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The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

As you requested, we obtained information on deposit insurance and protection systems in Germany, France, the United Kingdom, Italy, Japan, and Canada. Because a country's approach to deposit protection is driven in part by the structure of its regulatory regime and the size and nature of its banking system, we also outlined elements of the six countries' overall financial regulation systems. In addition, we reviewed the resolution of bank failure cases in five countries (Japan had no bank failures) and described throughout the report the European Community's efforts to encourage establishing Communitywide deposit protection.

We are sending copies of this report to the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Federal Reserve Board, the Secretary of the Treasury, and other interested parties. Copies will also be made available to others on request.

Please contact me on (202) 275-4812 if you or your staff have any questions concerning this report. The major contributors to this report are listed in appendix I.

Sincerely yours,

Allan I. Mendelowitz

Allan I. Mendelowitz, Director
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Executive Summary

Purpose

In light of current difficulties within the U.S. banking structure, Congress is reviewing methods of reforming the bank deposit insurance system. The Chairman of the Senate Committee on Banking, Housing, and Urban Affairs asked GAO to

- obtain information, for purposes of comparison, on the deposit insurance and protection systems of six developed countries. These countries are Germany, France, the United Kingdom, Italy, Japan, and Canada;
- outline elements of the six countries' overall financial regulatory systems that complement and support their deposit protection systems; and
- describe how cases of bank failure were resolved in Germany, France, the United Kingdom, Italy, and Canada.

GAO also incorporated into this report a description of the European Community's efforts to encourage Communitywide deposit protection.

Background

Deposit insurance is a common feature in many national systems of bank supervision. By protecting depositors in the event of a bank failure, these systems promote popular confidence in the safety and soundness of banks. Doing so lessens the prospects of bank runs or panics and helps enhance the ability of the banking system to support economic activity.

Results in Brief

Most of the deposit protection systems in other countries were initiated or reformed within the last 15 years, often as a result of banking crises. The systems offer a variety of arrangements, including private versus government administration, substantial coverage versus minimal coverage with depositors sharing the risk, and fixed yearly premiums versus variable post-assessments in the event of a bank failure.

Foreign regulators generally believe that their overall regulatory framework and certain structural elements in their banking systems, rather than their deposit protection plans, serve to ensure the safety and soundness of their banks.

Deposit protection systems have been used in handling foreign bank failures. Since the establishment of these systems, bank failures have generally been few in number and have involved smaller institutions. In most cases, only those depositor claims covered under the deposit protection plan were honored.

Principal Findings

Bank Deposit Protection Methods Vary

Most of the bank deposit protection systems in the six countries GAO reviewed were initiated or reformed within the last 15 years, often as a result of banking crises. Since the creation or reform of the deposit protection systems, most countries have experienced less than 20 bank failures, generally of smaller banks. The systems vary considerably in design, with differences in the level of government versus private association funding, coverage of deposits, and funding arrangements. How each deposit insurance scheme and design is organized depends in large part on the structure of the banking system and the extent of bank regulation in each country.

Bank regulators in the six countries reviewed contend that their deposit insurance and protection systems are not designed to protect the deposits of larger banks. They also say these systems are not expected to be able to ensure the safety and soundness of the entire banking system. This broader goal is generally assigned to strong regulation and close prudential supervision. Some countries, in fact, rely upon insurance or deposit protection provided by their private banking associations. These associations operate under the supervision of the bank regulators. Thus banks have relatively more responsibility in facing the consequences of their actions.

Philosophies on setting deposit coverage amounts vary among countries. Some guarantee plans offer minimal protection and may extend some risk to depositors in order to encourage prudent behavior by both banks and depositors. Others, at least in theory, protect virtually all deposits. Some protection plans avoid the term "insurance" completely, believing this term places too much emphasis on the fund's ability to protect the banking system. Phrases such as "deposit protection" are used in several countries.

Foreign regulators said that there was very little interest in the future use of risk-based premiums, which vary premiums according to the risk profile of the bank, as a means of making banks that indulge in more risky investments assume a greater share of the burden of deposit protection. The difficulty in assessing the riskiness of a bank's investment patterns and the fact that some protection schemes assess contributions after a failure has occurred were cited as reasons for the lack of interest.

The European Community of 12 nations is encouraging all Community member nations to put in place deposit protection systems in order to improve the overall safety and soundness of banks throughout the Community.

Overall Regulatory Framework Is Heavily Relied Upon

Foreign regulators regard their deposit protection schemes as a mechanism of last resort. Their regulatory and supervisory systems limit bank risk exposure through specifying bank audits by the regulator or external auditors, by placing restrictions on loans and permitted business, by having requirements that banks keep adequate capital to support their operations, and by mandating stringent reporting requirements.

Foreign regulators GAO interviewed believed that they are able to resolve bank difficulties before inordinate losses are sustained. These regulators identified flexible responses to problems and close working relationships with banks as crucial ingredients in their systems. They said these factors help them to deal with individual problems and to adopt ad hoc solutions when they believe circumstances warrant. Bank associations also indicated that they have worked to resolve the difficulties of weaker members, through arranging recapitalizations or mergers. Regulators also believed that the highly concentrated nature of their banking systems facilitates close supervision and cooperation.

Foreign regulators identified several structural elements of their banking systems which they believe ensure bank solvency, lessening their reliance on deposit insurance. These elements include (1) banks that hold equity shares in the private companies they service, (2) a relatively large number of state-owned banks, (3) long-term bank/customer relationships, and (4) diversification of risk through universal banking (i.e., banks that can perform both banking and nonbanking activities), and unrestricted geographic expansion.

Bank Failure Resolution Uses Deposit Insurance

Foreign countries have responded differently to the few bank failures they have experienced, but each has used deposit insurance as a part of its response. In no case has using a deposit insurance system or fund been the only reaction to a failure. The low number of failures, the use of other regulatory responses to these failures, and the subsequent changes in deposit insurance plans prevent reliable predictions about how these systems would handle any future failures.

Recommendations

This report provides GAO's findings on the deposit insurance and protection systems of Germany, France, the United Kingdom, Italy, Japan, and Canada. It contains no recommendations.

Agency Comments

As requested, GAO did not obtain written agency comments. However, GAO did obtain the views of responsible officials during its work, and their comments have been incorporated as appropriate.

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Abbreviations

CCB	Central Bank of Canada
EC	European Community
GAO	General Accounting Office
SMH	Schroder, Munchmeyer, Hengst & Co.
U.K.	United Kingdom

Introduction

Deposit insurance is a common feature in national systems of bank supervision and regulation, designed to protect depositors against loss in the event a bank fails. By acting to discourage or prevent bank runs, deposit insurance contributes to the safety and stability of the entire banking system.

Before the adoption of deposit guarantees, the threat of bank runs was a common problem. Panicky depositors historically sought to withdraw their funds in mass from banks perceived to be in difficulty. Historical reporting from the Great Depression often includes pictures of long lines of depositors seeking to retrieve their money from financially troubled banks. Such bank runs are harmful to the stability of the banking system because they are not limited to failing banks. Even a solvent bank, i.e., a bank whose assets are larger than its deposits and other liabilities, could be subject to a run on the basis of false information. And, not even a solvent bank can pay off all depositors simultaneously on demand. Banks keep only a small percentage of their assets in cash and other highly liquid items. The vast majority of bank assets are in the form of loans that are relatively illiquid and cannot be readily and quickly converted into cash. Deposit insurance, by giving depositors the assurance of prompt payment even in the event of a bank failure, substantially removes the reasons for a run and is part of the system that exists to promote confidence in the safety and soundness of individual banks and thus the entire banking system.

