BANKING REGULATION AND DEPOSIT INSURANCE: LEGAL AND COMPARATIVE PERSPECTIVE

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DECLARATION OF ORIGINALITY

I confirm that this submission is my own work. To the best of my knowledge, it contains no other material previously written or published by another person. All sources used in this thesis have been clearly referenced in both the text and the bibliography.

SIGNED: 

OLADAPO OLUMIDE OLANIPEKUN
ABSTRACT

A major point of debate in most financial systems is the relevance, form and scope of regulatory intervention, particularly on the trade-off between the benefits and costs of regulation. Deposit insurance is a prominent part of most modern regulatory financial safety nets. As with banking regulation in general, it is still debatable whether deposit insurance is necessary in all cases. While most deposit insurance schemes have the joint aims of financial stability and depositor protection, there are inherent difficulties posed by the introduction of such schemes, in particular the moral hazard and agency problems. For the purpose of this thesis, these difficulties have been generally termed as the deposit insurance problem.

A number of issues arise for consideration if deposit insurance is to be provided. The thesis argues that the optimal design of deposit insurance schemes is dependent on three factors: an effective system of bank supervision and regulation; identification and prioritisation of the policy objectives which the scheme is to achieve; and adoption of incentive-compatible systems in line with sound practice guides but tailored to country-specific circumstances.

There is generally no fixed or absolute model for all states. The thesis involves an assessment of deposit insurance schemes in the United Kingdom, the United States and Nigeria. An assessment of these schemes, as well as international and regional developments, will show that cross-country differences should play an important factor in the adoption or reform of deposit insurance schemes, but that there are
common concerns for policymakers whatever the distinctiveness of local circumstances.

The challenge for policymakers is how to achieve a fair balance between the protection of depositors and banking system stability on the one hand and minimizing elements of the deposit insurance problem on the other hand. The aim is to recommend a future course of reform that includes a general support model and specific recommendations for the jurisdictions that are examined.
DEDICATION

I dedicate this thesis to the Almighty God, the fountain of all knowledge and wisdom, and with whom all things are possible.
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CHAPTER 1

GENERAL INTRODUCTION

1.0 Banking Regulation and Deposit Insurance: Overview

The focal point of this thesis is an analysis of the concept and practice of deposit insurance¹ within the larger framework of banking regulation.²

A recent wave of financial crises³ in most parts of the world has resulted in a two-fold concern for governments and banking authorities. First, in order to engender financial and economic stability,⁴ economies all over the world have come up with various financial safety net designs.⁵ A major function of financial safety-nets is to ensure the

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¹ Deposit Insurance is also referred to as ‘deposit protection’ and ‘deposit guarantee’ schemes. These phrases are generally used interchangeably to denote an indemnification program to protect depositors against loss, up to a specified maximum, if their bank fails or defaults; BA Garner (ed.) Black’s Law Dictionary (8th edn Thomson West, St. Paul, 2004) 816.

² For the purpose of this thesis the term ‘bank’ will be used broadly to connote any financial intermediary that accepts deposits from the general public and extends loans or other credit facilities to individuals or businesses. Because sector integration has blurred the distinction between banks and other forms of financial institutions, the terms ‘bank’ and ‘financial institution’ are used interchangeably in this thesis. On the definition of the term ‘banking regulation’ (and the related concept of banking supervision), see Chapter 2, para. 2.1.1.

³ Financial crisis has been defined as ‘a disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities’; FS Mishkin. Anatomy of a Financial Crisis (NBER Working Paper No. 3932, 1992). Historically, the development of financial markets has entailed crisis and collapse; C. Kindleberger and R. Aliber, Manias, Panics and Crashes: A History of Financial Crisis, (5th edn, Palgrave Macmillan, New York, 2005).


soundness and safety of the financial system by detecting and reducing risks that have the potential to undermine financial stability. Financial safety nets also aim to promote financial stability by enhancing and sustaining public confidence in the system.\(^6\)

Apart from financial stability concerns, consumer protection is the other aspect of the two-fold concern.\(^7\) A principal feature of financial safety net design is the Deposit Insurance Scheme (DIS). Bank deposit insurance schemes have evolved out of the need to protect depositors, particularly the uninformed small depositors, from the risk of loss; and to also protect the banking system from instability occasioned by runs and general loss of confidence.

The banking system has been singled out for protection because of the special role that banks play in the economy.\(^8\) In spite of the various safety net devices that have been adopted in most countries, instances of bank instability and failure continue to occur. Some of these failures were precipitated by regulatory failure thus prompting wide-ranging debates on how best to adapt regulatory devices, including deposit insurance, to ensure stability and minimize the effects of failure.\(^9\)

\(^6\) Interrelationship issues between financial safety-net participants are discussed in Chapter 4.


\(^8\) See Chapter 2, para.2.1.2.

\(^9\) For example, in the UK, the failure of Northern Rock has led to ongoing efforts to comprehensively reform the regulatory and deposit protection systems. See Chapter 5, para. 5.1.3.1.
Globally, there has been a growing concern about the structure and fitness for purpose of financial regulation in individual countries. This concern continues to grow within the context of recent developments, which include globalization, the increased use of conglomerate structures and the gradual disappearance of demarcation lines between traditional financial sectors, services and products. These developments make it increasingly difficult for regulatory authorities to monitor and evaluate risks as financial institutions operate in more complex structures and the geographical spread of their activities cuts across several jurisdictions.

A considerable debate on restructuring financial regulation has focussed on deposit insurance reform. There are approximately one hundred deposit insurance systems in operation around the world, and while most of these systems are still evolving, even the oldest systems are continuously undergoing reform. This is due not only to the recent developments outlined above, but also to the problem of moral hazard, which is considered inherent to deposit insurance.

Although there appears to be a presumption that the adoption of deposit insurance represents the hallmark of regulatory best-practices, the paradox of deposit insurance is that the attempt to make banks safer by protecting them against depositor runs may create adverse incentives which will weaken them and increase the probability of

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10 For a discussion on the international debate over regulatory structure and the varying responses to regulation across jurisdictions, see DW Arner and J Lin Financial Regulation: A Guide to Structural Reform (Sweet & Maxwell Asia, Hong Kong, 2003).

11 There are 99 countries that currently have some form of deposit protection scheme in place, while 20 other countries are considering or planning to introduce their own schemes. http://www.fsb.org/Taskforces/Countries/20With/20Deposit/20Insurance/20System/1st_of_countries_with_a_DIN_MCC_1_May08_Final.pdf, accessed 30 May 2008.
failure. According to William Seidman, a former Chairman of the FDIC in the United States:

Deposit insurance is like a nuclear power plant. Operated properly, it is beneficial; but only appropriate safety precautions can keep it from going out of control. Once out of control, it can blow up with great damage to the entire country.\(^\text{13}\)

This underscores the sensitive nature of deposit insurance adoption and design. To prevent deposit insurance from creating adverse effects, a well considered planning and implementation process is imperative. The major consideration for policymakers is to ensure that the various features of the scheme create the right incentives for stakeholders to minimize risk.

1.1 Scope Of The Research

The principal theme of the research is the optimal design and implementation of deposit insurance schemes based on three essential factors. These are: an effective system of bank supervision and regulation; proper identification and prioritization of policy objectives; and adoption of incentive-compatible mechanisms in line with sound practice guides but tailored to suit country-specific factors.

The thesis consists of seven chapters. Chapter one entails a general introduction to the research. It provides a broad overview to the thesis and also includes a literature


review. The chapter explains the aims of the research and also provides a summary of the seven chapters in the thesis.

The second chapter examines the theory of financial regulation. The aim is to provide a theoretical background for the central focus of the thesis which is deposit insurance. Deposit insurance schemes do not exist in a vacuum as they usually form part of a financial safety net. As such, it is important to understand the rationale for the existence of financial safety nets. Deposit insurance reform must also be considered within the context of the overall regulatory system. This involves an analysis of the main aims and objectives of financial regulation. The core terms are defined and differentiated with an ultimate aim of establishing the justification for regulation in the sector. The main regulatory tools and devices are examined. The chapter concludes with an analysis of the role of deposit insurance within the context of financial regulation.

In Chapter three, the concept of deposit insurance is examined. The chapter explores the historical evolution of schemes to protect bank depositors in various jurisdictions across the world. The chapter aims to establish the basic theory and rationale for deposit insurance schemes. Although other objectives are identified, the two basic public policy objectives for the adoption of deposit insurance schemes, which are financial stability and deposit protection, are considered in detail. While it is argued that consumer protection concerns should take priority where deposit insurance is concerned, it is concluded that both are inextricably linked and thus the achievement of both aims is not mutually exclusive.
The deposit insurance problem is also examined in Chapter three. This centres on the moral hazard problem, on which considerable emphasis has been placed in the academic literature and policy debates. The various means by which moral hazard can be curbed are examined, and the advantages and disadvantages of each of them are considered. While it is argued that the introduction of risk-based deposit insurance premium and prompt corrective action mechanisms is the most effective way to minimize the effects of the deposit insurance problem, it is concluded that an optimal system of deposit insurance is hinged on the efficiency of the overall banking regulatory framework, and appropriate design, structure and implementation process.

Chapter four of the thesis involves an examination of the basic design and structural considerations in the adoption or reform of deposit insurance schemes. The design features considered include institutional and organizational structure; ownership; funding; mandates and powers; deposit insurance coverage; membership; interrelationship among financial safety-net participants; and the very topical issue of bank failure resolution.

The objective in Chapter four is to explore the various options that are open to policy makers and consequently identify a set of sound practices to serve as a guide. The guiding principle is the need to tailor deposit insurance schemes to suit specific public-policy objectives and the need to adopt an incentive-compatible design to minimize the risks associated with the deposit insurance problem. This chapter involves a constant reference to and an analysis of the report of the Financial Stability Forum’s Working Group on Deposit Insurance.
Chapter four builds on the recommendations of the FSF guidance paper by attempting, where possible, to resolve the trade-offs identified in the report. The issues are also considered within the perspective of recent academic literature and policy guidelines on deposit insurance. Although a set of sound practices are identified, it is concluded that there is no ‘one-size-fits-all’ approach to deposit insurance design. Deposit insurance should be designed to suit institutional, legal, economic and other country-specific factors. The scheme should also fit into and complement the general supervisory framework.

In Chapter five, the thesis puts the issues discussed in Chapter four into context by examining the design and operation of deposit insurance schemes in two key jurisdictions. The chapter involves a critical appraisal of the operation of deposit insurance schemes in the United Kingdom and the United States. While the scheme in the United States represents a quintessential risk-minimizing scheme, the UK scheme is a typical pay-box scheme. The analysis is carried out against the backdrop of the overall regulatory framework in these countries. In particular, the UK Compensation scheme in the context of the recent Northern Rock crisis and the consequent regulatory response.

In evaluating the schemes in both jurisdictions, it is observed that the prime objective of the UK compensation scheme is consumer protection while the main policy objective for the FDIC is financial stability. The chapter identifies the contrast in the mechanisms that have been employed in both jurisdictions to deal with the deposit insurance problem. While the UK scheme previously relied mainly on co-insurance, risk-based deposit insurance premium and prompt corrective action mechanisms have been adopted in the United States. It is argued that the contrast in approach
underscores the difficulty in developing a set of best practices to have general application to all jurisdictions.

In the latter part of Chapter five, the effect of globalization and recent international developments on deposit insurance is considered. Globalization and sector-integration in financial markets has led to increased efforts at international co-operation and harmonization of financial supervision. The chapter considers the feasibility of extending such co-operation/harmonization to deposit insurance. It is argued that certain factors, particularly differences in regulatory culture, make this impossible. It is also submitted that such international co-operation/harmonization might be easier to achieve on a regional as opposed to an international level. The EU Deposit Guarantee Directive, which was made possible by the existence of the EU legislative framework, is used to illustrate this point.

Chapter six entails a critical review of the establishment and performance of the deposit insurance scheme in Nigeria. Nigeria is used as a model for a developing country. The design and implementation of deposit insurance schemes poses a peculiar challenge for developing countries, as the deposit insurance problem has to be tackled along with the myriad of economic, social, legal, infrastructural and other challenges.

The chapter examines the history of banking and banking regulation in Nigeria as well as the framework for the regulation of the Nigerian financial market. The chapter identifies aspects of the deposit insurance problem within the Nigerian context then takes a critical look at the design and operation of the deposit insurance scheme, questioning the footing on which some of the design features are based.
Chapter six also considers recent reform in Nigeria and argues that while the reform represents a step in the right direction, further improvements are needed for the Nigerian scheme to attain its stated objectives. With the aid of lessons drawn from analysis of the UK and US schemes in Chapter five, sound practice principles enunciated in Chapter four, and experience of about twenty years of deposit insurance in Nigeria itself, the chapter concludes with specific proposals for further reform of the Nigerian deposit insurance scheme.

In contrast to the analysis of the UK and US deposit protection schemes in Chapter five, a disproportionate part of this thesis has been devoted to the Nigerian scheme in Chapter six. This is intentionally so, because of the dearth of relevant economic and legal literature providing a critical analysis of the operation of deposit insurance schemes in developing countries in general, and Nigeria in particular.

