information on the value of insured banking institutions. To provide regulators with more accurate information we recommended a strengthening of financial and management reporting requirements for banks and their external auditors, valuing problem assets based on existing market conditions, strengthening the corporate governance mechanisms for banks, and requiring annual, full scope, on-site examinations of all banks.

Finally, we recommended that the economic incentives of banks to control risk be enhanced by strengthening capital requirements and implementing a risk-based deposit insurance premium structure.

<u>WHAT DOES ALL OF THIS HAVE TO DO WITH POST-1992 EUROPEAN BANKING?</u>

As we have stated earlier, we would not presume to predict the future of European banking. We will leave that to those of you who obviously have greater expertise in making such prognostications. We believe, however, that aspects of the problems we found in the U.S. have the potential to pose difficulties in the EC as it proceeds down the road of financial deregulation. We hope that considering these matters now is one step in making sure that banking in Europe remains safe and sound and that the deposit insurance systems there do not bear the brunt of increased risk-taking.

Along these lines, we think there are 4 aspects of the U.S. experience that merit consideration.

1. <u>With the emergence of a unified financial services market, European banks will be operating in a competitive environment that is much more like that in the United States.</u>

As we have noted above, banking in the EC is much more concentrated than in the U.S., with a relatively few banks dominating their national markets. However, when viewed from the perspective of a unified market, the market structure for EC banks looks a great deal more like that of the U.S. This becomes more obvious when we compare the market share of the top 5 and 10 banks in the U.S. (table 3) and EC (table 4). As of December 31, 1988, the last year for which we were able to get comparable numbers, the top 5 EC banks comprised 15 percent of the total EC banking assets, compared to close to 16 percent for the top 5 U.S. banks. Comparisons between the top 10 EC and U.S. banks reveal similar results, 25.3 percent for the EC banks and 24.1 percent for the U.S. banks.

Although it is difficult to quantify the impact of a reduction in the market dominance of EC banks, intuition (buttressed by economic theory concerning the differences between oligopolistic and competitive markets) suggests no single bank will be able to influence its market in quite the same way it may now.

Furthermore, as the number of financial organizations able to offer banking products--and consequently, competition--increases, there will be a tendency for profit margins to be squeezed. Certain aspects of banking that banks used to be able to count on to contribute significantly to profitability--such as the payment of relatively low rates on consumer deposits--will no longer be sustainable. For example, McKinsey & Co. has calculated that bank profits from their savings account business

Table 3:

Market Share in U.S. of Top 10 U.S. Banks, December 31, 1988
(Ranked by Assets, Billions of U.S. Dollars)

Top 5 U.S. Banks		Percentage of total Assets[a]
Citibank NA	$150.2	5.4%
Bank of America	82.9	3.0
Chase Manhattan Bank	77.5	2.8
Morgan Guaranty	71.2	2.6
Bankers Trust	55.4	2.0
Total, top 5	$437.3	15.7%
Next 5 Banks		
Manufacturers Hanover Trust	$ 54.2	1.9%
Chemical Bank	50.9	1.8
Security Pacific	48.9	1.8
Wells Fargo Bank	43.7	1.6
First National Bank	35.2	1.3
Total, next 5	$233.0	8.4%
Top 10 U.S. Banks	$670.2	24.1%

[a]Numbers may not add due to rounding.

Note: Total assets in U.S. commercial banks on December 31, 1988: $2,780.0

Source: IMF Statistical Yearbook (1989): American Banker, Top Numbers 1990 Update

Table 4:

Market Share in EC of Top 10 EC Banks, December 31, 1988
(Ranked by Assets, Billions of U.S. Dollars)

		Percentage of total Assets
Top 5 EC Banks		
Credit Agricole Mutuel	$207.0	3.3%
Banque Nationale de Paris	194.5	3.1
Barclays Bank Plc	189.2	3.0
National Westminster Bank Plc	178.3	2.8
Credit Lyonnais	176.7	2.8
Total, top 5	$946.7	15.0%
Next 5 Banks		
Deutsche Bank	$170.3	2.7%
Societe Generale	143.9	2.3
Dresdner Bank	129.3	2.1
Commerzbank	100.8	1.6
Midland Bank Plc	100.8	1.6
Total, next 5	$645.1	10.3%
Top 10 EC Banks	$1,591.8	25.3%

Note: Total assets in EC banks on December 31, 1988: $6,330.0

Source: American Banker, Top Numbers 1990 Update, p. 121.

currently make up approximately 44 percent of yields in retail banking in the seven largest EC countries. If customer preferences in Europe were to shift toward money-market accounts, as happened in the U.S., this would lead to substantial losses in earnings for banks. Under such circumstances, there will be incentives for banks to take on more risks to maintain market share and to keep up profits--and just to survive.

The increased competition stemming from deregulation will, of course, be in addition to the increase coming from changes in technology and other developments in national and international banking markets. For example, the ability of large corporations to access financial markets directly will no doubt continue to affect wholesale banking in both Europe and the U.S.