Objectives, Scope, and Methodology

The Chairman of the Senate Committee on Banking, Housing, and Urban Affairs asked us to obtain data on how Germany, France, the United Kingdom, Italy, Japan, and Canada use bank deposit insurance and protection systems. We also reviewed the comprehensive financial regulatory systems that complement and support these countries' deposit protection structures. In addition, we described the resolution of bank failure cases in five countries — Germany, France, the United Kingdom, Italy, and Canada. Within the report, we also discuss the European Community's efforts to encourage Communitywide deposit protection.

To assess the six countries' bank deposit protection systems, we obtained information on the mechanics of the deposit protection plans, such as premium levels or other financing methods, coverage amounts, and methods of administration. We obtained foreign regulators' perspectives on their choice of deposit protection methods and what they considered essential to promoting the safety and soundness of their banking

systems. We obtained examples of how the various deposit protection schemes were applied to past and present bank failures.

We obtained (1) the statutes or bylaws of the various plans and banking regulations and prudential rules; (2) analyses of the systems from agencies including the Congressional Budget Office,[1] the Congressional Research Service, and the Federal Deposit Insurance Corporation; and (3) general studies on deposit insurance done by private institutes and academics. We spoke with the countries' central bank officials of France, Germany, and Italy who had offices in New York City, and with central bank officials in Germany and the United Kingdom. We also spoke with (1) deposit protection plan administrators and supervisory bodies, (2) academics with expertise in international finance, and (3) officials from the Federal Reserve Bank of New York. We also reviewed case studies done by some foreign regulators and by the Federal Deposit Insurance Corporation.

The information in this report does not reflect original analysis of the laws and regulations on our part but the views and interpretations of the foreign bank regulators with whom we spoke. The data provided by foreign government officials and others were not independently validated.

Chapter 2 presents more detailed information on the six countries' bank deposit insurance and protection methods. Chapter 3 describes the overall regulatory framework for the countries' banks, and Chapter 4 provides data on how cases of bank failures were resolved.

We conducted our work between November 1989 and September 1990 in Washington, D.C.; New York City; London, England; Brussels, Belgium; and Frankfurt, Bonn, Cologne, and Berlin, Germany.

As requested, we did not obtain written agency comments. However, we did obtain the views of responsible officials during our work, and their comments have been incorporated as appropriate.

[1] For further information on foreign deposit insurance systems, see Reforming Federal Deposit Insurance, Congressional Budget Office of the United States (Washington, D.C.: Sept. 1990).

Six Countries' Bank Deposit Insurance and Protection Methods

All six countries we reviewed, except Japan, have experienced bank failures and created their current bank deposit protection systems in response to crises in the safety and soundness of their banking systems. Each country devised its own solution.

Italy and the United Kingdom (U.K.) now extend some of the risk to depositors, while Japan depends primarily upon its banks' capital base and behind-the-scenes informal measures taken by its central regulator to ensure against bank failure. France, Germany, and Italy place primary responsibility on the banks themselves to guarantee deposits rather than rely on government-administered systems. In these three countries, this system gives banks more flexibility in resolving their difficulties, encourages them to work together in settling those difficulties before regulators step in officially and, by assigning banks relatively more responsibility in facing the consequences of their actions, creates disincentives to excessive risk taking. Generally, the privately administered plans are supported by strong supervision and close working relationships with bank regulators. Canada has a compulsory deposit insurance program, which, although administered by a quasi-government agency, is under the purview of the Department of Finance.

Table 2.1 shows the major characteristics of the deposit protection methods used in these countries as well as the U.S. methods.

Table 2.1: Deposit Protection Methods in Six Countries Plus the United States

Deposit protection method	Germany[a]	France	United Kingdom
Date established	1966	1980	1979
Government administered or private	Private	Private	Government
Voluntary or compulsory	Voluntary	Voluntary	Compulsory
Funding method	Contributions from members	Banking community is assessed contributions after a failure	Routine, and special contributions from members
Level of contributions	Annual premiums of 0.03 percent of each bank's deposits, not including interbank deposits	Based on a regressive scale dependent upon the bank's total deposits up to 30 billion francs	10,000 pounds. Further contributions if fund goes below 3 million pounds, or failures are anticipated
Coverage offered			
Basic protection[b]	Up to 30 percent of a bank's liable capital per depositor	Up to 400,000 francs ($63,000) per deposit	75 percent of first 20,000 pounds ($33,000) per depositor
Deposits in foreign currency	Yes	No	No
Interbank deposits	No	No	No
Branches of foreign banks	Yes	Yes	Yes
Branches in other countries	Yes	No	No

Italy	Japan	Canada	United States
1987	1971	1967	1934
Private	Government and private	Government	Government
Voluntary	Compulsory for several types of banks	Compulsory	Voluntary
Callable commitments	Insurance premiums	Insurance premiums	Insurance premiums
Up to 1 percent of total deposits with a fund target of 4,000 billion lire. If necessary an additional 0.5 percent of members' customers' deposits can be levied	Annual premium of 0.12 percent of total covered deposits	Annual premium of 0.1 percent of total covered deposits	Annual premium of 19.5 cents per $100 of total deposits, including interbank deposits
100 percent of the first 200 million lire ($146,000) and 80 percent of the next 800 million lire ($584,000) per deposit	10 million yen ($74,000) per depositor	C$60,000 ($50,000) per depositor	$100,000 per deposit
Yes	No	No	Yes
No	No	Yes	Yes
Yes	No	NA[c]	Yes
Only if host country does not offer coverage	No	No	No

[a]Does not include German savings banks and cooperative societies, which are covered by different deposit protection schemes.

[b]All dollar amounts are based on 1989 end-of-year average exchange rates.

[c]NA denotes not available.

Sources: Organization for Economic Cooperation and Development; U.S. Congressional Budget Office; and the Federal Deposit Insurance Corporation.

In an overall effort to instill confidence in and ensure the stability of Europe's banking system, the European Community (EC)[1] is formalizing plans to assure that all member states will eventually have in place some type of deposit protection scheme. The EC also hopes to devise general Communitywide standards for deposit protection. A proposal to the EC member states is expected at the end of 1991 that would establish initial guidelines for the member states' deposit protection schemes.

[1]The European Community was originally created under the provisions of the Treaty of Rome of 1957. It currently has 12 members, including France, Germany, the Netherlands, Italy, Greece, Spain, Portugal, the United Kingdom, Belgium, Ireland, Denmark, and Luxembourg.

Germany

The German deposit protection system for commercial banks was established in 1966. Originally it protected accounts with balances of up to 10,000 deutsche marks; it was later raised to cover accounts with balances of up to 20,000 deutsche marks. In 1976, the deposit protection system was changed to its present level of protection, which safeguards nonsecuritized liabilities to nonbank depositors up to a per-depositor level of 30 percent of the liable capital[2] of the bank concerned. This coverage essentially includes all but very large deposits. German bank regulators told us the main reasons for this extensive coverage were to ensure that any deposits taken in from the general public, even by small banks, would be protected and to ensure that different types of banks would be treated equally.