Chapter seven summarizes and concludes the thesis. The chapter links up all the arguments and major conclusions in Chapters two to six. A general framework of sound principles and guidelines is extracted from the thesis, with the aim being to serve as a guide to countries wishing to adopt deposit insurance and those wishing to reform existing schemes. This is necessary because there are common concerns for policy makers regardless of the distinctiveness of local circumstances.

The concluding chapter also summarizes the recommendations for reform of the deposit protection schemes in the United Kingdom, the United States and Nigeria, based on the appraisal of the schemes in Chapters five and six.
A major theme throughout the thesis is that deposit insurance can only work if the appropriate institutional and legal infrastructures are first put in place and its design must reflect the historical background and environmental peculiarity of the particular country. Effective and efficient co-ordination of the activities of the safety-net participants is pertinent, particularly the support role of the lender of last resort. A continuous evaluation and improvement process is imperative in reshaping the form and future of banking regulation in general and deposit insurance in particular.

1.2 Methodology

The research is based mainly on the analysis of primary and secondary sources. Primary sources examined include banking statutes and deposit insurance laws in various jurisdictions, particularly in the United Kingdom, United States and Nigeria. This research has also involved an examination of journal articles and newspaper publications, working papers, parliamentary hearings, conference proceedings, and reports of governmental and international agencies on banking regulation and deposit insurance.

Comparative studies of the deposit protection schemes in the United Kingdom, the United States and Nigeria have also been carried out to achieve the following aims:

1. To demonstrate how historical factors, policy objectives and country peculiarities shape the design and implementation of deposit insurance in different countries.

2. To demonstrate how the deposit insurance problem poses different challenges within different contracting environments.
3. To compare and contrast the schemes in order to glean any useful lessons, which may be adopted in other jurisdictions, particularly for Nigeria.

The analysis in this study is mainly theoretical and hypothetical; where relevant, I will refer to other empirical studies though no separate empirical study has been conducted for the purpose of this research. In analysing the main issues, the thesis applies a largely traditional legal review approach, with supporting historical and economical analysis of existing literature which cuts across several disciplines. Generally speaking, the thesis follows a mainly integrative approach to scholarly activity, with elements of discovery and application.

This research was concluded in July, 2008.

1.3 Literature Review

There has been extensive economic literature in recent years covering the field of deposit insurance. A bibliography published by the FDIC indicates more than seven hundred references of literature on deposit insurance, albeit for a period of ten years (1989 to 1999). It is not the intention in this thesis to review the entire literature in the field as this will be an impossible task. The review contained in the thesis is limited only to literature relating to general deposit insurance theory and policy, and

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14 See E Boyer ‘Scholarship Reconsidered: Priorities of the Professoriate’ A Special Report of the Carnegie Foundation for the Advancement of Teaching (Jossey-Bass, San Francisco, 1990). The report articulates the concept of scholarship activity, traditionally viewed as the scientific discovery of new knowledge, to include three other important aspects. These are the scholarship of integration, the scholarship of application, and the scholarship of teaching. Integration creates new knowledge by bringing together and interpreting divergent knowledge or existing research work, thus creating new insights and understanding. It means ‘interpretation, fitting one’s own research – or the research of others – into larger intellectual patterns.’

15 Application involves the use of knowledge in solving significant societal issues.

the design and implementation of deposit insurance schemes. The literature is also limited to the country schemes that are examined in the thesis.

Chapters two, three, and four contain a review of the relevant literature in the area of banking regulation in general, and deposit insurance in particular. This review is necessary in order to establish a theoretical framework for the thesis and also to establish the rationale for the existence of banking regulation and deposit insurance schemes. However, for the introductory purposes of this chapter, a brief review of significant developments in the literature is undertaken here.

The classic work of Diamond and Dybvig\textsuperscript{17} laid the foundation for the contemporary understanding of the function of financial intermediation. They illustrate how financial panics can occur when financial institutions issue short-term debts to finance illiquid long-term investments. The theory explains how customer runs on individual banks can result in contagion, which leads to systemic failure and the role of deposit insurance in preventing market failure. This theory also provides the foundation for the justification of deposit insurance in this thesis but the text goes further to explore other justifications and also it is argued that deposit insurance has become a political necessity.

The report of the FSF (Financial Stability Forum) Working Group on deposit insurance also forms an important part of deposit insurance literature. The FSF report proposes a general method for the benefit of countries considering the adoption or reform of an explicit, limited-coverage deposit insurance system. As observed earlier,

\footnote{\textsuperscript{17} D Diamond and P Dybvig, 'Bank Runs, Deposit Insurance and Liquidity' (1983) 91 \textit{Journal of Political Economy}, 401.}
this thesis builds on the FSF report by attempting to resolve the trade-offs identified in
the report and analysing the issues within country-specific contexts.

The works of Garcia,18 Ketcha19 and MacDonald20 have also considered design and
structural issues involved with deposit insurance systems. They also consider the
rationale for deposit insurance against the backdrop that it creates the risk of moral
hazard. This thesis differs to the extent that these issues are examined within country-
specific contexts and against the background of recent developments in the literature
and in the markets.

Kyei,21 Garcia22 and Hoelscher et al.23 have conducted a survey of the key
characteristics of deposit protection arrangements around the world. The statistical
data contained in these studies have been referred to in this text where relevant.

There are also general texts, which give an overview of banking regulation and
supervision. Some of these texts provide an overview of the structure and practice of
banking regulation in the countries that have been studied in this research while others
provide an international perspective. Such texts include the works of Blair et al.24

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18 G Garcia ‘Deposit Insurance: Obtaining the Benefits and Avoiding the Pitfalls’ (1996) IMF Working
Paper No.96/83.
No.7, 221.
No.99/54.
24 W Blair and others ‘Banking and Financial Services Regulation’ (Butterworths, London, 2002).
There are other texts that deal specifically with the subject of deposit insurance. These include the works of Campbell et al.,31 Campbell,32 Campbell and Cartwright,33 and Umoh.34

1.4 Remarks

Although there is continuing debate on the pros and cons of deposit insurance schemes, the increasing number of countries that have adopted one form of scheme or the other to protect bank depositors suggests that such schemes have come to stay as a feature of the financial safety-net. This has raised awareness on the need to appropriately design and structure such schemes for effectiveness and efficiency.

While it appears that the near inevitability of deposit insurance adoption has relegated deposit insurance theory to the background, with significant attention shifting to issues of design and structure, it should be noted that this shift in focus has mainly resulted from the emphasis that has been placed on the deposit insurance problem in

26 JR Macey and others Banking Law and Regulation (Aspen Law & Business, Gaithersburg, MD, 2001).
30 N Danjuma, N. The Banker’s Liability (Heinemann, Ibadan, 1993).
31 A Campbell and others Deposit Insurance (Palgrave Macmillan, New York, 2007).
academic theory. Thus the goal for policy-makers is to design deposit insurance schemes that will optimally minimize the deposit insurance problem.

Deposit insurance design throws up different challenges in different situations and as a result it is argued in this thesis that schemes should be tailored to suit specific policy objectives and country factors. There are also common concerns and it is hoped that the model of sound practices in this thesis will serve as a useful guide. Countries can also learn, not only from their own experience but from the experience of others, and thus it is also hoped that the country studies in this thesis serve as a useful tool for comparison.

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CHAPTER 2

BANK REGULATION: THEORY AND RATIONALE

2.0 Introduction

The global concern about the need for adequate regulation and supervision of financial institutions has been instigated by the experience of systemic failures leading to the collapse of the banking systems in many countries. The ongoing financial crisis, which is the worst since the great depression, is a reminder of the perennial problem of excessive risk-taking in banking, which has resulted in boom and bust cycles. These cycles have become more proximate, as the frequency, effects and costs of banking crisis continue to increase.

In the last two decades, financial crises have occurred in developed as well as in emerging economies. These crises have resulted in significant cost, not only to bank shareholders and depositors, but also to taxpayers. In some countries, the fiscal cost of bailing out the banking system has exceeded ten per cent of GDP. In the wake of the

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ongoing credit crisis, significant amounts have been committed to bailing out Northern Rock\(^4\) in the UK and Bear Stearns\(^5\) in the United States. With no immediate signs of the crises abating, it is likely that governments would have to keep providing significant support to financial markets to prevent systemic crisis.

Three main denominators are found in banking crises around the world: weak information and incentive structures; weak management and control systems within banks and poor regulation, monitoring and supervision.\(^6\) Thus national authorities continually aim to improve financial sector infrastructure, upgrade existing regulatory and supervisory frameworks, and promote sound macro policies as a means of reducing the likelihood and costs of financial crisis.\(^7\)

The foregoing notwithstanding, the trend towards economic liberalization across the globe has brought the issue of regulating financial markets to the fore in public and academic debate. To some, the continuous introduction and implementation of regulatory measures and policies at national and international levels is inimical to the spirit of liberalization, which is characterized by less government control. Banking system failures have been attributed to the effects of the various regulations that have been introduced.\(^8\) Traditionally, the banking system has been treated as an industry


\(^7\) Caprio (n6) 2.

having strong public policy implications. Thus, the need for financial regulation has been motivated and justified by the need to protect the investing and depositing public, instil confidence in the system and ensure financial and economic stability.

Existing theories have failed to provide a cogent argument for the role of regulation and they have not incorporated concepts of economic and social development that emphasise the importance of appropriately designing and tailoring regulatory models to the economy’s specific stage of development. In order to prevent regulatory failure resulting in financial crisis, it is important for policymakers to have a clear understanding of their own goals, the available economic resources and infrastructure, the legal system and the quality of human capital necessary for enforcement of regulatory requirements. Banking regulation has also drawn considerable attention because of recent industry changes in developing and developed economies. Such changes include globalization and sector integration, increased use of conglomerate structures, innovations in technology, and the development of new and more complex financial instruments and risk management practices. These revolutionary changes are bringing banks closer to their customers, changing the way financial transactions and banking operations are conducted, and expanding the variety of services that banks can provide. It is important that banking regulation is kept relevant and in line with its objectives in the light of these changes.9

This chapter examines the conceptual basis for bank regulation and supervision. Key theories and definitions are identified and clarified in order to ascertain the rationale for regulation. As a first step towards reform, it is important to consider why

regulation was introduced in the first place. Major regulatory devices and their respective functions will be considered. The import of this chapter is to provide the necessary background for the rest of the thesis, as deposit insurance schemes are often part of a larger and sometimes complex regulatory structure. A properly designed and implemented deposit insurance scheme should work to complement other components of the financial safety net.

2.1.0. Rationale for Financial Regulation

It is important to establish the justification for financial regulation. Given the arguments against regulatory intervention, it is imperative that policies, practice and structures are tailored to suit the guiding rationale. Whether or not regulation is appropriate in the financial and other public utility sectors has been and still remains very contentious. Baldwin and McCrudden observe:

"These bodies undertake important public functions but are constitutionally awkward because they combine powers that have traditionally been kept separate. They act on behalf of central government, yet they are not central departments of state. They expend considerable resources in deciding disputes between parties and in interpreting a particular body of law, yet differ from courts and tribunals. They enforce the law as well as interpret it. They employ a substantial number of specialist staff. They exercise continuing influence over a specific industry, trade or social practice. They constitute an identifiable species, yet they are the broader genus variously

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10 See para 2.1.1. for the definition of financial regulation.
referred to as quangos, fringe bodies, non-departmental public bodies or public corporations.¹¹

2.1.1. Regulation and Supervision: the Distinction

It is important to differentiate between financial regulation and supervision. These complementary concepts have generated considerable confusion in economic and legal writings.¹² This has resulted in further difficulty in attempting to develop an acceptable and coherent national and international policy, and justification for financial risk prevention and regulation in general.¹³

The need to differentiate between both terms is underscored by the fact that ‘...one of the important trends has been, and continues to be, a move away from regulation and towards supervision – a move, in other words, away from compliance with portfolio constraints, and toward an assessment of whether the overall management of a financial firm’s business is being prudently conducted.’¹⁴ The growing deregulation of most financial systems has been accompanied by an increase in prudential supervision and this has led to questions on whether or not deregulation is an illusion and whether ‘supervision’ is merely a euphemism for re-regulation.¹⁵ This issue has succinctly been addressed thus:

¹² Both terms are also used interchangeably in this thesis because of the inconsistency in the use of both words in the literature.
‘Continued deregulation of the banking industry, while both necessary and beneficial, increases the potential level of risk in banking operations. Nevertheless, deregulation is not incompatible with increased supervision. Rather, by introducing new risks and increasing those risks already present, deregulation will contribute to a need for increased supervision.\(^{16}\)

Regulation can be defined as the body of legal rules, administrative and prudential requirements put in place by financial authorities or market participants to limit or to absorb the effects of the risks assumed by financial institutions. Supervision, on the other hand, refers to the process of monitoring or reviewing the compliance of financial institutions with regulatory provisions or with more general standards of prudence in any particular market.\(^{17}\) Simply put, while regulation refers to the general body of legal and administrative rules or guidelines that must be complied with, supervision is the mechanism or process of ensuring compliance with the rules or guidelines and to ensure that banks do not behave imprudently. Supervision refers to a formal oversight with an emphasis on the way supervised institutions do business.\(^{18}\)

Banking supervision involves monitoring the financial condition of banks so as to promote sound and prudent operational practices and to engender public confidence in the sector. Supervision focuses on individual banks because the state of individual banks is symptomatic of the general state of the system. The objective of bank supervision is to protect depositors and avoid confidence crises or major capital


flight. Supervisory functions are vested in the Central Bank in most jurisdictions. With reference to the role of the US Federal Reserve System, supervision has been defined generally in terms of three main functions. These are:

- The establishment of safe and sound banking practices;
- The protection of consumers in financial transactions; and
- Ensuring stability in US financial markets by lending funds through its discount window.