It is sometimes argued that the adoption of the universal bank approach may make European banks better able to compete since they can provide a full range of services to their customers, benefit from economies of scale and scope, and survive economic downturns because of higher diversification. While there is no doubt some truth to this, it should not be overemphasized as a failsafe protection against competition or a solution to potential earnings problems. Even in a universal bank, the ability to cross-subsidize will be distinctly limited by outside competition. Specialist firms that can offer lower prices and/or better services in areas such as mutual funds will have a good chance to lure customers away from these banks. Furthermore, economic studies of banking in the U.S. raise questions about how great synergies or economies of scale actually are once a threshold of $1 to $5 billion in assets has been reached.

2. <u>Successful supervision in a more competitive environment may strain traditional supervisory approaches</u>.

It is our understanding that bank supervision in Europe has tended to be more informal and perhaps more supportive than in the U.S. With fewer, larger banks to supervise in smaller markets, the regulators can bring to bear their first hand knowledge of the markets in which the banks operate and their fairly close acquaintance with bank officials. Problems are generally headed off informally before official sanctions are required.

In a bigger market, these traditional ways of approaching supervision may become less effective. Home country supervisors may find it harder to keep up with developments throughout the market as the banks they supervise become involved in new activities throughout a significantly larger market. Regulators may also believe it necessary to approve additional activities are considered risky, to ensure that home banks don't lose their competitive edge against foreign banks allowed to participate in such activities. This, of course, is part of the convergence goal behind the Second Banking Directive. However, because these activities are new to both the banks and bank regulators, it becomes more likely that some of the risk characteristics of the activities are not well understood and that informal contacts between a bank and its regulator will become insufficient to control risk.

Problems along these lines certainly occurred in the U.S. after deregulation. One of the factors that contributed to the magnitude of the savings and loan problem was a cutback in supervision at a time when many institutions began to exercise new powers that turned out to be very risky. Also, as we pointed out earlier, bank regulators have preferred informal regulation to formal enforcement actions and, partially as a result, have not been successful in maintaining safety and soundness in the banking system. We also found that the discretion built into the U.S. supervisory system made it difficult for bank regulators to make a strong case--both in court and in the political arena--for disciplining problem banks. While European countries do not appear to be as litigious as the U.S., bank regulators may increasingly be forced to more drastic measures to enforce regulatory actions if the system of informal regulation begins to break down.

Traditional approaches to supervision could also be strained in other ways. With the issuance of a single banking passport in the EC, many bank managers may increasingly be coming from outside the home country, so that on a personal level there are fewer informal ties between banking officials and regulators. Also, while host country regulators are generally not responsible for regulating banks branching into the country, the activities of these banks can certainly have an impact on the operations of host country banks. Yet, regulators may not as easily be able to rely on moral suasion to change operating practices that might be detrimental to the market.

To elaborate on this last point, in the U.S. we found that operating policies of risky banks could have severe detrimental effects on the market. These banks tended to bid up interest rates, provide below market rates on loans, and consequently squeeze the profits of all the banks competing in their market. Unfortunately, U.S. regulators found it very difficult to control such actions--partially because they felt they lacked the authority to make supervisory actions stick, but also because they did not have the intimate knowledge of the internal controls and risk profiles of a bank that was necessary before effective action could be taken. We found that regulators in the United States did not appear to have the information necessary to control excessive bank risk taking.

In order to try to create a level playing field, EC banks have agreed to common minimum capital standards that conform to the risk-based standards negotiated by the major industrial nations through the Bank for International Settlements. While a common standard is important, by itself it may not be sufficient to prevent risky banks from damaging healthy ones. In our study, we found that much of the key risk-taking activity, though known to some extent to the regulators, took place while the bank looked healthy by standard capital measures. Capital fell rapidly when the economy changed and loans went bad.

3. <u>A national system of bank supervision may make it harder to control risk</u>.

Under the EC second banking directive, home country bank regulators will be responsible for safety and soundness regulation of their banks. There will be no single entity that is responsible for the consistent examination and regulation of banks throughout the common market. Instead the market will be divided among a dozen bank regulators who may have contradictory views on how to supervise and will certainly have varying degrees of expertise and effectiveness.

We have fragmentation in the U.S. in that each of the 50 states charters banks and supervises those banks it charters. But, each bank in the U.S. is also regulated and examined by one of the three federal bank regulators--the U.S. Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit

Insurance Corporation. The largest share of banking assets are in national banks examined by the U.S. Comptroller of the Currency. Furthermore, 93 percent of the banking assets in the U.S. are controlled by single or multi-bank holding companies, and these companies are all subject to examination by the Federal Reserve.

In the U.S., where there are only three primary regulators at the federal level, we have found that there are instances of what we refer to as "charter-flipping." These are situations where a bank changes its charter to come under the jurisdiction of the federal regulator it perceives to be most lenient. We refer here to the quality of supervision, not the formal regulations.