Germany has three main types of banks: public sector banks (savings banks and their central institutions), cooperative banks, and private commercial banks. These private commercial banks, including the "Big Three" (Deutsche Bank, Dresdner Bank, and Commerzbank), typically act as universal banks. Their total assets, 9 percent of the aggregate total assets of the entire German banking sector, do not entirely reveal their relative importance. In the bank services sector, however, such as providing trade financing and letters of credit, the big three play a dominant role, conducting their business through an extensive network of branches and agencies throughout Germany.

Public sector banks are guaranteed in full by the municipalities in which they operate, and cooperative banks guarantee each other in mutual associations. Both are also universal banks. The protection systems for both these types of banks safeguard not just the deposits but also the individual institution against insolvency. No such guarantee exists for private commercial banks.

Following the failure of the Bankhaus I.D. Herstaat in 1974 (see chap. 4), German bank regulators feared an erosion of public confidence in the private commercial banking system. They also were concerned about the transfer of large amounts of deposits into the other two banking sectors, as private commercial banks sought overly risky but highly profitable business to pay higher interest rates to depositors.

To renew confidence in the private commercial banking system and avoid this potential business hazard, a deposit protection system was created that provides virtual total deposit coverage to each depositor.

[2] "Liable capital" is defined as the paid-up endowment capital and the reserves.

Although the regulators agreed that this extensive coverage might create a new "moral hazard" should commercial banks increase their high-risk activities because of total deposit coverage, they believed that strong prudential supervision precluded this possibility.

The German deposit protection system for the private commercial banks is administered privately through the Federal Association of German Banks. The bylaws of the Association's Deposit Protection Fund state that its purpose is to "give assistance, in the interest of depositors, in the event of imminent or actual financial difficulties of banks." The Fund has the power to intervene and attempt to resolve a member bank's difficulties, so its role is broader than merely paying depositors of a failed bank. Thus, the Bundesbank (Germany's central bank) and the country's Federal Banking Supervisory Office depend, in part, on the banks to resolve their own difficulties before stepping in to resolve them directly. The Fund may request its own bank audit; however, the report must also be submitted to the Bundesbank and the Federal Banking Supervisory Office.

Fund officials we interviewed placed primary importance on the private nature of their deposit protection method for both legal and practical reasons. The Deposit Protection Fund chose to use a voluntary payout method to avoid being labeled and supervised as an insurance fund. As an insurance fund, it would be legally liable to cover losses under all, even extreme, circumstances. Under the voluntary method, neither the credit institutions concerned nor their creditors have a legal right to demand intervention or payments. A general banking crisis does not constitute grounds for invoking protection.

A private system also gives Fund managers flexibility in dealing with problem banks. The Federal Association of German Banks can apply pressure on its members to come to the aid of a troubled bank and work among themselves while coordinating informally with regulators to resolve bank difficulties and avoid insolvency. German bank regulators and fund administrators told us that this flexibility, along with the extent to which the banks are held responsible for resolving their own difficulties, was a key factor in the success of their deposit protection system.

France

The French approach to handling banking crises combines a strong supervisory role for its central bank, the Bank of France, with an

industry-administered deposit protection plan administered by the Association of French Banks. A central bank official emphasized that the system is not insurance but a loss-sharing agreement among member banks, whose sole purpose is to dissolve financial institutions once they have failed.

The Banking Act of 1984 established the Banking Commission and its supervisory authority to oversee the credit institutions' observance of French laws and regulations applying to them, to take disciplinary actions against any contravention of the laws, and to monitor the safety and soundness of their financial situation. A central bank official told us that French banking difficulties are handled on a case-by-case basis, and a "cookbook approach" is not followed. The two major tools available to French bank regulators are section 52 of the 1984 banking law and the loss-sharing agreement within the banking community.

Section 52 allows the Governor of the French central bank to call upon major shareholders of a bank in difficulty to make contributions to the bank to rebuild its capital base. The Bank of France can also assess the banking community for funds needed, above and beyond those contributed by shareholders, to rescue a failing bank. If this appeal is not successful, the Governor can "take appropriate measures to rescue the bank" or let the bank fail and ask the banking system to activate the loss-sharing agreement. A French central bank official told us that to date the Governor of the Bank of France has used section 52 in only one case, that of the Al Saudi Banque in 1988. (See chap. 4.)

The official stated that the loss-sharing agreement is a limited mechanism designed to protect small depositors. Interbank deposits are not covered, nor are deposits in foreign currencies. In fact, larger banks refused to contribute to the agreement on a pro-rata basis since the agreement was not sufficient to cover the potential failure of a large bank. Therefore, if the loss-sharing agreement is activated, the smaller the bank, the more it will pay as a percentage of its deposit base since theoretically the smaller banks are more likely actually to use the system.

The United Kingdom

The U.K.'s deposit protection plan was established under the provisions of the Banking Act of 1979 and revised in the Banking Act of 1987. According to a Bank of England official, the plan was designed not to protect the system but to shield "widows and orphans," meaning small, financially unsophisticated depositors. However, even these depositors

are expected to consider carefully where they bank, since the U.K. system requires that all depositors share part of the risk in the event of a bank failure. Depositors receive only 75 percent of their total insured deposits. U.K. regulators believe strongly in their system of "co-insurance",[3] which they maintain encourages all depositors to appraise the financial health of the bank in which they place their funds, not just the types of products or the level of interest rate offered.

The Deposit Protection Board administers the deposit protection plan and is comprised of representatives from both the Bank of England and the contributory institutions. The Board has no regulatory or oversight function but only steps in when a bank becomes insolvent and depositors require coverage.

A Deposit Protection Board official told us that U.K. bank regulators do not consider their deposit protection method to be fundamental to ensuring the overall safety and soundness of their banking system. Strong supervision under the Bank of England, not deposit insurance, is believed to be the main protection against depositor loss. The official noted that banks are not required to advertise their deposit insurance coverage and often choose not to do so in the belief that such coverage implies a chance of insolvency and, thus, some weakness on their part.

Italy

Italy's Interbank Deposit Protection Fund, established in 1987, is the newest guarantee system in the six countries we reviewed. In developing this fund, Italian regulators considered aspects of other European country deposit protection methods as well as that of the United States in creating their protection plan.

An underlying theme of Italy's deposit protection method is to give banks autonomy in running their operations, while encouraging them to make decisions based on their own self-interest in strengthening their solvency and, thereby, the overall stability of the banking system. This theme is reflected in several ways. The system is privately administered and allows a fair amount of autonomy in resolving bank difficulties. Participation is based upon meeting certain prudential requirements, such as a series of balance sheet ratios that measure the degree of participants' risk, solvency, liquidity, and efficiency. Contributions are

[3] "Co-insurance" refers to a system of insurance whereby both the insured and the insurer suffer some loss in the event of a claim.

made as needed, and their amount reflects the bank's capital base. In addition, depositors partly share in the risk of failure.

Although the Bank of Italy, Italy's central bank, authorizes all Italian Interbank Deposit Fund interventions and is represented at its board meetings,[4] the Bank considers this fund to be essentially a quasi-private independent body. Regulators stress, however, the importance of close cooperation between the banks and the supervisory authorities.

Italian regulators chose to establish a private system to enhance the autonomy and entrepreneurship of banking and to shift the cost of bank failures to the banks themselves. In this regard, the system requires larger depositors to share in some of the risk of bank failure by covering, for each deposit, 100 percent up to 200-million lire and 75 percent of the next 800-million lire.