The goal of these duties is to minimize risk in the banking system. It is important to note that the review function within supervision necessarily assumes the existence of some applicable regulatory provision while the control component within regulation implies the existence of an appropriate compliance mechanism.

Regulation and supervision can also be distinguished in terms of content as opposed to function. Some systems impose a degree of control and statutory direction while others allow a degree of flexibility and discretion to be exercised by the appropriate authority. While the United States, for example, operates a rules-based system, the United Kingdom follows a discretionary and judgement-based approach.

Supervision can also entail the review function of ensuring individual bank compliance with rules and prudent behaviour while regulation may refer to actions controlling the activities of banks. Financial regulation, in achieving its objectives, can be characterized as prescriptive and quantitative with an approach that is

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generally not flexible; for example, the prescribed amount of minimum risk based
capital to be maintained by deposit-taking financial institutions is a regulatory
requirement. Supervision is a qualitative process, which usually depends on the
judgement and approach of the supervisory agency. The role of regulators has been
compared to that of 'a flagman on the highway telling motorists when to stop and
when to go and in what circumstances they may use the highway...the bank examiner
is a backseat driver.'

Regulation can further be classified in terms of prudential and systemic regulation.
The purpose of the latter is to ensure safety and soundness in institutions for systemic
reasons. This is because the social costs of failure outweigh its private costs.
Prudential regulation, however, ensures financial safety and soundness, in line with
consumer protection practices. This is based on the premise that when an institution
fails, the consumer loses, even if there are no systemic consequences. Prudential
regulation focuses on the stability of the individual institution rather than the system
as a whole.

Although regulation and supervision are different concepts, in practice, the distinction
between regulation and supervision is often blurred not least because the two
functions are invariably performed by the same agency. Supervisors are often
assigned with rule-making powers for refining legislation through principles and
guidance. Regulation and supervision are complementary concepts. For regulation
to effectively achieve its goals there must be an efficient monitoring system which

22 E Patrikis 'Supervision and Regulation', Speech before the PSA 1997 Annual Meeting by Ernest
Patrikis, First Vice President, New York Federal Reserve.
21 A Grunbichler and P Darlap (2004), 'Integration of EU Financial Markets Supervision:
permits feedback, a continuous evaluative process for early warning, and good crisis resolution.25

2.1.2. Why Banks are Special

It is crucial to consider why financial institutions, deposit taking institutions in particular, are such an integral part of a nation's economy as to necessitate any form of intervention in their activities. Any argument to justify the regulation of financial institutions must be hinged on the premise that the banking system has special features that warrant its regulation.

Four principal reasons have been identified as to why banks are considered special.

- Banks play an important role in the financial system:26
- Bank runs pose a potential systemic danger;
- Bank contracts have a distinct nature;
- There are adverse selection and moral hazard27 problems associated with the lender of last resort role and other safety net structures that apply to banks.28

26 These functions have been described to consist of facilitating payments in the exchange of goods and services; mobilizing savings; allocating capital; monitoring managers and exerting corporate control, and providing the relevant tools for managing and trading in risks. See R Levine, R. (1997), 'Financial Development and Economic Growth: Views and Agenda' (Jun 1997) 35 Journal of Economic Literature (2), 668.
27 Adverse selection and moral hazard are closely related. Adverse selection refers to the tendency for the most risky banks to be the more likely to take advantage of safety net features so that their risk taking is subsidized. Moral hazard refers to the incentive created for a party insulated from risk to behave differently and be less risk averse than it otherwise would. See Chapter 3, para.3.5.1.
28 Goodhart (1998) (n23) 10. Banks have also been described as being special based on three considerations: First, they offer transaction accounts; second, they are the backup source of liquidity for all other institutions and; third, they are the transmission belt for monetary policy. G Corrigan "Are banks special?" (1982) Federal Reserve Bank of Minneapolis, Annual Report Essay. 
http://minneapolisfed.org/pubs/ar/ar1082.cfm , accessed 4 July 2005. For further discussion on why banks are considered special, see E Hupkes ‘The Legal Aspects of Bank Insolvency’ (Kluwer, Boston,
Banks play a pivotal role in any economy primarily on two considerations. Banks constitute the only source from which a vast majority of borrowers get access to funds and they also manage the payment system. Banks perform the crucial role of intermediation through specialized services for borrowers and savers as they facilitate the mobilization of resources from the ‘haves’ (surplus units) and their transfer to the ‘have-nots’ (deficit units), thereby aiding savings and investments as well as promoting economic growth. Banks are lenders to the corporate sector as well as to individuals, and thus determine how a large portion of credit is to be allocated. The nature of these services, therefore, justifies a degree of regulatory control and oversight ‘more intrusive and expensive than the legal rules governing other business enterprises.’

In most countries, banks are a means through which government channels its monetary policy and interacts with the financial sector. Through a combination of lending and deposit activities, they can affect the aggregate supply of money and credit, making them an important link in the monetary mechanism and in the overall state of the economy. Financial institutions may also be used to promote public policies, which are not necessarily related to the general health of the financial sector. In most developing countries, financial institutions are used to promote particular activities such as financing small and medium scale enterprises and agriculture.

31 EH Jackson and J J Symons Regulation of Financial Institutions (West Group, St Paul, 1999) 5.
The case has been made that with good corporate governance, regulatory mechanisms such as deposit insurance and capital requirements would not be required to keep a firm stable and sound. However, this argument ignores the special nature of banking contracts, which makes instability inherent. Bank contracts involve money certainty on assets with an uncertain value. This, coupled with the potential for contagion, makes banks prone to runs where the collapse of a particular bank leads depositors of other banks to make panic withdrawals. Banks are now interconnected with each other in many ways (clearing systems, inter-bank deposits etc.), thus failure in one bank can also have consequences for the others.

The nature of bank contracts creates the problem of maturity transformation or mismatching difficulties. Banks collect liquid deposits from customers that they use to finance the acquisition of illiquid assets and other investments of uncertain value and returns. These deposits are redeemable on demand irrespective of the asset value or rate of return of the banks’ investments. Bank contracts, by their nature, are thus risky. No bank, no matter how solvent, can guarantee a full redemption of total depositors’ funds at any particular time. Such an unexpected demand can only be met by disposal of assets. This situation will invariably lead to a bank having to sell its assets at a loss. This ‘distress selling’ could trigger insolvency in what would otherwise be a solvent bank because, owing to problems of asymmetric information, the market is unable to assess the quality and value of the assets being sold.\footnote{M Dewatripont and J Tirole "Efficient Governance Structure: Implications for Financial Regulation" in C Mayer and X Vives (eds.) Capital Markets and Financial Intermediation (Cambridge University Press, Cambridge, 1993) 12. \footnote{M Lewis and K Davis Domestic and International Banking (Philip Allan, Deddington, 1987).} 33 34}
Failure of a large number of banks or a small number of large banks could set off a chain reaction with systemic effects on the financial system. According to Bagehot, 'in wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure which causes them.' As a result of information imperfections, the news that some banks have failed may result in destructive panic runs on other solvent but illiquid banks by depositors who are unsure whether the shock may affect their banks. The failure of one institution can also be transmitted to others through inter-bank markets because inter-bank transactions are large, opaque and difficult for outsiders to monitor.

Systemic considerations constitute the principal justification for the prescription of regulatory capital so that the probability of insolvency is reduced. In this regard, regulation also seeks to achieve allocative efficiency by controlling the risk return behaviour of banks so that deposits are directed into the highest yielding form of investments. Operational efficiency is also achieved so that service is provided at a minimal cost and dynamic efficiency enables the system to be innovative and adapt to changing needs and raise productivity.

Banking institutions provide a safe depository of wealth; they are also involved in other important activities within the financial system. In particular, banking organizations, through the use of financial conglomerates, are expanding into new...
markets and services as a result of sector-integration in financial services and markets. It is thus the duty of the government to ensure safety in the sector by providing depositor and investor protection in the form of regulation.

2.1.3. Theory of Financial Regulation

Regulation has been defined as a ‘sustained and focused control exercised by a public agency over activities that are valued by a community’.\textsuperscript{40} In all spheres of human enterprise, there are two approaches to economic organization. First, individuals and groups may be left free to pursue their own goals and interests. Interactions are based on the legal system but mainly through the instrument of private law, and regulation has no significant role to play. The second is a system in which the state seeks to direct or encourage certain forms of behaviour, which it believes would not occur without its intervention. This is aimed at correcting perceived deficiencies in the system in order to achieve public interest goals.\textsuperscript{41} The means of directing or encouraging the intended form of behaviour is generally referred to as ‘regulation’.

There have been different approaches to regulation, particularly to financial sector regulation. These approaches range from direct and total government control to the so called ‘free banking’ episodes.\textsuperscript{42} The degree and nature of regulatory intervention is generally determined by the philosophy underlying regulation. The two main theories for justifying financial regulation are known as the ‘public interest’ theory and the ‘private interest, market or capture’ theory.


\textsuperscript{41} IA Ogus \textit{Regulation: Legal Form and Economic Theory} (Clarendon Press, Oxford, 1994).
The public interest theory argues that regulation exists to maximize social welfare, for the benefit of the public at large and that there is a desire to achieve collective goals. The private interest theory is premised on the view that certain stakeholders have a vested interest in regulation. This interest is largely perceived in terms of the existing participants trying to monopolise the market and exterminate competition. Regulation, to them, is a means to achieving this end. Thus, proponents of this theory argue that regulation operates in favour of market participants and against public interest. \(^{43}\)

It is impossible to formulate a general list of public interest goals, which may be used to justify regulatory intervention because what constitutes 'public interest' will vary according to the specific values held by different social systems \(^{44}\) at different times. \(^{45}\) Given the special role that banks play in any economy, the public interest in regulating banks would invariably be to foster economic development. \(^{46}\) Bank regulation has been described as a 'public good', \(^{47}\) and in reference to financial regulation, 'public interest' can be defined to include two basic goals, which are:

- Financial stability, \(^{48}\)
- Depositor/Consumer protection. \(^{49}\)

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\(^{42}\) For example, the Scottish free banking era between 1695 and 1864, and the free banking era in the mid-1800s in the United States. For a detailed discussion on free banking, see Dowd (ed) (1992) (n8); Sechrest (2008) (n8).

\(^{43}\) For an extensive discussion on the Public Interest and Market Interest theories, see Ogus (1994) (n41) ch3 and ch4.


\(^{45}\) Following recent events, prevention of financial crime and terrorism have both become regulatory aims in many jurisdictions. This can also be classified as public interest rationale for regulating financial markets. See for example Financial Services and Markets Act (FSMA) 2000, S. 2(2).

\(^{46}\) See for example FSMA 2000 S.2 (3) (d),(e),(f),(g).


Banking regulation evolved from the need to protect citizens and the economy from the consequences of bank failure. It has been noted that ‘the demand to be protected from bank failures arose with economic development, as development was met by demands to be protected from the negative consequences of industrialization, which became more evident and more expensive.’

Protection from the consequences of bank failure is desirable both for the individual citizen and the economy. A safe and stable banking system will encourage savings in banks, which would have been directed to other uses that are less productive for the economy. Apart from the loss of individual savings, banking crisis is usually followed by economic recession. The pressure and cost of a banking crisis can lead to reduction in public spending in other important areas such as health and education.

The public interest justification for financial regulation was developed in reaction to the Wall Street Crash in 1929 and the consequent economic depression (the Great Depression). Several laws were promulgated in the United States, which still form

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51 Following the US banking crisis in 1933, President Roosevelt noted: ‘People will again be glad to have their money where it will be safely taken care of and where they can use it conveniently at any time. I can assure you that it is safer to keep your money in a reopened bank than under the mattress.’ See ‘Franklin D. Roosevelt’s First Fireside Chat’ Sunday, March 12, 1933 [http://www.infoplease.com/ipa/A0900146.html](http://www.infoplease.com/ipa/A0900146.html) accessed 29 May 2007.

52 *Barth* (n50).

the basis of modern financial regulation. The original public interest theory was premised on the assumption that financial markets were inherently imperfect and that the public required protection from the inevitable consequences (market failure).

Supervision of the sector would thus help to achieve a safe operation of the market. The explanation that regulatory intervention is premised upon the attainment of public goals has been given judicial affirmation. Thus, whenever a question of interpreting a regulatory statute arises for determination, the court must consider the 'mischief' which the legislation was intended to remedy, particularly where there is ambiguity in the meaning of the legislation. In such situations, the court attempts to determine the 'social purpose' of the statute, although this must be done with caution as it is a delicate exercise. The power of the courts to undertake judicial review is to ensure that the implementation of regulatory policies is kept in line with the public purpose for which they were promulgated.