Obviously, decisions about where to locate banking activities depend on many factors. However, differences in supervision could be one of those factors affecting EC banks. Banks could choose to establish their headquarters (or separately capitalized subsidiaries) in any of 12 countries based on perceptions of regulatory strictness--or the lack thereof. While it is hard for us to judge from the outside, it is possible that regional interests could also lead to what in the U.S. has been called "competition in laxity" among the bank regulators. In order to spur economic development within their national boundaries or to lure headquarters jobs in financial services, some nations may be inclined to use concessions in the rigor or cost of supervision as an incentive. Any incentive for forbearance can increase risks in the system and, as described above, put pressure on healthy institutions to operate at the lowest common denominator. This could have a serious effect on bank safety and soundness in the EC if regulatory convergence results in increasingly lax supervision.

One of the lessons from the U.S. experience is the importance of distinguishing sharply between regulation and supervision. Regulations can be agreed to by governments, but the quality of supervision has to do with the resources and skill of the officials in various countries. Without either an EC central bank or a community-wide bank regulatory agency, there is no single authority whose job it is to be sure that the banking system as a whole is well supervised and operated in a safe and sound manner. We do not suggest that EC-wide structural changes will have to occur in order to assure adequate supervision, but we would urge, based on our experience, that problems in the supervisory area not be underestimated.

4. <u>Potential deposit insurance problems.</u>

In the U.S., consumers of banking services have come to rely on the deposit insurance guarantee, instead of the safety and soundness of the banks with which they do business, to assure them of the safety of their deposits. The lack of information and the thousands of banks in the U.S. makes it all but impossible for bank customers to judge accurately the soundness of their financial institutions, and bank advertisements routinely note that deposits up to $100,000 are insured by the federal government.

Such a tendency to rely on the deposit insurance guarantee could develop in the EC as consumers are attracted to banks from foreign countries with which they are not familiar. The availability of accurate information on banks is even more of a problem in most European countries than in the U.S. because disclosure requirements are not as extensive.

It is our understanding that all EC countries are required to have a deposit insurance system, but that some of the characteristics of such systems are still to be worked out. At the present time there is considerable difference in coverage. For example, as we understand it, in Germany deposits are covered up to 30 percent of a bank's equity capital (which implies 100 percent coverage for deposits in the $1 billion range for a large bank) while in the United Kingdom coverage is for 75 percent of deposits up to $40,000.

If depositors begin to factor deposit insurance coverage into their decisions of where to place their deposits, unless the same coverage exists in all countries, banks may begin using the coverage their countries' deposit insurance systems provide as a marketing tool. Again, in order to promote the competitiveness of home banks, regulators might be tempted to expand the coverage of deposit insurance.

One way to try to avoid this type of competition is to have host country deposit insurance rules apply to all retail deposits in that country. However, we have seen in the U.S. that in competitive markets, mechanisms such as deposit brokers can spring up that one way or another can channel funds to banks that offer the most favorable terms, wherever they are located. If the host country were to actually provide the insurance for banks operating in its jurisdiction, then it would find itself financially responsible for banks it cannot control. This type of arrangement was very costly to the U.S. government in the savings and loan situation due to the failure of a number of state-chartered institutions whose powers were not controlled by the federal government.

As happened in the U.S., banks operating in a more competitive environment will be able to increase risk without losing customers due to the deposit insurance guarantee. Unless supervision is up to the task of controlling such risk taking, safety and soundness may be compromised and banks will get into trouble. Resulting bank failures, particularly if there are any large bank failures, can quickly overwhelm the ability of private deposit insurance systems to cover the cost. If depositors lose confidence in the deposit insurance system's ability to pay, they may pull their deposits out of the affected country's banks. To avoid such runs, which have occurred in situations in the U.S. where deposit insurance was not backed by the full-faith and credit of the U.S. government, governments may find it necessary to guarantee the deposit insurance systems. But we also discovered in the U.S. that doing so can be very costly if bank supervision is not adequate. Furthermore, since deposit insurance in the EC is a national responsibility, if any nation's banks begin to lose out competitively for whatever reason, that government will have to make difficult choices involving propping up failing banks, moving quickly to allow its banks to be taken over by foreign banks, or risk having to pay large sums to cover deposit insurance losses. If the number of weak banks that are kept from failing were to become large, the efficiency of the EC financial system could be impaired.

CONCLUSIONS

In conclusion, we believe that EC bank regulators can benefit from many of the lessons learned in the U.S. to help them prepare for a more deregulated financial services firms. First, deregulation, and associated intensity of competition, almost by definition, will exacerbate the industry overcapacity already present in the EC. As a result, banking institutions are likely to increase risk in order to make up for squeezed profits. Consequently, the quality of supervision must be high in order to control bank risk taking and to reduce costly failures. Second, accurate information on banks' financials is imperative if regulators are to be able to resolve bank problems before they reach crisis proportions. Finally, in a competitive market, incentives to relax supervision and expand deposit insurance may be created. These must be resisted. Otherwise, risk in banking is likely to increase at the same time as depositor discipline is being reduced. Increasing bank insolvencies are liable to be the result, unless, of course, governments step in to protect their banks. Such actions are not without cost, however, and will not resolve the problems of overcapacity.