With the authorization of the Bank of Italy, the fund can determine the size and type of intervention depending upon the circumstances. The fund can contribute to the repayment of customer deposits or, if less costly, it can arrange a takeover of the bank's assets and liabilities by other credit institutions. The fund can also call upon the Bank of Italy to appoint a special administrator to attempt to handle emergencies.

To limit the cost of participation, the Italian Interbank Deposit Fund, as in the French system, is not funded by member banks making initial payments or fixed yearly installments, but by callable commitments to pay. In fixing the amount of that contribution, Italian regulators decided not to follow the example of most other countries in collecting a percentage of member bank deposits. Instead, contributions are based upon total customer deposits and outstanding loans, less capital and free reserves. The more capital a bank has on hand, the less it contributes to the fund, providing further incentive for banks to be strongly capitalized.

The Bank of Italy uses the protection fund not just to pay depositors in case of bank failure but also to create preventive measures for protecting the banking system from ever facing such a situation. Bank admission to the Interbank Deposit Protection Fund is subject to a requirement that the bank come into compliance with favorable balance sheet ratios, such as low bad debts to outstanding loans and high total

[4]The board is comprised of 21 members nominated by the associations of the various credit institutions.

liquidity to liabilities. Should a member bank fail to comply with various ratios within 2 years of admission to the protection fund, the protection fund board may decide to terminate the bank's membership or impose other penalties, such as suspending the right to vote at board meetings and possibly doubling the amount of membership contributions.

The ratio requirements are meant to reduce the banks' reliance on the fund by discouraging excessive risk taking. The ratios also provide the fund with a large body of information on the banks' financial status. The fund requires banks whose ratios are not in compliance to write more frequent reports with additional information as required and to notify it of any corrective action. These requirements supplement the Bank of Italy's monitoring function and allow it to apply early solutions should problems arise. The Bank of Italy regularly collects such data along with other information about the banks' operations.

Japan

The Japanese Deposit Insurance Corporation was established in 1971 to protect depositors and maintain the stability of the Japanese banking system. No insured institution has failed since the establishment of this corporation.

The Japanese Deposit Insurance Corporation administers the Deposit Insurance Fund, which insures deposits held in Japanese banks, not including foreign currencies, up to a maximum of 10-million yen per depositor. The corporation can also provide assistance for mergers and acquisitions of financially insolvent institutions. The Deposit Insurance Fund was originally capitalized with a 450-million yen contribution divided equally among the Bank of Japan, other parts of the government, and the banking industry. However, the deposit protection plan would apparently only cover very small bank failures. As of March 1989, the Deposit Insurance Fund balance was approximately 439-million yen (slightly less than the original capitalization due to fund investments), which would cover less than one-tenth of 1 percent of all insured deposits.

Canada

Canada has a government-run deposit insurance scheme administered by the Canada Deposit Insurance Corporation, which was formed in 1967. However, Canada has initiated a major overhaul of its banking regulations since serious bank difficulties occurred in 1985 (see chap. 4).

The Canada Deposit Insurance Corporation insures the deposits of federally chartered financial institutions. It also insures depositors at provincially chartered trust companies, as does the Quebec Deposit Insurance Board. Bank membership in the Canada Deposit Insurance Corporation is compulsory.

Although the Canada Deposit Insurance Corporation is a Crown Corporation—a quasi-private agency—and not a government agency, it is essentially under the purview of the Department of Finance: Three of its nine directors are bank regulators, and a fourth is the Deputy Minister of Finance. Like the Deposit Protection Board in the U.K., the Canada Deposit Insurance Corporation is not responsible for prudential supervision. The Office of the Superintendent of Financial Institutions performs bank supervision and examinations.

Canadian deposit insurance, similar to the United States but different from the other countries we reviewed, covers interbank deposits. Deposits not covered include funds in foreign currencies and funds in foreign branches of domestic banks. The deposit guarantee covers up to 60,000 in Canadian dollars per depositor.

The European Community

The EC plans to create a single market by 1992, characterized by the unrestricted movement of people, capital, goods, and services across its member states' borders. As part of this single market program, the Commission[5] recommended in December 1986 that all 12 member states put in place some type of deposit protection scheme by January 1, 1990.

In January 1988 the Commission strengthened its recommendation by proposing a directive[6] concerning the coordination of laws, regulations, and administrative provisions relating to deposit insurance schemes, allowing member states to extend their deadline for compliance to January 1, 1992.

Some issues have yet to be resolved. The deposits of branches whose head office is located outside the member state in which it is operating can be covered in one of two ways: (1) by the "host country" scheme, meaning that of the country in which they are operating, or (2) by the

[5]The Commission is the executive branch of the European Community. It drafts and proposes legislation and enforces the implementation of Community law.

[6]An EC directive requires member states to ensure that their national regulation conforms to the directive's objectives but leaves them free to decide how it should be implemented.

"home country" scheme, that of the country in which their head office is located. The EC has yet to settle definitively on either course. Both the recommendation and the directive call for the host country scheme. However, as a transitional measure until all member states implement their own deposit guarantee schemes,[7] the directive requires that the home country provide coverage where the host country has none.

A Community official told us that the Commission is now leaning toward requiring coverage by the home country exclusively, in keeping with the idea of the "single passport." Under the single passport concept, a financial firm has the same powers and is subject to the same home country supervision and regulatory limits regardless of where its services are rendered. One concern is that home country control could be confusing and disadvantageous to domestic customers of foreign branches. Should the parent bank fail, such depositors would be reimbursed according to a foreign country's rules. Aside from the logistics of dealing with a foreign regulator, depositors may not realize that they could receive less under the foreign scheme than they would have received under their own country's scheme.

The Community is also exploring the possibility of setting further guidelines, such as minimum or maximum coverage, and coverage exclusions. This plan presents a challenge due to the variation in amounts and types of coverage throughout the Community. The Commission may propose a directive to the Council[8] by the end of 1991.

[7]Two member states, Greece and Portugal, do not at present have deposit insurance schemes in place.

[8]The Council of Ministers, made up of one minister from each member state, approves and converts Commission proposals into Community law.

Six Countries' Overall Bank Regulatory Framework

Foreign bank regulators we interviewed consistently noted that their deposit protection and insurance systems play a minor role in ensuring the safety and soundness of their banking systems. Limiting risk through strong prudential supervision was considered a much more important factor. Several regulators also identified the following elements as important to a healthy banking system: equity shareholdings by banks in the companies they service; long- term bank/customer relationships; diversification of risk through universal banking; and a concentrated banking industry, which allows more effective regulatory oversight.

These regulators also believed that having an adequate capital base was essential to providing a buffer against unforeseen losses and risks and, thereby, reducing reliance on the deposit protection system. Bank regulators are in the process of ensuring compliance with the Basle framework[1] to improve the safety and soundness of the banking system.[2]

Strong Central Regulation

Foreign bank regulators generally concentrate on risk prevention through close monitoring and stringent reporting requirements while giving banks the authority to carry out a wide range of banking and nonbanking activities. Bank regulators we interviewed identified their timely receipt and analysis of information, such as capital adequacy, asset quality, management, earnings, loan amounts and concentration, and liquidity, as a crucial tool in ensuring the safety and soundness of the overall banking system. These bank regulators may use their own examiners, such as in France, Japan, and more recently Canada, or rely on qualified auditors hired by the banks, such as in Germany and the United Kingdom. The regulators believe examination and audit reports uncover bank difficulties before their severity precludes preventive action.