The public interest theory became subject to criticism and scepticism that marked the advent of the market or capture theory. Regulation had been adopted in most spheres of public utility and regulatory agencies were given wide and discretionary powers.

54 Examples of such laws include the Securities Act 1933. The Glass Steagal Act 1933 and the Gramm-Leach-Bliley Act 1999.
56 This is known as the 'mischief rule' or 'purposive approach' to legislative interpretation. The rule has its origins in the Heydon's Case (1584) 3 Co. Rep. 7a; 76 ER 637.
57 RD Miers and CA Page Legislation (Sweet & Maxwell, London, 1982).
58 It has been observed that 'many lawyers still react with unease or even distaste when invited to view law as an instrument of policy, and even those who find nothing strange about the notion will readily admit that the relationship between law and policy remains a problematic one.' See K McGuire 'Emergent Trends in Bank Supervision in the United Kingdom' (Sept 1993) 56 Modern Law Review (5) 669.
However, it became increasingly difficult to justify most regulatory mechanisms from a welfare-maximizing perspective. Inherent institutional flaws and poor incentive mechanisms led to the failure of regulation and it became apparent that the principal purpose of regulatory intervention was to restrict competition in these markets. Thus the capture theory argues that the principal reason why financial services regulation was enacted was to serve the interests of governments, legislators and regulated financial firms.\(^6\) Hence regulation exists to fulfil private ends.

The private interest theory considers the regulatory process as one which is made up of competing well-organized interest groups, which make use of the legislative power of the state to capture rents at the expense of more dispersed groups.\(^6\)\(^2\) Governments are also viewed as beneficiaries of the regulatory process, as government imposed regulation exists to 'facilitate the financing of government expenditure, to funnel credit to politically attractive ends, and more generally to maximise the welfare and influence of politicians and bureaucrats, even where loftier public interest objectives are the ostensible goal.\(^6\)\(^3\)

This capture theory emerged from the close relationship that existed between the regulators and the regulated at the time, with the result that the authorities could not exercise fair and independent judgement in making policies.\(^6\)\(^4\) This relationship had

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\(^6\) Barth (n50), 35.

\(^6\)\(^4\) For an historical analysis of the close relationship that has always existed between governments and financial institutions, see *ibid.*
developed for various reasons; recently, these include the fact that the information required for effective regulation may be obtainable only from regulated firms and the regulator might also have to recruit experts and other staff from the industry and vice-versa. 65 This close relationship created the notion that the regulators had been ‘captured’. 66

As with public interest, what constitutes private interest also varies over time and place. This is due to the fact that in every society, there is a rivalry of interests and the balance of power continually shifts between various groups. Variations in the size, influence, and organization of interest groups provide the rationale for policy changes. 67 Hence, banking regulation at a particular point in time will be in line with the interests of the dominant group.

It is important to note that despite these criticisms, banking regulation, regardless of what is considered as its primary purpose, will invariably serve the public interest. This is due to the pivotal role that banks play in the economy and the uncertainty associated with them, which makes regulation essential. However, it is arguable whether regulation, in all circumstances, would serve the public interest more than it would serve private interests. Proponents of the capture theory argue that while there are always public interests in regulation, the industry’s gain in regulatory outcome is much greater, and that the private interests of a few are given priority over the general public interest. 68

67 Kroszner and Strahan (n61).
68 Barth (n50) 35.
Because regulatory policies are amenable to both private and public interests. regulators will be under pressure from both sides in determining policy outcomes. It has been posited that the outcome will depend on the regulator’s personal characteristics and the available incentives, and thus vacillation of policies between both competing ends is to be expected.  

2.1.4. A Functional Approach to Bank Regulation

The challenge to the original public interest theory led to new attempts to re-evaluate the purpose and role of regulation in the financial sector. While private and public interests dictate the direction of public policy, it should be noted that in times of crisis, the influence of special interests would be significantly weakened. Regulatory policies at such times tend to be an instant reaction to the crisis that has occurred.

Examples of regulatory response to market failure abound; as will be seen in Chapters three, five and six, deposit protection schemes were adopted and reformed in the United Kingdom and Nigeria in response to specific developments in the banking industry. Kane also notes that restrictions on interstate banking in the United States were removed in the 1990s because of ‘sustained surges in the failure rates…experienced in the deposit institution industry during the prior decade and a half. High failure rates among geographically confined banks and S&Ls teach taxpayer-customers important lessons about the longer run dangers of doing business

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70 After authorities in Argentina repealed deposit insurance in the 1980s, it was re-instituted in 1995, shortly after the Tequila crisis began in December 1994. See Barth (n50) 47.
with under-diversified institutions, especially at a time when advancing financial technology is fusing financial markets across the nation and across the globe. 71

Failure is a fact of life in financial markets; hence the justification for financial regulation can be hinged on the inherent instability and inefficiency within the market. Even the best of markets can fail; thus regulatory intervention becomes necessary because of the negative impact of such failures on economic efficiency, safety and fairness.

The approaches to bank regulation considered above have been mainly normative in nature. However, it is important to take a functional approach to bank regulation. Bank regulation exists because markets fail; if markets continue to fail despite the introduction of regulation, the original rationale has not necessarily become invalid even though regulation has failed to achieve the desired objective. Thus the ‘ineffective hand’ view of regulation does not question government’s intent but asserts that the means and mode of regulation is ineffective. The pertinent question for policy-makers in regulatory reform is therefore how best to design and structure efficient regulatory mechanisms to achieve the desired objectives. 72

2.1.5. Sources of Market Failure

It is important to understand the sources of market failure and the regulatory tools that are available to counteract them. The failure of financial markets to produce efficient outcomes can be attributed to one or more of four factors. These are:

• Systemic instability;
• Information asymmetry;
• Anti-competitive behaviour/natural monopolies;
• Market misconduct.

I. Systemic Instability

This relates to the cost of contagion and systemic collapse that, over the years, has emerged as the most potent argument for financial regulation. Financial institutions function efficiently when there is public confidence in their ability to honour their obligations and to effectively perform the functions for which they were designed.

Systemic instability occurs when a bank failure induces customers into a panic withdrawal from other institutions. The threat of contagion can leave institutions, which are otherwise sound, prone to failure. Systemic problems can lead to heavy social costs as borrowers find it difficult to get credit to finance investments, which in turn could exacerbate macro-economic problems. Significant bank failures can also threaten the integrity of the payments system and undermine the effectiveness of monetary policy. The appropriate regulatory tool to contain this type of market failure is the lender of last resort facility and deposit insurance.

II. Information asymmetry

72 This is the approach that is adopted in the analysis of the main subject of this thesis, which is deposit insurance.
74 Bernanke (n29).
75 This is because monetary policy operates primarily by changing the quality of bank loans and this would be difficult to control in a crisis. See BS Bernanke, and AS Blinder ‘The Federal Funds Rate and the Channels of Monetary Transmission’ (1992) 82 American Economic Review (34) 901.
76 See para 2.5.5.
Information asymmetry arises where a party on one side of a transaction possesses more information than the counterparty.\textsuperscript{77} Bank contracts are inherently more opaque than other firms; hence there are different levels of information, in terms of quality and accuracy, possessed by financial institutions and their customers.\textsuperscript{78} This results in a limited availability of information necessary to make an informed investment decision. If a competitive market is to function well, bank customers must have sufficient information to evaluate competing products. Yet, even where such information is available, it is usually too complex for investors and consumers alike to decipher.\textsuperscript{79}

Information asymmetry is fundamental to the existence of banks and their role in intermediation. It has been aptly observed that 'banks might not exist if there were no information asymmetries or contracting costs, for otherwise those with surplus funds and those seeking access to them could come together with equal information and sign contracts at no costs.'\textsuperscript{80}

Information asymmetry, if not properly managed, can potentially lead to a bank run and consequently, a crisis. Bank managers have more information about the quality of bank assets than depositors and creditors. The opacity of information means that it is difficult to accurately assess the condition of a bank. In the absence of information imperfections, the likelihood of bank runs occurring would be minimal because fully


\textsuperscript{78} It has been shown that major rating agencies have more significant disagreements on banks than they do over other firms. See D Morgan ‘Rating Banks: Risk and Uncertainty in an Opaque Industry’ (2002) 92 American Economic Review; 874.

\textsuperscript{79} It has been aptly observed that ‘in no other field involving such large public interests is there more uncertainty for the investor...partly because of the difficulty involving loans and discounts...and partly because...any fluctuation in the value of the assets bulks so large for the small net worth.’ See, New HG Guthman Analysis of Financial Statements (4th ed., Prentice-Hall, York, 1953) 494.
informed depositors and creditors would demand higher interest rates from risky banks. This would serve as a means of checking excessive risk-taking.\textsuperscript{81}

The proper regulatory tool to deal with this is the adoption of strict disclosure rules. Additional conduct of business rule prohibiting insider trading, non-disclosure and false or misleading information, may also be adopted.

III. Anti-competitive behaviour/natural monopolies

Natural monopolies\textsuperscript{82} exist in financial markets, as they tend to move towards high levels of concentration and dominant positions.\textsuperscript{83} As firms grow in size and as the main institutions merge, they are able to generate increasing returns mainly through cost savings. As there will be little or no competition, customers will have a restrictive access to capital for business and the oligopolistic market will have the advantage of dictating the price of products and services. This leads to a situation where there will be no other mechanism, apart from the public oversight role of regulation, to ensure that customers receive a fair service and at a reasonable price.

The principal measure used in counteracting anticompetitive behaviour is competition law and policy which include rules designed to deal with business structure (merger and antitrust laws) and laws that ensure markets remain contestable by allowing free entry and exit.\textsuperscript{84}

\textsuperscript{80} Barth (n50) 23.
\textsuperscript{81} Ibid 24.
\textsuperscript{82} W Sharkey: The Theory of Natural Monopoly (Cambridge University Press, Cambridge, 1982).
\textsuperscript{83} For a review of arguments on economies of scale that could lead to a natural monopoly in banking, see K Dowd: Is Banking a Natural Monopoly? (1992) 45 Kyklös (3), 379.
By counteracting anti-competitive behaviour, regulation ensures efficiency in the financial system as efficiency and competition are closely linked together. A competitive banking system will encourage banks to operate efficiently and utilize their resources wisely if they are to keep their customers and remain in business. Competition is a driving force for innovation in the provision of financial products and services. It is therefore important that regulation should not overly restrict the activities of banks, place them at a competitively disadvantaged position with less regulated firms, or hinder their ability to cater for their customers’ financial needs.

IV. Market misconduct

Market misconduct is a major cause of market failure. Unfair and fraudulent conduct of management has been a major factor in the collapse of many financial institutions. It has been observed that mismanagement and fraudulent practices became ‘more attractive to managers and shareholders in the riskier and less profitable world of the 1980s.’ Because of the systemic risk of contagion that the failure of one institution poses to the others, it is imperative that market participants act with integrity. Regulation seeks to ensure this and to protect the customers as well as other market participants from unfair and fraudulent practices.

Asymmetry of information means that in the retail market, the nature of the proposed contract between the firm and the individual may not be entirely clear, especially in terms of the purpose, outcome and charges involved. The performance of such contracts depends on the financial soundness of the firm, which the retail consumer

85 Spong (n9).
87 M Dewatripont and J Tirole The Prudential Regulation of Banks (MIT, Cambridge MA, 1994).
does not have access to, either because of cost restraints or due to a lack of requisite expertise. Hence, regulation is required to protect the interest of the customer who relies on the solvency and prudent behaviour of the firm long after a purchase decision has been made.\textsuperscript{88}

Market integrity regulation usually focuses on conduct of business rules, disclosure of information, entry restrictions, corporate governance and fiduciary responsibilities. The aim is to ensure the honesty and integrity of firms and their employees in dealing with customers. These rules also provide guidelines for the objectivity of financial advice.

\textbf{2.2. The Case against Regulation}

Free market proponents have argued that market failure is a direct consequence of regulation and that market forces will be best suited to achieve allocative efficiency on their own. Introducing regulation into an otherwise free market is seen to weaken incentives for owners and managers to monitor and control themselves. The case has been made that an unregulated banking system tends to achieve an optimal allocation of resources, given four important assumptions: (a) a given endowment of wealth among individuals; (b) a competitive market; (c) government regulation cannot improve administrative efficiency; and (d) there are no externalities that could justify government interference. It is believed that violations of the first two assumptions do not support the regulation of banking while the third and fourth might.\textsuperscript{89}

\textsuperscript{88} Davies and Green (n 3) 22.
\textsuperscript{89} G Benston and GG Kaufman 'The Appropriate Role of Bank Regulation' (May 1996) 106 The Economic Journal (436), 688.
The above argument ignores the important role that banks play in financial intermediation. While it is true that in today's economy, 'many non-bank firms provide the same financial services as banks', it is equally true that such non-bank firms are usually part of a conglomerate structure, which more often than not, is dominated by a banking institution.\(^9\) This argument is also based on the assumption that banking industries do not naturally gravitate towards oligopolies and even where they do, it is a direct consequence of regulatory policy that restricts entry or subsidises a favoured bank.