Close supervision and monitoring is typically facilitated by one main regulator, for example the Ministry of Finance, who oversees the entire banking system. Actual day-to-day supervision is generally carried out through a subordinate agency that usually coordinates with the central bank. Some deposit protection fund administrators have supervisory

[1]Recently, bank regulators in the Basle Committee on Banking Regulations, under the auspices of the Bank for International Settlements, established supervisory guidelines, known as the Basle framework, setting capital adequacy standards for international banks.

[2]For an assessment of how the Basle framework is being implemented in several countries, see International Banking: Implementation of Risk-Based Capital Adequacy Standards (GAO/NSIAD-91-80, Jan. 25, 1991).

powers and discretion in deciding how to resolve bank difficulties. But, ultimately, the bank regulator must approve such measures.

Frequent communication between the regulators and protection fund administrators is done formally through written reports and informally through meetings between supervisors and bank managers. Such close communication is aided by the presence of a concentrated banking industry, in which relatively few banks hold a large percentage of the banking assets.

Although all the regulators we interviewed agreed on the importance of bank examinations, their philosophies vary. Until Canada's recent efforts to reform its system of regulation, supervision, and examinations, its main bank regulator did not conduct on-site examinations. Outside accounting firms audited the banks and reported to the federal supervisor. This system failed to adequately uncover bank difficulties in the early 1980s due to inadequate reporting on the part of auditors and lack of disciplinary action by bank regulators. In the late 1980s, Canadian bank regulators began conducting limited on-site examinations and were given stronger disciplinary tools.

In Japan, the Banking Bureau of the Ministry of Finance performs on-site examinations. The central banks of France and the United Kingdom have substantial supervisory powers over their banks, but France places great importance on its in-house examiners, while the United Kingdom prefers to allow banks to conduct their own audits. The U.K. bank regulator relies on detailed reports filed by banks and has frequent discussions with bank managers to resolve difficulties. Also, U.K. banks are required to have their annual accounts audited by independent, qualified auditors. Germany also requires banks to hire independent certified auditors, whose reports are submitted simultaneously to both the regulator and the bank managers.

Germany

The Federal Supervisory Office, which reports directly to the Federal Banking Supervisory Office, under the Federal Ministry of Finance, has the central role in bank supervision and coordinates closely with the Bundesbank. The Federal Banking Supervisory Office issues administrative acts, such as general regulations, while the Bundesbank is more involved in direct surveillance through collecting and analyzing annual and other reports from the banks. Bank regulators believe that protection begins with stringent bank licensing requirements, which include having at least two bank managers that meet certain professional and

personal qualifications and possessing minimum start-up capital. Allowing particular loan volumes depends upon maintaining certain minimum capital requirements, and liquidity requirements for long-term and short-term assets are specified. In addition, loans to a single borrower are limited, and regulators require special credit information on loans above a certain monetary value.

The Bundesbank maintains that German banking law places responsibility for business decisions on bank managers and restricts the activity of banks only by quantitative general provisions and obligations that banks disclose their books to the supervisory authorities. Bank regulators maintain that they monitor the banks closely but allow them to perform a wide variety of activities as long as they meet certain regulatory requirements.

The Federal Banking Supervisory Office and the Bundesbank do not have their own auditors. Bank audits are performed by independent certified auditors hired by the banks or by the Federal Association of German Banks as administrators of the deposit protection plan. The audits must comply with detailed Federal Banking Supervisory Office auditing guidelines. Regulators stated that auditors come from highly respected accounting firms, and their reports must be submitted to both the Federal Banking Supervisory Office and the bank managers to avoid any conflict of interest. The German deposit protection fund also has access to member bank information to ensure the banks' continued fiscal soundness. According to the bylaws of the Deposit Protection Fund, member banks must support the auditing activity of the Auditing Association of German Banks and must comply promptly with any conditions the Association may impose.

Supervisory authorities place importance on the monthly returns, including balance sheet statistics, which banks must submit to the Bundesbank. The Bundesbank passes these returns on to the Federal Banking Supervisory Office along with its comments. Regulators believe the Bundesbank's first-hand knowledge of the day-to-day operations of the banks, facilitated by its network of 200 branches and sub-branches throughout the country, provides a valuable service to the Federal Banking Supervisory Office.

France

The French banking system operates under a centralized regulatory system. The supervisory body, the Banking Commission, is headed by the Governor of the Bank of France, with the Treasury Director as a

member. A central bank official told us that the Commission has detailed knowledge of the daily operation of banks and can act quickly if it perceives a bank is facing difficulties. The Commission has a fair amount of discretion in resolving bank difficulties, as the 1984 Banking Law provides a general framework rather than detailed requirements. In addition, regulators felt it was significant that every bank is required to have two technically competent managers so that major decisions are made jointly.

Bank examiners have much discretion and power in impressing upon bank managers their findings and recommendations. The inspectors that conduct the actual supervision of the banks, the Banking Commission's staff, come from the Bank of France. A French central bank official told us that the bank inspectors are not mid-level civil servants but high-ranking officials from the Bank of France at an advanced stage in their careers. French banking law grants banking regulators access to the financial records of nonbanking entities that own banks, permitting investigations of the owners.

French bank regulators believe the structure of their banking institutions also helps limit bank failures. About 68 percent of French banks are either publicly owned institutions backed by the French government or are mutual savings associations and mutual banks which rescue each other through banking networks in the event of failure. Bank regulators also note that their highly concentrated banking system aids close supervision by allowing regulators to focus on a limited number of potentially weak institutions.

The United Kingdom

The United Kingdom has traditionally operated under an informal, non-statutory system of supervision. The Bank of England has been the primary banking supervisor since its establishment in 1694 by Act of Parliament and Royal Charter as a corporate body. The entire capital stock was acquired by the U.K. government under the Bank of England Act of 1946. That act gave the Treasury powers to issue directives to the Bank under certain circumstances. However, not until the Banking Act of 1979 was the Bank given actual statutory powers to carry out its supervisory role. For example, the 1979 act required, for the first time, that deposit-taking institutions be licensed by the Bank.

The Banking Act of 1987 spelled out the Bank's supervisory role and renewed the Deposit Protection Board. The 1987 act also created the Board of Banking Supervision to serve in an advisory role to the Bank,

which continues to have regulatory control. The Board consists of the Governor and Deputy Governor of the Bank and the Executive Director for Banking Supervision, along with independent members such as retired senior bankers and members of the legal and accounting professions. The Board's aim was to increase the banking expertise of the Bank supervisors and raise the level of mandatory reporting by the banks without the use of on-site inspections.

Despite the more substantial statutory powers granted to it by the Banking Act of 1987, the Bank of England prefers to retain its consultative, flexible role and exercise its statutory powers only when necessary. The Bank does not perform its own bank examinations, but banks are required to have their annual accounts audited by an independent qualified auditor. The Bank relies on detailed monthly balance sheet returns filed regularly by banking institutions. The Bank examines these returns to gain an up-to-date picture of the health of the banking institutions. The returns include such characteristics as the banks' loan concentration in certain areas, their income, their key ratios covering capital adequacy, and their liquidity. The Bank meets with bank managers on a regular basis to discuss the information revealed by the returns, review or revise guidelines, and generally assess the banks' ability to meet the banks' objectives and continue as an authorized financial institution. The Bank then treats each bank problem individually on a case-by-case basis and does not set specific standards for all institutions.

Despite the informal nature of the relationship between the Bank and the banking institutions it oversees, the Bank has substantial discretionary powers. These powers include the ability to (1) revoke an institution's authorization if it acts in an imprudent manner and (2) give "directions" to the institution "to take certain steps or to refrain from adopting or pursuing a particular course of action or to restrict the scope of business in a particular way."

Italy

The two main bank regulators in Italy are the Interministerial Credit Committee and the Bank of Italy. The Governor of the Bank of Italy is not a member of the Committee but is entitled to attend its meetings, thus providing a link between the political and regulatory banking functions. The Committee establishes monetary, financial, and foreign exchange policy and promulgates regulations in instructions to the Bank of Italy. The Bank of Italy essentially serves as the executive arm of the Committee along with having its distinct duties, including purchasing

government securities, issuing currency, and managing and implementing monetary policy.

The Bank of Italy uses the Interbank Deposit Protection Fund not just to pay depositors in case of bank failure but also to protect the banking system from facing such a situation. Bank admission to the Interbank Deposit Protection Fund is subject to compliance with a number of balance sheet ratios (see chap. 2).

These restrictions are meant to (1) reduce the risk of heavy reliance on the fund in times of crisis, (2) facilitate the Bank of Italy's monitoring function, and (3) apply early solutions should problems arise. The Bank of Italy regularly collects data on bank ratios and liquidity thresholds, along with other information about the banks' operations.

Japan

In Japan, the Ministry of Finance has exclusive power over the banking system. While the Bank of Japan is not officially a part of the government, the Bank acts as an administrative extension of the Ministry. The Ministry can issue directives and give supervisory orders to the Bank, appoint and dismiss Bank officers, fix the amount of outstanding bank notes, and approve all changes in reserve requirements. The Ministry consists of seven bureaus, of which the Banking Bureau has the most influence over the banking system.

The Ministry of Finance uses an unofficial supervisory method, known as "administrative guidance," which involves issuing verbal or written directives to individual banking institutions. Although these directives are not legally binding, institutions face possible negative consequences in other unrelated activities under the Ministry's purview if they fail to comply. For example, the Ministry could later deny an uncooperative bank's application to open a new branch.

Japanese banking law, as revised in 1981, provides the Ministry of Finance unlimited power to obtain information via on-site examinations of banks' financial reports. The Ministry also approves all bank mergers and acquisitions and virtually any other changes a bank wishes to make in running its business.

The Bank of Japan, in coordination with the Ministry of Finance, supervises various parts of the banking system. The Bank requires institutions to file periodic financial reports and to facilitate periodic on-site examinations. The Bank also uses what it calls "window guidance" to

control the amount of additional credit offered by banks. Through daily discussions with bank managers, the Bank advises each bank on the amount of new lending it feels is appropriate.

Canada

Regulation of financial institutions in Canada has recently undergone a major reorganization. Traditionally, Canadian bank regulators had preferred to rely on the honor system rather than on closely supervising the banking community. However, due to bank difficulties in the mid-1980s (see chap. 4), a system of stricter supervision has been instituted.

The newly created Office of the Superintendent of Financial Institutions[3] supervises all federally chartered financial institutions. Although the Bank of Canada has no official, direct, supervisory role, the Governor of the Bank is a member of a new consultative committee which also includes the Superintendent of Financial Institutions, the Chairman of the Canada Deposit Insurance Corporation, and the Deputy Minister of Finance. According to the Committee rules, the Bank of Canada will be able to consult on "issues of prudential regulation; the practices and condition of individual institutions; and the coordination of action when solvency comes into question." Another committee, composed of nongovernment specialists in law, accounting, and auditing, will assist the Superintendent in monitoring new developments in the financial area and thereby help to avoid potential bank difficulties.

Bank regulators in Canada have the power to examine and audit financial institutions. Canada is developing and implementing a new bank examination system whereby the Office of the Superintendent of Financial Institutions will carry out examinations at the financial institutions. These on-site examinations will assess the institutions' risk profile by (1) reviewing and analyzing reports by shareholders' auditors and internal auditors, (2) reviewing the minutes of meetings of boards of directors, and (3) assessing the quality and valuation of selected risk assets. Meetings will then be held with bank managers to discuss the findings of the examinations.

Canadian bank regulators apply general prudential lending guidelines rather than statutory limitations or legislatively mandated thresholds. These prudential lending limits are merely guidelines with which banks

[3]As part of the ongoing reform of Canadian banking supervision and regulation begun in the late 1980s, the Office of the Superintendent of Financial Institutions was created through the merger of the Office of the Inspector General of Banks and the Superintendent of Insurance.

need not necessarily comply. They suggest, for example, that banks not make excessively large loans and that they limit their exposure to any one client.

Other Factors That Protect Deposits

Regulators we interviewed highlighted several other factors they believe contribute to the safety and soundness of their banking systems. In a number of countries we reviewed, banks have established close ties with their customers both by maintaining long-term relationships and, in some cases, by owning shares in the companies they service. Regulators believe such relationships increase the incentive for both the bank and its customers to preserve the soundness of the bank.

Regulators also identified the ability of banks to diversify their risk as important to the health of the banking system. This diversification can involve offering nonbanking services, such as securities underwriting and insurance, and operating nationwide rather than in restricted geographical areas. In addition, regulators maintained that their concentrated banking systems (fewer and larger banks) facilitate close supervision.

Strong Shareholder Base and Long-Term Customer Relationships

Banks in Germany, Japan, and, to a lesser extent, France, hold equity shares in the private companies they service. They believe these holdings not only help raise their capital base but also help increase the information flow between lenders and borrowers and create an incentive on both sides to ensure the other's safety and soundness. The downside is the risk that companies in which banks have substantial shareholdings could suffer from an economic downturn. However, the banks sometimes have a fair amount of influence over the private firms' business decisions.

German banks are known for their shareholdings in private firms. Germany's three biggest banks, Deutsche Bank, Dresdner Bank, and Commerzbank, have substantial holdings in the top German companies. Deutsche Bank, for example, has holdings in Daimler Benz (28 percent) Philipp Holzmann (30 percent), and Sudzucker (23 percent).[4] In addition, these banks have several seats on the supervisory boards of Germany's biggest firms as well as holdings in one another. In fact, the power of German banks goes beyond simply owning shares in private companies.

[4] The Economist, August 4, 1990, p. 61.

The law known as "depotstimmrecht" allows banks to vote on behalf of other shareholders at annual general meetings.

In part due to their shareholdings, and in part due to tradition, German banks have established long-term relationships with their customers which they believe allows them to better evaluate credit risk. Germany's "hausbank" system permits one bank to provide most of the deposit-lending and investment banking a company needs. Many bank clients may be shareholders in the bank or the bank may own a share in the customer. German bankers believe that this interdependence between banks and industry means that both sides of the transaction have a vested interest in preserving the soundness of the bank. One regulator admitted, however, that banks could also be vulnerable to the economic problems of such companies. On the other hand, a bank in difficulty is not prevented by law from obtaining a loan from one of its nonbank shareholders.

Risk assessment in Japan has traditionally relied on long-term customer/banker relationships and on industry groups known as "keiretsu." These groups, in which the large city banks play a major role, provide mutual support in financial, service, and product development. Reciprocal shareholding exists among member firms. Information-sharing and disclosure allows banks to participate in the risk and ensures the long-term stable economic performance of their members instead of placing emphasis on achieving high, short-term profits.