Systemic risks and the perceived fragility of banks are also considered as insignificant to the financial system 'if depositors and bankers are aware of it and act appropriately'.\(^9\) This argument might be correct if it is assumed that the information on which depositors and bankers are to act is available and understandable, and that financial institutions are not susceptible to a sudden loss of confidence. However, information imperfections exist and the relevant information is, more often than not, only available to the relevant supervisory agency.

Bank depositors find it more difficult to protect their interests than customers of other businesses. General judgements about the condition of banks tend to be difficult and prone to error. As a result of the opacity of bank operations, individual depositors cannot determine the solvency of a bank. It has been observed that supervisors also find it difficult to determine whether a bank has a liquidity or a solvency problem.\(^9\) Where a few depositors are well informed, they may equally fear that a solvent bank

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\(^9\) These other 'non-bank' firms also pose systemic dangers and in some countries, have been brought under the same regulatory ambit as banks.

\(^9\) \textit{Benston and Kaufman} (n89) 688.

can be made insolvent by uninformed actions of others. As noted earlier, banks are vulnerable to runs from the interaction of liquid liabilities that are repayable on demand and illiquid assets that can only be realised at short notice by accepting a discount on their book value. Failure of a large number of banks or a small number of large banks can create a general loss of confidence with systemic implications because: (a) information asymmetry makes it difficult for depositors and creditors to judge the strength of a bank based on publicly available information; and (b) there is a network of interlocking claims and liabilities through inter-bank transactions (for example clearing systems and inter-bank deposits).

It has been aptly observed that in comparison to other industries, bank failures tend to occur faster, spread more broadly, result in a larger number of failures, result in larger losses to creditors, and do more damage to the economy. Although other regulated industries (for example, telephone and power) also play vital roles in the economy, unlike in the financial services, failure of one company would not necessarily cause systemic disruptions in the same way.

The case has also been made that the empirical literature gives very little credence to the theory that a run on one bank might give rise to runs on other solvent banks. While this may be true to some extent, there is another dimension to the debate, which is the ‘risk vs. seriousness’ of the issue. Accordingly, it has been noted that: ‘while the probability that the failure of a single bank will induce a systemic problem

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93 Llewelyn (n 13).
96 Jackson (n 18).
may be very low, if it were to occur it would be serious and the costs would be high. Thus, regulation to prevent systemic problems may be viewed as an insurance premium against 'low-probability-high-seriousness' risks.\textsuperscript{99}

Regulation performs an important role in financial stability, primarily by promoting confidence and guaranteeing the safety of depositors' funds and investments. Yet, it should not be overly prescriptive and needlessly restrictive. The following problems have been articulated as direct consequences of a highly prescriptive regulatory regime:

- An excessive prescriptive regime may bring the entire regulation system into disrepute as it is perceived by the market participants as mainly redundant.
- Risks are often too complex to be covered by simple rules.
- Book entries only reflect an institution's financial position at a particular point in time, although its position can change within a short period.
- A rigid approach to regulation prevents firms from adopting a suitable cost effective mode of regulatory compliance, thus inhibiting financial innovation.
- A prescriptive regime tends, in practice, to focus upon processes rather than outcomes. This makes it easy for institutions to circumvent regulatory provisions.
- Regulation may lead to friction between the regulatory authorities and the regulated institutions, or alternatively lead to overreaction on the part of the regulated institutions in an attempt to achieve internal compliance out of fear of being challenged by the regulatory authorities.

\textsuperscript{98} For a contrary view, see Schoemaker (n73).
\textsuperscript{99} Llewelyn (n13).
• A highly prescriptive regulatory regime may be too inflexible and unable to adapt to dynamic market conditions.

• Excessive regulation may lead to a potential moral hazard. Regulated institutions may assume that areas not explicitly covered by the regulatory regime fall outside the scope of regulation.¹⁰⁰

Arguments against regulatory intervention are based on the fact that regulation alters the natural and independent functioning of financial markets and is costly for market participants.¹⁰¹ The costs of regulation include compliance costs,¹⁰² institutional costs,¹⁰³ and structural costs.¹⁰⁴ This notwithstanding, the cost and risks associated with market failure is greater than that which can be imposed by regulation and less than the benefits derived from regulation. Regulation is therefore a response to the gap between the private cost of failure of financial institutions and the public cost.¹⁰⁵ Adopting a cost benefit analysis, regulation and its costs will be justified if it succeeds in achieving its set goals and objectives by promoting financial stability and preventing the disruptive effects of bank collapse.¹⁰⁶ An important factor is that the regulatory model adopted should be best suited for the prevention, resolution and mitigation of market failure.

It is also important for regulatory policies to be kept constantly in alignment with the objectives for which they were introduced. It is important to note that:

¹⁰⁰ Goodhart (n24) ch1.
¹⁰¹ Ibid. ch8.
¹⁰² This is the cost of monitoring compliance with regulatory guidelines.
¹⁰³ This is the cost of establishing and maintaining institutions to administer and supervise regulatory compliance.
¹⁰⁴ This is the cost incurred because business has to be conducted in a more complex form to comply with regulation.
- Regulatory intervention cannot prevent all banks from failing. Concerns about individual bank failures should not be the focus of regulators provided there are no systemic risks, depositors are protected and uninterrupted banking services can be maintained. If the purpose of regulation is to prevent all bank failures, the result will be to sacrifice one of the objectives of regulation, which is to maintain the integrity of the financial system. If poorly managed banks are not allowed to fail, their owners will be protected from competition and market discipline. This will create incentives for mismanagement and excessive risk-taking.

- Bank regulation and supervision is not a substitute for the banker’s role in operational decision making. A bank supervisor is not in the best position to determine policy at a bank or to establish particular lending or investment practices. For example, credit decisions which are partly based on the characteristics of individual borrowers are best made by the lending officer rather than the supervisor, who spends only a few days or weeks in a bank.  

Policymakers should ensure that bank regulation balances the need to maintain prudential banking practices against the financial needs and services available to bank customers. An excessive regulatory regime or one that focuses on inappropriate objectives will result in avoidable costs which may exceed the costs of failure.


\[107\] Spring (n5) ch1.
2.3 Legal Rationale for Financial Regulation

From a legal perspective, financial regulation can be justified on two grounds:

(i) In most jurisdictions, banks and financial institutions are required to be incorporated companies. According to Kyd on Corporations, a company is 'a collection of many individuals, united into one body, under a special denomination, having perpetual succession under an artificial form and vested, by the policy of the law, with the capacity of acting, in several respects, as an individual.'

From the perspective of the economic theory of law, a company is a means of raising and organizing capital by investors who aim to reduce risk through diversification, and to liquidate their investment quickly and cheaply. The concept of legal personality and limited liability ensures that the company is a distinct person from its members and that liability of the shareholder for the debts of the corporate entity is limited to the amount, if any, unpaid on the value of his shares. This principle was established by the House of Lords in the famous case of Salomon v Salomon & Co. Ltd. and it has been justified on the ground that it enables business to be undertaken with limited financial liability in the event of the business proving to be a failure.

Bank managers are agents of the shareholders and they are hired to run the bank on their behalf. This creates a separation between ownership and control.

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110 [1897] AC 22, HL.
111 See Lord Diplock in Dimbleby & Sons v National Union of Journalists (1984) 1 All ER 751; also Jenkins v Pharmaceutical Society (1921) 1 Ch 392, 393.
and also creates a principal-agent problem, where the principal (shareholder) strives to ensure that the agent (management) runs the firm in the principal’s best interest. The principal interest of bank owners is to make profit and this can be achieved by risky investment. This position is detrimental to the interest of the more risk-averse depositor. Although limited liability encourages investment as the members’ risks are minimised, it certainly encourages risk-taking by managers, knowing well that the liability of members is limited. As risk is effectively moved to the corporation’s creditors, they have developed risk-monitoring mechanisms to protect their interests. These include secured lending by fixed or floating charges, board representation and increased interest on loans to reflect risk.\(^\text{112}\)

Most financial institutions are either public or private limited liability entities operating in the normal course of events to make profit and to shift risk to creditors. The special nature of banking business, which is funded by short-term deposits, usually repayable on demand,\(^\text{113}\) places the relationship between a bank and its customers in a debtor-creditor category. The contractual nature of this relationship was judicially articulated in Foley v. Hill.\(^\text{114}\) While bank deposits are repayable on demand, there is no obligation that they be repaid in specie. Hence, banks have a high degree of discretion with the way they can use depositors’ funds.\(^\text{115}\) The implication of the decision in Foley v. Hill is that a bank is not, in strict legal terms, the agent of its customer. There is no


\(^{113}\) Joachimson v. Swiss Bank Corporation (1921) 3 KB 110, 127.

\(^{114}\) (1848) 2 HL Cas 28. This approach is reflected in other common law jurisdictions. See generally R Cranston (ed.) European Banking Law: the Banker-customer Relationship (Lloyd’s of London Press, London, 1998).

imposition of strict fiduciary duties, which would have been too burdensome for banks and their business, as it would have imposed a continuous obligation to give meticulous accounts for their use of customers’ funds. 116

The implications of the rule in Foley v. Hill should ordinarily make customers wary of placing their funds in banks that are at liberty to use the funds at whatever risk they consider necessary. However, bank managers are required to manage their banks, like every other corporation, in good faith in the general interests of the corporation. 117 What constitutes the ‘interests of the corporation’ is open to debate. 118 Generally, it is construed to refer to the shareholders’ interests. 119 Directors are obliged to manage their corporations to maximize shareholder value. They are not obliged to take other interests, such as creditors’ interests, into account except where there is a legal requirement to do so. 120 Imposing such an obligation would create ‘insoluble problems of reconciling conflicting interests.’ 121 This remains the position if the corporation is solvent. 122

There is a departure from the traditional position above where the company is insolvent or is of doubtful solvency. The duty to manage the company in good

118 The corporate governance debate has revolved on whether managers of corporations should focus exclusively on protecting the interests of shareholders or if their duty should be expanded to include the interests of other groups, generally referred to as ‘stakeholders’.
119 Brady v Brady [1988] BCLC 20, 552.
120 This is also the dominant view in the United States where it is believed that ‘needless complexity would result if corporations were required to serve the interests of groups other than shareholders.’ See JR Macey and M O’Hara ‘The Corporate Governance of Banks’ (2003) 9 Economic Policy Review (1), 9.
121 RI Barrett ‘Directors’ Duties to Creditors’ (1977) 40 Modern Law Review (2) 226.
faith is then extended to creditors. In West Mercia Safetywear Ltd. v. Dodd\textsuperscript{123} the Court of Appeal, referring to the decision in Kinsela v. Russel Kinsela Pty. Ltd.\textsuperscript{124}, held that directors owed a duty to have regard to the interests of creditors.\textsuperscript{125}

While the question of whether directors owe fiduciary duties to creditors when the company is insolvent or at risk of insolvency may be beyond doubt,\textsuperscript{126} it is still uncertain whether such a general duty exists at all times. Furthermore, the directors are only required to act in the interests of the creditors as a whole\textsuperscript{127} and they owe no duty of care to individual creditors for economic loss.\textsuperscript{128}

The foregoing, coupled with the fact that bank depositors are unsecured creditors, leaves depositors in a precarious position. Under most legal systems, secured and preferential creditors rank ahead of unsecured creditors in a liquidation process.\textsuperscript{129} Information asymmetry and cost restraints also mean that they are unable effectively to monitor the risk behaviour of banks. Thus, in the absence of regulation and its resolution mechanisms (and deposit insurance scheme where available), bank depositors will have little or no protection in an insolvent liquidation. Thus financial regulation is necessary to

\textsuperscript{122} A Campbell and D Singh ‘Legal Aspects of the Interests of Depositor Creditors: The Case for Deposit Protection Systems’ in A Campbell and others (eds.) Deposit Insurance (Palgrave Macmillan, New York, 2007).
\textsuperscript{123} [1988] BCLC 250.
\textsuperscript{124} (1986) 10 ACLR 395.
\textsuperscript{125} For a discussion of directors’ duties to creditors in the context of insolvency, see BS Butcher Directors’ Duties: A New Millennium, a New Approach? (Kluwer Law International, Boston, 2000) ch6.
\textsuperscript{127} Re Welfab Engineers Ltd [1990] BCLC 833.
\textsuperscript{128} Nordic Oil Services Ltd v Berman, [1993] SLT 1163; Re Pantone 485 Ltd [2002] 1 BCLC 266.
\textsuperscript{129} For a detailed discussion of the position of the bank depositor as an unsecured creditor, see Campbell and Singh (n122).
protect depositors' funds and interests in the event of bank failure and to monitor and prevent excessive risk-taking.\footnote{A Mullineux 'Re-Regulating Banks: The Unfinished Agenda' (2000) 8 Journal of Financial Regulation & Compliance (1) 9.}

(ii) Most advocates of free and unregulated markets proceed on the basis that market failures tend to be either a direct result of, or precipitated by, regulatory failure. This postulation may be true in the sense that there has never been an entirely unregulated market. However, regulatory intervention has been a consequence of the search for an antidote to market failure. Thus, regulation has been imposed because the inherent rules of the market, prescribed by the common law, as enshrined in privately enforced and contractual rights, have failed to achieve the desired effects. Hence the choice is not strictly between free unregulated markets and regulated markets but between the regulatory mechanism of the common law and that of the administrative system of public control.\footnote{Posner (n109) ch1.}

A fundamental difference between the common law approach to regulation and the direct administrative regulatory control is that the former is reactive while the latter is largely proactive.\footnote{The common law facilitates private arrangements while administrative control enforces obligations.} The common law relies on public officials to function (judges and court officials) but their regulatory intervention can only be triggered by the action of private citizens (litigants and lawyers). Judicial power has to be invoked; its exercise does not begin until a court of competent jurisdiction is called upon to take action.\footnote{Shell Co. of Australia v Federal Commissioner of Taxation (1931) AC 275, 295; Anakwenze v Aneke [1985] 1 NWLR (pt 4) 771, 781.} Apart from the fact that it is left to individuals and not the state to enforce rights.
obligations are also incurred on a voluntary basis in the sense that they can always be displaced by agreement between the parties. Common law rules are only obeyed because of the fear of sanctions and the possibility of having to pay compensation to a victim where there has been a breach.