French banks have been increasing their equity shareholdings in industrial companies, particularly since the 1987 stock market crisis. These banks have been able to raise their capital base as the French stock market recovered in 1988 and 1989.

Officials from the Bank of France stated that French banks generally have the advantage of a strong shareholder base because they are either state owned or are subsidiaries of large international banks, industrial corporations, or holding companies. The officials maintained that the Bank of France and the Banking Commission closely monitor the identity and controlling interests of all bank shareholders; banks must inform the Commission of major changes in their shareholders. The Commission may require a bank to increase its capital to offset the weakness of a shareholder or, in the worst case, may withdraw the bank's charter. Bank regulators have access to the financial records of industrial companies that own a bank.

Diversification of Risk and Concentration of Industry

In the opinion of their national regulators, French, German, and Italian banks that operate as universal banks are able to lessen their risk of exposure through their ability to offer diversified services. There is no separation between commercial and investment banking as occurs in the United States and Japan. Both banking and nonbanking activities, such as securities underwriting, are performed by banks. This lack of separation between commercial and investment banking also occurs in the United Kingdom, although deposit-taking institutions usually offer securities-related activities through subsidiaries of the bank. There are no geographic limitations, since banks generally operate nationwide and can open branches or offer services anywhere within the country's borders. Insurance can also be offered by the bank, although in France, Germany, and the United Kingdom this offering is done indirectly through a subsidiary of the bank.

A French central bank official told us that French regulators and banks follow the philosophy that "bad results in one region or one product line are likely to be matched by better results elsewhere. The profit pattern over the years is smoothed, and the likelihood of failure diminished."

German bank regulators believe that their banks do not face a potential for incurring prohibitive loss despite the banks' exposure to the market risk inherent in conducting securities-related activities. A Bundesbank official explained that a German bank must consider the financial health of the entire bank when dealing in securities. Therefore, he believed the bank would likely be more cautious and conservative than an entity such as a U.S. investment bank, whose sole livelihood is purely dependent on investment banking. German bank regulators maintain they treat their securities activities as long-term investments. They believe that U.S. banks look only for fast turnover and short-term profit.

Italian bank regulators consider their universal banking system to be important to their ability to compete internationally as financial markets become increasingly global. Their larger banks can underwrite securities issues through merchant bank subsidiaries. Italian regulators believe this structure enables banks to offer a variety of financial services and also allows them to choose to specialize in certain financial products.

Foreign bank regulators we interviewed believe that effective regulatory oversight is aided by the relatively concentrated nature of their banking systems, which have far fewer commercial banks than does the United

States.[5] Statistics from the last 5 years show that three of the countries, France, Japan, and Canada, had less than 500 commercial banks, while the United Kingdom had just over 500. Italy had closer to 1,000 commercial banks, but a majority of the total bank assets were held in the top 25 banks. At the beginning of 1989, Germany had approximately 4,400 commercial banks, including 1,200 small banks with a business volume of less than $28.4 million (based on an exchange rate of 1.76 deutsche marks to the dollar).

[5] According to the Federal Deposit Insurance Corporation, as of June 30, 1990, there were approximately 12,800 commercial banks in the United States.

How Cases of Bank Failures Were Resolved

All of the countries we surveyed, except Japan, have experienced some type of bank failure, both before and after they implemented their current deposit protection systems. Several of these systems were created in response to major banking crises. Bank failures that occurred within the past 15 years were relatively few in number and involved smaller institutions. Most countries we reviewed have no official policy that some banks are "too big to fail,"[1] so that most failures were handled by the deposit protection systems without industry or government intervention. However, in reality, some exceptions have been made to protect the overall banking system, both internationally and domestically.

Germany

In 1974, the Bankhaus I.D. Herstaat failed. At that time, it was one of the largest privately owned banks in Germany. The bank was reported to have experienced large losses in the foreign exchange markets and sought assistance from the Bundesbank. As a result of poor record-keeping at Herstaat, it was virtually impossible to determine the bank's actual losses. The Bundesbank closed Herstaat in June of the same year.

Following the closing of the Herstaat bank, Germany's commercial banks set up a fund to pay off the banks' small depositors. The remaining creditors subsequently approved a plan funded by Germany's commercial banks that allowed German banks to receive 45 percent of their claims, foreign banks 55 percent of their claims, and smaller creditors 65 percent of their claims.

Approximately 15 banks have failed since the Herstaat failure. According to officials that administer the Deposit Protection Fund, only approximately $100 million (based on an exchange rate of 2.43 deutsche marks to the dollar) has been paid out to reimburse depositors of these banks, representing a small proportion of the overall banking system.

As a result of the Herstaat failure, the German deposit protection system was reformed, and bank failures are now handled in the following manner:

If a German bank is reported by the bank's auditors to be having difficulties, the Federal Banking Supervisory Office notifies the bank and informs it of the steps needed to resolve the problems. If these problems

[1] "Too big to fail" is a term commonly used within the banking community that essentially says that the government will not allow very large banks to fail since such a failure could erode confidence in, and thereby damage, the entire banking system.

cannot be resolved, the Supervisory Office closes the bank and declares a moratorium period. The bank uses this moratorium period to determine if there are any unexplored avenues that could prevent its closure. If the moratorium does not result in a solution, the bank is declared insolvent by the Supervisory Office and is forced to file for bankruptcy protection. After bankruptcy is filed, the Federal Association of German Banks works out a plan to pay protected depositors.

According to officials representing the Bundesbank, the Bundesbank does not function as a lender of last resort. The German government, via the Bundesbank, does not officially advocate a policy of "too big to fail." The government emphasizes the fact that it is the responsibility of the banking industry to resolve its own problems and to advocate sound business practices that minimize the likelihood of a banking crisis. German banking officials endorse strong supervision and stringent regulatory requirements to make failure of one of the large German banks highly unlikely.

The unusual handling of the Schroder, Munchmeyer, Hengst & Co. (SMH) failure in 1983 illustrates, however, that the Germans are serious about maintaining international confidence in their banking system and, if necessary, will go to special lengths to preserve this confidence.

The SMH bank, which had a subsidiary in Luxembourg, was overly indebted and on the verge of failure. If SMH had been allowed to fail, the effect on the Luxembourg banking system could have been disastrous. Such a failure would have seriously affected international confidence in its banking system. The German Federal Banking Supervisory Office and the Bundesbank established a cooperative effort among all segments of the German banking system to support the SMH. This effort was ultimately successful, and the bank was eventually reopened, although a portion of its assets was sold to a British bank. Though several German banks and the Federal Association of German Banks did suffer considerable losses, no foreign banks, particularly in Luxembourg, took losses. As a result, international confidence in the German banking system was actually strengthened.

France

The bailout of the Al Saudi Banque, S.A., provides an interesting example of how the Bank of France can use section 52 of the Banking Law of 1984 to rescue problem banks.

The Al Saudi Banque was formed in Paris in 1976 by investors from the Middle East. Its business was mainly related to external markets, and it ranked 20th among foreign banks established in France. The Governor of the Bank of France used section 52 powers to save the bank from insolvency. In 1988, the French government formally announced plans to rescue the Al Saudi Banque.

Especially noteworthy was the fact that the French government extended coverage to foreign currencies, although such deposits are not covered under its deposit protection plan. In fact, all foreign depositors were reimbursed in full for their deposits. The French central bank endorsed this policy as a means of maintaining confidence in the French banking system and supporting the promotion of Paris as an international financial center.

Most of Al Saudi's shareholders, many of which were foreign, refused to contribute funds toward the bank. Several French corporations offered to buy the institution to increase their presence in the Middle East, but a $33.6-million gap (based on an exchange rate of 5.96 francs to the dollar) remained to rescue the bank. The French financial community, including commercial banks and mutual savings associations, provided the needed funds. Financial institutions with deposits in Al Saudi, such as money market funds, had to contribute more than nondepositors.

Al Saudi's assets and liabilities were transferred to new owners, including France's Banque Indosuez, which supplied 35 percent of the new bank's capital, and Indosuez's Middle Eastern affiliate, the Hariri group of Saudi Arabia, and Thomson, a state-owned electronics firm.

Despite the bank's rescue, some domestic depositors did lose money. French banking officials hoped that this loss would instill a certain degree of market discipline among depositors in small banks.

The Al Saudi case is the only situation in which section 52 has been invoked. French regulators told us that they follow no standard way of invoking section 52. Instead, they strive to imply some uncertainty in how much creditors will lose if a bank fails, as a means of encouraging investors to use good judgment in investing their funds.

In 1989, three Lebanese-owned banks in France failed and went through the loss-sharing agreement procedure. These banks' deposits were covered only up to the extent of the agreement. Since the end of the 1970s, there have been about 12 other bank failures, and depositors of these

banks did lose money. However, these banks were not very large, and total losses to creditors were of a relatively small amount.

The United Kingdom

In 1984, the Bank of England came to the assistance of Johnson Matthey Bankers, who were suffering a loan loss of $337 million (based on an exchange rate of 1.34 dollars to the pound). This loss could have had detrimental effects on the gold market, since Johnson Matthey conducted substantial bullion business as a member of the London Bullion Market. The Bank wanted to avoid damaging London's reputation as a world leader in the international gold market. An emergency fund was financed equally between the central bank and a group of U.K. clearing banks and members of the London gold market to rescue the bank. Losses turned out to be about $57 million, which was smaller than the Bank of England had expected.

According to an official at the Deposit Protection Board, there have been about 14 bank failures in the United Kingdom since the early 1980s, requiring a total payout of approximately $9.7 million (based on an average exchange rate of 1.29 dollars to the pound). Most of these banks failed as a result of a combination of poor management and inadequate record-keeping. No exceptions were made in deposit protection. The Deposit Protection Board honored insured deposits exclusively.

In the United Kingdom, when a bank is declared insolvent the Bank of England provides the Board with information to identify those depositors eligible for protection. The insolvent bank files for bankruptcy, and the court appoints a liquidator to sell assets and pay creditors. After the Bank of England's supervisors inform the Deposit Protection Board, a creditors' meeting is called, with the Board representing the bank's depositors and other creditors. There are no advance cash payments to creditors from the protection fund, and the Board does have some authority in determining how assets are sold and how the business of the bank is terminated.

According to an official at the Deposit Protection Board, the Bank of England does not officially acknowledge the concept of "too big to fail." Yet, according to this same official, if necessary, the British Parliament would probably intervene to prevent or resolve a major banking crisis.

Italy

In 1982, the Bank of Italy was forced to take steps to prevent the failure of the Banco Ambrosiano. The Bank of Italy discovered a large irregularity in the financial records of the bank's foreign subsidiaries, presenting potential losses. In addition, a scandal was uncovered concerning some questionable loans made to several foreign holding companies by the bank's Luxembourg subsidiaries.

The Bank of Italy eventually decided that it was not responsible for bailing out the bank's foreign holding companies, including the bank's Luxembourg subsidiary. The Banco Ambrosiano was forced into liquidation; bank regulators considered this the most practical solution. An agreement was reached with the bank's creditors after 2 years. Overall, creditors received about 67 percent of their claims. The Banco Ambrosiano crisis lead Italy to establish the Interbank Deposit Protection Fund.

The Deposit Protection Fund is currently undergoing its first test, with the Cassa di Prato case. In 1987, the Cassa di Prato Savings Bank was taken over by the Bank of Italy because the savings bank ran up $1 billion (based on exchange rate of 1,297 lire to the dollar) in bad debts. After the public discovered the bank was having problems, a depositor run on the bank substantially reduced its deposit base.

Regulators have tried several methods of saving the bank, ranging from management changes to capital infusions by other savings banks and by the Protection Fund itself. Managers of the Protection Fund had proposed a rescue plan that included capital infusions from the Protection Fund, local savings banks, and six national banks. However, this plan was never implemented amid allegations of fraudulent behavior at Cassa di Prato.

The Cassa di Prato case is still being discussed by the Bank of Italy and the Protection Fund. The outcome of this case may have an important impact on how any future bank failure in Italy may be handled.

Canada

In 1985 two Canadian banks, Canadian Commercial Bank (CCB) and the Northland Bank of Calgary, failed. These two failures drew attention to the insufficient state of the Canada Deposit Insurance Corporation fund, which had a deficit of $670 million (based on an exchange rate of 1.29 Canadian dollars to the dollar) at year-end 1984. The Canada Deposit Insurance Corporation fund was already depleted from the failures of numerous trust and mortgage loan companies, which are similar to U.S.

savings and loan associations. As a result of these failures, the Canadian government formed the Estey Commission to investigate the causes of the failures, how bank regulators responded, and any overall shortcomings in the regulatory framework that may have contributed to the banks' downfall.

The CCB failure can be attributed to a combination of several factors; however, the downfall can be originally traced to an attempt to expand the bank beyond the regional scale to a national enterprise. To achieve this goal, CCB attempted to capitalize on a large boom in the real estate and energy industries in Alberta and British Columbia. As a result of a 1981 recession in western Canada, many of these loans became bad assets. This event is considered to be the prime cause of the failure of this bank.

The Canadian government announced a bailout plan of $200 million, with $57 million coming from the Canada Deposit Insurance Corporation and $140 million coming from the Alberta and federal governments along with six commercial banks. The plan was originally considered necessary to prevent a general financial crisis within the Canadian banking system. The government stopped the bailout of CCB after a further examination of CCB's assets. This examination concluded that around 40 percent of the bank's loans were highly risky and should never have been undertaken. Canadian banking officials believed that if the bank were saved, the remaining assets in the bank's portfolio had a high probability of being unrealizable.

During the CCB crisis the government gained control of the Northland Bank of Calgary. Many of Northland's problems were attributed to a lack of senior management with practical banking experience. Due to poor management decisions, the bank made many unadvisable loans, which contributed to the bank's demise. Additionally, many of the bank's accounting practices were questionable and led to overvaluing many of the assets on the bank's books. In the early 1980s, two of the bank's directors reported the condition of the bank to the board of directors, but no action was taken to resolve these problems. The board of directors' inaction and poor decision-making were the primary causes of the bank's failure.

The attempted bailouts of CCB and Northland cost the central bank $1.4 billion in short-term loans that, as a result of the cessation of the banks' operations, were never repaid. The Canadian government

granted uninsured depositors coverage, at a cost of $400 million to the Canadian government.

Several other Canadian banks experienced difficulties soon after these failures but were never forced to liquidate. These problems were dealt with through supervisory-assisted mergers with other institutions.

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