Direct regulation is carried out mainly through public officials and bodies whose duties have been expressly stated by statute. The aim is both prophylactic and counteractive, to forestall the occurrence of failure and where it occurs, to mitigate its disruptive effects. Under the common law, directors of corporations are deemed to hold a position of trust and as such owe certain fiduciary duties to the corporation. A director must carry out his responsibility with reasonable care and skill and must act in good faith, in the best interest of the company and avoid conflict of interest. Although these duties are owed to the corporation as a whole, in certain circumstances, they are also owed to others with vested interests in the corporation such as creditors. Breach of these duties will usually attract sanctions; however, the complex and seemingly impossible conditions for proving that the duty is owed to the particular claimant, more often than not, leaves these breaches unresolved.

In apparent contrast to the remedial approach of common law control, direct administrative control, through its authorisation and market control

134 Ogas (n 41) ch1.
135 In the United Kingdom, the common law principles on directors' duties have been codified in Chapter 2 of Part 10 of the Companies Act 2006, under the heading 'General Duties of Directors'. See Companies Act 2006, ss. 170-177.
136 Perrival v Wright (n 117); Perkin v Anderson [2001] 1 BCLC 372.
137 Lonrho Ltd v Shell Petroleum Company Ltd [1961] 2 All ER 456.
mechanism, prevents fraudulent and incompetent management from entering the market. Prudential regulation and the general oversight function of supervision also ensure that bank management conduct their affairs in a prudent manner by creating and enforcing standards.

The special nature of banks renders the general regulatory tool of the common law inappropriate and inadequate thus requiring specialized regulation.

2.4. Sources of Financial Regulation

There are three principal sources of financial regulation in any system. These are:

- Statute;
- Secondary legislation and Regulation;
- Administrative practice.

2.4.1. Statute

This is the primary source of regulation in most countries. There are specific laws governing financial institutions and there are other relevant laws such as company and competition legislation. The statutory framework varies from country to country.

2.4.2. Secondary Legislation and Regulation

The details of regulatory requirements are mostly set out in secondary legislation. This allows the primary statute to be kept devoid of complex provisions. It also allows the primary statute to be easily amended, revised and interpreted. It is often the case

that the primary legislation provides the basis for the secondary legislation and gives
the power to make such regulations to a particular authority or person.

Secondary legislation involves the use of less formal rules to implement the actual
regulatory requirement. An example of this practice in the United Kingdom is the
issuance of rules under Section 138 and guidance under Section 157 of the Financial
Services and Markets Act (FSMA) 2000.

2.4.3. Administrative Practice and Non-legal Supervisory Policy

This source of financial regulation is derived from the substance of administrative
decisions and supervisory policy developed in applying any relevant statutory
 provision or other rules set out by secondary legislation. This involves the use of
discretionary power; the degree of discretion exercisable will depend on the content of
the particular regulation to be applied.

2.5. Structure/Form of Financial Regulation

The term ‘financial safety net’ refers to the various institutions, mechanisms and rules
that exist to protect the safety and soundness of the financial system.\textsuperscript{140} In broad
terms, a financial safety-net comprises of three basic components. These are
Prudential Supervision, Lender of Last Resort and Deposit Insurance.\textsuperscript{141}

\textsuperscript{140} CW Calomiris \textit{The Postmodern Bank Safety Net: Lessons from Developed and Developing
Economies} (AEI Press, Washington DC. 1997); C Issard ‘Financial Safety Nets: Where We Stand’
\url{http://www.adb.org/en/trade/1_english/4_specialinfo/conference/2003/o_sept9_rede/isoardppt.pps},
accessed 2 August 2006.
Mimeo.
Financial safety nets are designed to prevent bank failure and, where it occurs, to mitigate its effects.\textsuperscript{142} The components of the safety net perform different but complementary functions. Banking crisis, globalization, sector integration and advances in technology have brought the form and structure of bank regulation to the fore in policy and academic debate. As stated earlier, the focus of regulatory debate should be on the nature, form and scope of regulation, and how best to achieve efficiency. The approach to regulation varies from country to country. While some countries have adopted a functional approach to regulation, others have adopted an institutional approach.

The objective of a functional regulatory system is to control the activity (function) of the regulated firm and not the firm itself. Separate regulatory regimes cover different aspects of financial services and markets. This approach aims at supervising the individual components and activities of diversified entities. The United States and Australia are countries that have adopted this approach to regulation.

While the functional approach focuses on the activity of the regulated firms, the institutional approach focuses on the firm. Where a regulated institution provides diversified financial services, the scope of the regulation is extended to cover the other services provided. This is the prevalent approach in European economies.\textsuperscript{143}

Both approaches to financial regulation have their advantages. As a result of the specialized nature of functional regulation, it is generally perceived to be more suitable to the needs of specific types of business. Functional regulatory systems often

lower market entry restrictions and this may contribute to market dynamism as new participants bring innovation and also increase competition.\textsuperscript{144} A functional approach to regulation is also more adaptable to the dynamic nature of financial markets and services. Functional regulation can provide a more stable framework than institutional regulation because functions tend to be more stable over time than the institutions that provide them.\textsuperscript{145}

Furthermore, functional regulation ensures that power is diversified and not centralized in a single entity. This tends to reduce the scope for discretionary and arbitrary action. The intention of market participants to capture the regulatory authorities will be more difficult to achieve, as there are more regulators to be ‘captured’.

However, where financial conglomerates are involved, functional regulation tends to compartmentalize regulation thus enabling conglomerates to avoid regulation for some activities. Moral hazard may also arise in the sense that conglomerates may be erroneously led to assume that certain activities, not covered by a specialized regulatory feature, fall outside the scope of regulation.

The potential for disharmony among functional supervisory bodies regarding the allocation of often overlapping supervisory roles could lead to disagreements over enforcement of prerogatives and a rush for assets in the event of insolvency. To prevent this situation, supervisory authorities could put pressure on financial conglomerates to separate the particular function that falls under the specific

\textsuperscript{144} RJ Herring, [Untitled] (Sept 1993) 48 \textit{Journal of Finance} (4) 1553.
regulatory ambit as an incorporated subsidiary, thus subjecting corporate structure to regulatory convenience.146

An integrated approach has been adopted by some countries where regulation of all financial activity is carried out through a single regulatory entity. This is the approach that has been adopted by the United Kingdom under the Financial Services and Markets Act 2000.147 As the traditional distinction that existed between financial markets had been blurred, it became necessary to develop an integrated and harmonized approach to their regulation. Different arguments have been canvassed for the justification of this approach to regulation, but it is generally believed to be more effective in achieving efficient regulation.148

This approach comes at a cheaper cost to market participants and taxpayers because of the economics of scale in supervising banks.149 The cost of supervision falls as the number of institutions to be supervised decreases. Because it is a cheaper option,

147 Other countries that have adopted this approach include Singapore, Norway, Sweden, Japan and Austria. See J Martinez and TA Rose ‘International Survey of Integrated Supervision’ in D Arner and J Lin (eds) Financial Regulation: A Guide to Structural Reform (Sweet & Maxwell Asia, Hong Kong, 2003).
149 In comparing the fragmented system of banking supervision in the United States to the United Kingdom’s integrated model, Jackson notes that ‘Total U.S. annual expenditure on financial regulation in the United States during 1998-2000 was in excess of $4.5 billion or 13.7 times the annual expenditure of the FSA...Personnel levels of the U.S. (41,722) were more than 15 times higher than those of the FSA (2,675)...these multiples do not simply reflect differences in the size of the two economies in question...Nor is the difference simply a reflection of financial markets...even if one normalized annual expenditures for the size of the economy or capital markets, substantial differences would remain.’ See HJ Jackson ‘An American Perspective on the U.K. Financial Services Authority: Politics, Goals and Regulatory Intensity’ (2005) Harvard Law and Economics Discussion Paper No. 522.
single regulatory authorities are particularly ideal for low-income countries. ¹⁵⁰ There is also more consistency and coherence in the design and enforcement of regulatory policies because there is less friction between regulatory goals. ¹⁵¹

As a result of the overlapping nature of the regulatory bodies and different country practices, it is most suitable to describe the structure of financial regulation in terms of the functions that regulatory institutions perform. Some of these functions are considered below.

2.5.1 Authorisation/ Licensing

Authorisation or licensing requirements may either be formal or market based. The requirements cover initial market entry and continuing business compliance as well as professional chartering. ¹⁵² These requirements set market entry standards and bar imprudent or incompetent managers from the market, thus reducing the risk of collapse occasioned by poor management and excessive risk-taking. In some developing countries, the infiltration of the market by fraudulent shareholders and unskilled and incompetent management has led to bank failure. This has been characterized by insider related loans as well as non-disclosure and misrepresentation of information to the supervisor. ¹⁵³

¹⁵⁰ A survey of 153 countries conducted by Barth (n50) showed that only Nigeria, among the low-income countries, has a multiple bank supervisory system.
¹⁵² See for example the general prohibition of regulated activity in the UK under s.19, FSMA 2000; see also the licensing requirement in Nigeria under s.2. Banks and Other Financial Institutions Act (BOFA) 1991.
¹⁵³ An example of this was the failure of Banco Latino in Venezuela. The bank lured about 1.2 million depositors by setting interest rates far above what was obtainable in sound banks. The funds were used to 'build a lavish headquarters, charter jets for each director of the bank, throw lavish parties and make
Regulatory entry restrictions, apart from promoting the stability of the banking sector by allowing only high-quality entrants, also ensure that the number of supervised banks is kept in tandem with the capacity of the supervisory authorities.

In addition to initial authorisation requirements, there are also provisions for continuing compliance. After a bank has been authorised to conduct deposit-taking business, it must continually conduct its activities in a prudent manner. These continuing compliance provisions are also market entry conditions insofar as the benefit of entry is withdrawn except strict compliance is adhered to.

2.5.2 Prudential Supervision

Banks, occupy a pivotal position in any economy and must continually conduct their business in a prudent and transparent way. The relevant prudential supervisory authorities prevent institutions from exposing themselves to risks that can lead to insolvency. Forms of prudential regulation include bank examination, capital requirements and requirements to submit regular accounts on a consolidated basis.

The aim of prudential regulation is to protect consumers, who are not well informed and are not in a position to assess the soundness of financial institutions. Prudential regulation also serves to prevent unnecessary costs to the safety net and deposit protection or compensation schemes, especially where the premium payable in such deposit protection schemes is not risk-based.\(^{155}\)

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\(^{155}\) WJH Blair and others Banking and Financial Services Regulation (Butterworths, London, 2002).

Goodhart (n24) ch1.
Banks are not only regulated on an individual basis but full account is taken of all
group and connected relationships. Where such group relationships exist, it is
important that any additional financial risk or contractual relationship that may arise
out of the corporate affinity is properly identified and monitored.\textsuperscript{156} This has become
crucial with the emergence of large conglomerates which usually consist of more than
one financial institution.

The Basel Committee on Banking Supervision has adopted the consolidated approach
at the international level. A statement issued in 1979, which was incorporated into the
1983 Revised Concordat, recommended that all banking supervision be conducted on
a consolidated basis.\textsuperscript{157} This was mainly in response to the failure, in 1982, of Banco
Ambrosiano in Italy. The Italian regulatory authorities attributed their failure to detect
corrupt practices in the bank’s foreign operations to the fact that they occurred outside
their jurisdictional authority, as the bank operated through several foreign subsidiaries
but was managed by the Italian holding company.\textsuperscript{158} Consolidated supervision was
introduced in the EU by the adoption of the First Consolidated Supervision Directive
in 1983.\textsuperscript{159}

\textbf{2.5.3 Failure Resolution/ Winding Up}

An effective system of bank regulation and supervision should minimize the
occurrence of bank failure. However, when individual failures occur, it is important to
have an effective failure resolution mechanism in place to ensure that the failed bank


\textsuperscript{157} Basel Committee on Banking Supervision \textit{Consolidated Supervision of Banks’ International Activities} (1979); Basel Committee on Banking Supervision \textit{Principles for the Supervision of Banks’ Foreign Establishments (the Concordat)} (1983).


is resolved in a timely and efficient manner. This would ensure that such failures are isolated events and do not result in systemic crisis.\textsuperscript{160}

A termination authority may terminate a depository institution that is at risk before it becomes insolvent and causes loss to depositors. It is important to have a statutory-based system that enables early intervention and for determining when a bank has failed. The relevant laws should provide appropriate exit rules and procedure for an institution that has to leave the market. There should also be provision for liability and asset resolution procedures; and determination of claims brought by creditors and depositors.\textsuperscript{161}

The termination power is usually vested in the Central Bank or in the Deposit Insurer. It is pertinent that the relevant law clearly states the conditions that will initiate the powers of the termination authority. These powers are either exercised through rules or regulatory judgement.

\textbf{2.5.4 Lender of Last Resort}

The origins of the name ‘lender of last resort’ can be traced to Sir Francis Barings: in 1797 he described the Bank of England as the ‘\textit{dernier resort}’ from which all banks could obtain liquidity in times of crisis.\textsuperscript{162} The lender of last resort (LoLR) function helps institutions with liquidity problems and in danger of insolvency to meet depositors’ claims and other obligations. The LoLR maintains ‘a strategic stock of

\begin{footnotesize}
\begin{itemize}
    \item \textsuperscript{160} For further discussion, see Chapter 4, para. 4.8.2.
    \item \textsuperscript{161} For a detailed discussion on failure resolution, see JF Bovenzi and ME Muldoon ‘Failure Resolution Methods and Policy Considerations’ (1990) 3 \textit{FDIC Banking Review} (1), 1; W Su ‘General Guidance for the Resolution of Bank Failures’ in A Campbell and others (eds.) \textit{Deposit Insurance} (Palgrave Macmillan, New York, 2007) ch10.
    \item \textsuperscript{162} T Humphrey and R Kelcher ‘The Lender of Last Resort: A Historical Perspective’ (Spring/Summer 1984) 4 \textit{CATO Journal} (1) 275.
\end{itemize}
\end{footnotesize}
high powered money’ used to satisfy demands for liquidity at critical times.\(^{163}\) This prevents a fire sale disposal of assets and its distressing consequences. The immediate availability of central bank credit makes the LoLR particularly suitable to confront emergency situations.\(^{164}\) The LoLR doctrine is based upon four pillars:

1. The central bank, acting as lender of last resort should prevent temporarily illiquid but solvent banks from failing. LoLR lending is by nature short term.\(^{165}\)
2. Central bank lending should be free but at a penalty rate.
3. The central bank should accommodate anyone with good collateral valued at pre-panic prices.
4. The central bank should make its readiness to lend freely clear ex ante.

As stated earlier, the focus of financial regulation is not to prevent individual bank failure \textit{per se} but to prevent systemic instability. Thus, in providing LoLR facility, the main consideration is whether the failure of a particular institution will pose systemic risks.\(^{166}\)

Some advocates of free banking argue that the provision of LoLR facility has potential costs to the system. It may prejudice what would otherwise have been a

\(^{161}\) Bagehot (n.36); H Thornton ‘An Enquiry Into the Nature and Effects of the paper Credit of Great Britain’ (J. Hatchard, London, 1802).

\(^{162}\) RM Lastra ‘Lender of Last Resort. An International Perspective’ (April 1999) 48 \textit{The International and Comparative Law Quarterly} (2) 340.

\(^{163}\) It has been argued elsewhere that LoLR assistance should be available to insolvent institutions and that the distinction between insolvent and illiquid institutions is a ‘myth’, since banks experiencing liquidity problems will more often than not become insolvent. See CAE Goodhart \textit{The Evolution of Central Banks} (London School of Economics and Political Science, London, 1985); CAE Goodhart ‘Why Do Banks Need a Central Bank?’ (March 1987) 39 \textit{Oxford Economic Papers. New Series} (1) 75.

timely distress signal. It may also tacitly encourage incompetent management and excessive risk taking when market forces would have disciplined the institution concerned. This may lead to expectation of future assistance and intense political lobbying for such assistance.\textsuperscript{167} Where political lobbying is involved, a potential conflict may arise where the same agency acts as lender of last resort and termination authority. They also contend that the need for LoLR has evolved only because central banks hold a monopoly over the issue of currency.\textsuperscript{168}

While the provision of LoLR has a cost, in each case the cost should be less than the potential cost of leaving the bank to fail.\textsuperscript{169} The provision of the LoLR facility by the central bank is predicated on the need to maintain market confidence. The central bank therefore chooses to act as LoLR when it fears a general loss of confidence that could have systemic implications. The central bank can exercise its discretion not to provide the facility where it considers a particular crisis as isolated one, and posing no systemic concerns. The following elements have been articulated as basic considerations for the central bank in the exercise of its discretion as LoLR:\textsuperscript{170}

1) The size and inter-bank exposure of the institution

2) The danger to a particular market

3) The reputation of a financial market

In addition to these considerations, the central bank should also ensure that liquidity assistance is not only provided where necessary but that it is provided promptly. This point has become particularly important in the wake of the Northern Rock crisis in the

\textsuperscript{167} Herring and Santomero (n146).

\textsuperscript{168} See generally: G A Selgin 'Legal Restrictions, Financial Weakening and the Lender of Last Resort'. (Fall 1989) 9 CATO Journal (2), 429.

\textsuperscript{169} Davies and Green (n3) 18.
United Kingdom where the Bank of England has come under criticism for not intervening early enough to avert the crisis.\textsuperscript{171}

It is important to decide whether to vest the central bank with powers and responsibilities for bank supervision in addition to its role as LoLR and responsibility for monetary policy.\textsuperscript{172} While the disadvantage of having the central bank perform all roles is the potential conflict of interests involved, the main advantage of having the central bank as supervisor is that it will have direct information and knowledge of the condition of the banks it regulates.\textsuperscript{173} As such it will be in a better position to identify emergency situations that could raise systemic concerns and act promptly and appropriately.\textsuperscript{174} The central bank will also be better informed in deciding the fine line between solvent and illiquid banks when exercising its discretion in providing the LoLR.

2.5.5 Capital Adequacy

Banks play a crucial role in financial intermediation because they are able to convert liquid deposits from the liability side of their balance sheets into loans as illiquid assets on the asset side. By providing this important function, banks are open to credit


\textsuperscript{171} ——— ‘MPs Attack BoE for not Preventing Northern Rock Crisis’ \textit{The Independent} Friday 21 September 2007

\textsuperscript{172} CAE Goodhart and D Schoenmaker ‘Should the Functions of Monetary Policy and Banking Supervision be Separated?’ (1995) 47 \textit{Oxford Economic Papers} (4) 539.


\textsuperscript{174} The wisdom of splitting responsibilities between the Treasury, Bank of England and the FSA, has been questioned in the UK following the Northern Rock crisis. See ——— ‘Tripartite Regulatory System Simply Hasn’t Worked’ \textit{The Independent}, Thursday, 20 September 2007.
risk. Credit risk refers to the potential that a bank borrower or counterparty will default on his obligation to pay either the principal or interest, or both. This raises a mismatching difficulty, as to the source of the funds and its application, which could result in liquidity problems for banks in the event of a shock. The primary role of capital requirement is to provide protection against the risk of credit default by bank customers in the bank’s loan book. Liquidity problems in a single bank may trigger systemic reactions that may undermine systemic stability. A strong capital base thus enables banks to withstand severe financial pressure and losses. Historically, markets have always promoted the adherence to healthy capital ratios even in the absence of regulatory capital prescription.

The viability of a bank is dependent, to a large extent, on public confidence. Although the availability of capital is not a perfect indicator to the state of a bank’s health, it represents a major standard for assessing its solidity. Capital is the major yardstick against which the market measures a bank’s capacity to withstand adverse conditions and to manage the risks encountered in the course of business. Capital cushions serve as a line of defence against abnormal financial pressures that may result in a sudden and relatively high level of realized losses.

Capital requirements achieve two main aims: the reduction of risk-shifting by bankers whose assets are insured and the prevention of destructive bank runs.

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175 Walker (n17) 571.
176 It has been noted that ‘all banks need capital to cover and extend fixed assets and business investments, to enable trading to continue and increase, to maintain the confidence of depositors, and to ensure viability in the face of loss arising from the inevitable business and political fluctuation and uncertainty, particularly in an inflationary climate.’ See Gardener (ed.) (n19) ch12.
178 Gardener (ed.) (n19) ch14.
Financial safety nets create incentives for lowering market disciplinary standards: thus, regulators require capital to insulate themselves from the costs of financial distress, moral hazard and agency problems arising from the reduction in market discipline. In this regard, the interests of the regulator are akin to those of the uninsured creditor. Regulators also respond to other externalities associated with financial intermediaries, particularly systemic risks and the potential disruptive effects on the system. Concern about the social costs associated with a systemic crisis may lead regulators to strive for a higher degree of safety for banks by requiring higher capital ratios than if they were acting solely to protect the government’s position as an uninsured creditor. To this extent, it has been noted that market forces cannot, on their own, efficiently ‘cull’ institutions whose debts are explicitly or implicitly guaranteed by the government, unless supplemented by regulatory pressure. Therefore a high capital standard will reduce the incentive for shareholders and bank managers to take excessive risks.

Capital ratio can be described as the amount of a bank’s capital expressed as a percentage of its risk weighted credit exposures. The measurement process is complex and the aim is to arrive at a proximate measure of the degree of possible cumulative default in the loan book. A simple approach is to require banks to hold such a high level of capital that the risk of default becomes negligible. However this

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182 For example, deposit insurance can lower market discipline where depositors are guaranteed full repayment if their banks fail. This is known as moral hazard. See chapter 3 for a detailed discussion.
183 AN Berger and others ‘The Role of Capital in Financial Institutions’ (June 1995) 19 Journal of Banking and Finance (3-4) 393.
184 Ibid.
186 Berger (n183).
187 Walker (n17) 571.
would reduce the availability of capital for financial intermediation.\textsuperscript{188} It has also been shown that where equity is increased beyond the market requirement, the value of the bank is reduced.\textsuperscript{189} Thus, in setting capital standards, regulators are involved in a trade-off between the benefits of reducing the risks associated with negative externalities from bank failures and the cost of reduced intermediation.\textsuperscript{190}  

The Basel Committee on Banking Supervision\textsuperscript{191} has developed a general standard for the measurement of capital adequacy for internationally active banks.\textsuperscript{192} This is a minimum capital of eight per cent of risk-weighted assets. Although the committee’s recommendations are meant to apply to internationally active banks, they have nonetheless been adopted as a policy guide in developing capital adequacy standards in most countries. Generally, the Basel core principles have become the most important global standard for prudential regulation and supervision. Although the capital accord was initially adopted in 1998, the fact that it took a period of six years to agree on a final set of proposals, known as Basel II,\textsuperscript{193} underscores the complex nature of capital regulation.\textsuperscript{194}  

\textsuperscript{188} Where excessively high capital adequacy standards leave banks with less funds to intermediate, they may seek to make up for their reduced earnings by investing in more profitable but risky assets. See D Di Cagnio \textit{Regulation and Banks’ Behaviour Towards Risk} (Dartmouth Publishing, Sudbury, MA, 1990).  
\textsuperscript{189} Berger (n 183) 407.  
\textsuperscript{190} A Santomero and R Watson ‘Determining an Optimal Capital Standard for the Banking Industry’ (Sept 1977) 32 \textit{Journal of Finance} (4) 1267.  
\textsuperscript{191} The Basel Committee on Banking Supervision is a forum, created by the Central Bank Governors of the Group of Ten (G10) countries, for international cooperation in banking supervisory matters. For a detailed discussion of the committee’s nature, structure and method of operation, see Walker (n 17) 39.  
\textsuperscript{192} The Basel Accord was introduced following concerns ‘about a decline in capital held by banks, exacerbated by the expansion of off balance sheet activity, and worries that banks from some jurisdictions were seeking a short-term competitive advantage in some markets by maintaining too low a level of capital.’ See P Jackson ‘Bank Capital Standards: the New Basel Accord’. (Spring 2001) Bank of England Quarterly Bulletin. http://www.bankofengland.co.uk/publications/quarterlybulletin/qb010101.pdf, accessed 3 August 2005.  
While the revised Accord has retained the requirement to hold minimum capital equivalent to eight per cent of risk-weighted assets, the main innovation is the reliance on banks' internal models to assess the risk position of their portfolios and to determine the required capital cushion. The second major difference is that the new accord recognises the role of complementary mechanisms in ensuring bank safety, by building on two additional pillars to strengthen the minimum capital requirement provision.\(^{195}\) The three mutually reinforcing pillars of the new accord are:

- Minimum regulatory capital requirement (pillar 1);
- Supervisory review (pillar 2);
- Market discipline (pillar 3).

Pillar one imposes the minimum capital requirement. In implementing this, banks and supervisors may adopt the Standardized Approach,\(^{196}\) or one of two internal ratings based (IRB) approaches. These are the Foundation or Advanced IRB Approaches.\(^{197}\) Supervisory Review (pillar 2) will require that effective internal processes are put in place to manage banks' capital positions with regard to their lending and trading exposures. Pillar 3 is based on market discipline\(^{198}\) through enhanced disclosure. This

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\(^{196}\) This is seen as appropriate for banks without sophisticated risk models.

\(^{197}\) The IRB approach allows banks to use their own internal models to forecast the average level of credit losses it can reasonably expect to experience. This forecast is translated into an estimated potential future loss amount, which forms the basis of the minimum capital requirement. See — 'An Explanatory Note on the Basel II IRB Risk Weight Functions.' (2005) Basel Committee on Banking Supervision.

\(^{198}\) The phrase 'market discipline' is often used to incorporate two components: the ability of market investors to monitor and identify changes in bank conditions (market monitoring), and their ability to
will lead to effective market discipline as market participants would have more access to the risk profile and adequacy of capital positions, and exert market discipline accordingly.¹⁹⁹

The purpose of the new capital accord is to make capital requirements more risk-sensitive. The introduction of the Standardized and IRB options has also been commended for creating ‘a degree of compliance flexibility for banks with differing levels of operational and management sophistication.’²⁰⁰ As the new framework revolves around internal risk control mechanisms, an additional incentive is created for banks to improve their internal risk control systems. This would bring a reward of lower capital charges in the short term, and more stable institutions and a sound financial system in the long term.²⁰¹

The inclusion of the two additional pillars should shift much of the focus away from the mere prescription of capital requirements to the steps to be taken to ensure compliance and further necessary action when banks fail to comply. Capital standards should provide early warning signs and regulatory intervention thresholds for failing banks. The recourse to market discipline is also justified by the increasing complexity of banking activities and the difficulty encountered by banking supervisors in effectively monitoring these activities. Therefore, bank monitoring by professional investors and financial analysts can serve as a complement to bank supervision and

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¹⁹⁹ For a detailed explanation of the Standardized and IRB Approaches, see Walker (n17) 576; Davies and Green (n3) 44.

²⁰⁰ Walker (n17) 592.

²⁰¹ Ibid.
the information provided by these market sources can be used by supervisors in addition to the information provided by bank examination.  

2.5.6 Deposit Insurance

Deposit insurance can be described as a mutual insurance system supported by insured banks, and administered either through a government controlled agency or a privately held one. Deposit insurance has also been defined as the protection offered under a system which provides a guarantee that all or a limited amount of the principal and the interest accrued on protected accounts will be paid.

There are two principal functions of deposit insurance:

(i) Deposit insurance indemnifies the depositor in the event that the risk insured against (bank failure) occurs;

(ii) Deposit insurance provides confidence and thus ensures that problems at individual banks do not spread to the entire system. To this extent, deposit insurance promotes stability in the financial system. This is supported by the lender of last resort function which provides emergency liquidity support for illiquid but solvent banks.

While regulation serves to prevent excessive risk-taking and promote prudential management of financial institutions, deposit insurance exists to minimise the

disruptive and costly effects of bank failure. Bank failure results in loss of depositors’ funds, restricted access to funds for borrowers, and the risk of contagion, which could lead to the insolvency of otherwise sound banks. It is important to note that bank failure in itself is not necessarily an indicator of financial sector instability. A financial sector can still be described as generally stable, even where bank failure has occurred, if the risk of contagion can be contained and an effective failure resolution regime is in place.

Deposit insurance promotes effective and efficient competition between financial institutions. The overall competitiveness of the system increases as the distinction between the bigger and smaller banks is blurred because the assumption that the bigger banks are generally safer is removed.206

The issue that often arises is whether deposit insurance and regulation are mutually exclusive concepts or whether the existence of one necessarily implies the redundancy of the other. The moral hazard problem associated with deposit insurance requires a continuing role for regulation even where deposit insurance has been adopted.207 While deposit insurance can foster financial stability, it can also create perverse effects. The protection provided reduces the incentives for depositors to monitor banks’ risk-taking and also encourages banks to pursue riskier strategies, thus the need for prudential regulation is reinforced with the existence of deposit insurance. Where deposit insurance has been adopted, regulation is retained to enforce institutional and depositor discipline.208

205 This is discussed in more detail in Chapter 3.  
206 Di Cagnio (n188).  
207 Moral hazard is considered in detail in Chapter 3.
Where explicit deposit insurance has been put in place, the main focus of regulation becomes the prevention of excessive risk-taking associated with moral hazard. Regulation thus becomes part of the cost of deposit insurance. It has been observed that 'the counterpart of Government insurance is some degree of government regulation because, if the government merely provides safeguards, it would tend to create excessive risk-taking by the banks. The central question is where one strikes the proper balance between differing levels of regulation.'\(^{209}\) It is for this reason that the various national deposit insurance laws confer extensive regulatory powers on the deposit insurer to minimize the risks associated with deposit insurance.

It is important to note that while deposit insurance can promote financial stability, the existence of a deposit insurance scheme on its own does not solve the problem of bank runs. Inasmuch as there is no full guarantee or cover, there is still the incentive for depositors whose balances are not fully covered to run on their banks. Hence, policy makers must ensure that deposit insurance schemes are closely co-ordinated with, and fully integrated into, other safety net devices providing the functions of lender of last resort, regulation and supervision, and failed bank resolution. It is not uncommon to find the deposit insurer performing one or more of these functions. Deposit insurance is often used to inject capital into distressed banks and to purchase their assets, thus it is entwined with the lender of last resort function and the resolution mechanism. It is important that the statutory framework clearly sets out the duties and functions of each regulatory agency. Policymakers should also ensure that the agencies work together without conflict where their functions overlap.

\(^{208}\) Llewellyn (n17).

\(^{209}\) William R Cline in Bennet (n1).
2.6. Effective Regulation

Regulation has evolved mainly as a reaction to banking failure. It has been observed in relation to the US regulatory system that:

‘Much of the U.S regulatory system has developed in response to financial crises and other historical and political events. No central architect was assigned to design the overall system or lay out a single set of principles... As a consequence, bank regulation has evolved to serve numerous goals – goals which have changed over time and on occasions have been in conflict with one another.’

As financial crises continue to occur, the scale and scope of financial regulation will also be evaluated in order to prevent the reoccurrence of a previous crisis. This is a continuous process because new sources of risk will always emerge due to the dynamic nature of financial markets. The challenge to banking regulators is thus to keep pace with the changes, while maintaining the traditional goals of financial stability and consumer protection. Part of the ongoing efforts toward a more effective system of regulation is the shift away from a prescriptive system of bank regulation to a risk-based approach, which recognises the role of effective market discipline in financial stability. It is pertinent to note that reliance on internal risk-management might not be entirely appropriate for developing countries in transition, where institutions are not as sophisticated and bank supervisors lack the capacity to effectively monitor and assess risk.

\(^{210}\text{Spong (n9) 5.}\)
An additional concern is what regulatory structure will be most appropriate in the face of new developments such as sector integration, technological innovations, increased use of conglomerate structure by banks, and the development of more complex financial instruments and services. As noted earlier, the structure and approach to banking regulation varies across jurisdictions.\textsuperscript{211} Regardless of the structure adopted, a system of banking regulation should have at least six functions in place to offer a credible approach to maintaining financial stability. These are:\textsuperscript{212}

- Regulation to ensure a set of standards for prudential behaviour and conduct of business;
- Supervision and monitoring of individual institutions to ensure regulatory compliance and development of risk management;
- General oversight of the financial system to help in the identification of systemic risk;
- A means of providing emergency support in the event of a crisis or sudden lack of liquidity in the system or in individual solvent institutions;
- An effective means of resolving troubled banks, including a defined bail-out policy and an orderly and rules-based exit mechanism, to prevent isolated problems from spilling into the system as a whole;
- A means of protecting small depositors so that they have confidence in the banking system.

These functions should be supported by an institutional and legal framework that includes sound macroeconomic policies, good corporate governance and disclosure regime as well as an effective judicial system. As regulation seeks to adapt to a

\textsuperscript{211} Chapter 1, para 1.0; Chapter 2, para 2.5.
\textsuperscript{212} JR Labrosse and DG Mayes 'Promoting Financial Stability through Effective Depositor Protection: The Case for Explicit Limited Deposit Insurance' in A Campbell and others (eds.) Deposit Insurance (Palgrave Macmillan, New York, 2007) 14.
changing environment, policymakers should ensure that the evaluation process examines the best way to achieve the stated regulatory objectives.

2.7. Provisional Conclusion

Regulation of the banking system is necessary because instability is inherent in banks. The importance of confidence in the banking sector cannot be overemphasized. It has been aptly noted that ‘a special importance attaches to the integrity and stability of the banking system; if people cannot trust their banks, whom can they trust?’ Regulation aims to achieve two general public policy aims of financial stability and consumer protection. While there are polarised views on the fragile nature of banking and the threat of systemic risks, there is apparent consensus that the introduction of government safety nets makes prudential regulation necessary to curb excessive risk-taking as a result of moral hazard.

While the rationale for regulation has been outlined, it has been stated that the focus should be on the scope and nature of regulation, and how best to structure regulation to achieve its aims. Recent developments in the academic literature have also raised awareness of the role of moral hazard in regulation in general, and this has led to efforts to re-engineer incentive mechanisms in existing regulatory frameworks.

The arguments for regulation notwithstanding, there are limits to what regulation can achieve in practice. The existence of financial safety nets does not imply that banks would not fail or financial crises would not occur. It also does not imply that consumers would be fully insulated from the effects of such failure. Thus, it is

important that the limitation of safety net mechanisms is clearly understood by regulators, regulated institutions and consumers.

There is no doubt that regulation imposes high costs on taxpayers, consumers, financial institutions and markets. Thus, in all cases, the benefits of regulation should clearly exceed the costs imposed. If regulation becomes excessive, the costs may come to exceed the benefits. Effective regulation involves striking a balance between the objectives of regulation, and providing a regulatory regime that is not overly burdensome and costly to the taxpayer, that provides appropriate incentives for market discipline, and gives institutions the flexibility to compete in a dynamic financial system.
3.0 Introduction

A safe and competitive banking system is critical to a nation’s economic growth. The central role that banks play in financial intermediation, the payment and settlement process and the formulation of monetary policies was discussed in the preceding chapter. The nature of bank contracts make them susceptible to runs which could threaten systemic stability. Deposit insurance\(^1\) has increasingly been utilized by policy-makers, as part of the safety net, to maintain financial stability and to protect depositors from losses associated with bank failure.\(^2\)

This chapter examines the theory and concept of deposit insurance. The analysis starts with a discussion of the historical evolution of schemes to protect bank depositors in several jurisdictions. Furthermore, it examines the two main forms of deposit insurance, implicit and explicit deposit insurance, and argues that a well-designed explicit deposit insurance system is generally preferable to implicit guarantees.

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\(^1\) For the definition of deposit insurance, see Chapter 2, para 2.5.6. The terms ‘deposit insurance’, ‘deposit guarantee’, and ‘deposit protection’ are interchangeably used to denote schemes that exist for the protection of bank depositors.

The conceptual analysis of deposit insurance involves a comparison between deposit insurance and general insurance practice. The rationale and objectives for such schemes are examined to determine the primary essence of deposit insurance, and to establish the desirability of its inclusion in the financial safety net. While explicit deposit insurance can reduce the incidence of bank runs if designed properly, its design is often complex and the provision of deposit insurance can exacerbate the problem of excessive risk-taking in the banking system. The chapter concludes by examining the deposit insurance problem and exploring different solutions to the problem. Although the moral hazard and principal/agent problems are isolated, the chapter concludes that the deposit insurance problem is essentially one of design.

3.1 History of Deposit Insurance

Deposit insurance schemes, whether privately or publicly owned, exist worldwide. The exact origin of deposit insurance is unknown. However, as a consequence of the wave of financial crises around the world, the number of countries that have initiated deposit insurance schemes has significantly increased in the last three decades. Most member countries of the Organization for Economic Co-operation and Development (OECD), as well as most developing nations, have adopted some form of explicit deposit protection.\(^3\)

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\(^3\) Deposit insurance schemes can be found in every region of the world, except in China and Africa, where only 6 countries have deposit insurance. Among the developed countries, Australia, Israel and New Zealand are important exceptions. Generally, there are 99 countries that currently have some form of deposit protection scheme in place, while 20 other countries are considering or planning to introduce their own schemes. Most recent schemes are transition countries of Eastern Europe that have established their schemes in compliance with the EU directive on Deposit Insurance. See http://www.eadi.org/last/2004/20Countries/20with%20Their%20Deposit%20Insurance%20System/List
devolution_with_a_DIS_MCC_1_May08_Final.pdf, accessed 30 May 2008.
Indeed, the establishment of an explicit and government funded deposit insurance scheme is widely believed to be an antidote to financial instability and crisis. It has become part of the generally accepted best practice advice given to developing economies. The historical evolution of deposit insurance in some of these jurisdictions will be considered below.

3.1.1 The United States

In the US, deposit protection can be traced back to 1829, when the first scheme to protect bank depositors was established in New York. Prior to this time, there was no formal regulation scheme and banks were chartered by special acts of state legislatures or congress, usually for a number of years. Bank failure was a rare occurrence during this period with the exception of the Farmers’ Bank of Gloucester, Rhode Island in 1809. This incident was followed by a series of bank failures a few years later, which prompted the introduction of regulation.

New York became the first state to establish a bank insurance scheme. The 1829 scheme was the innovation of a businessman named Joshua Forman. Under this scheme, merchants who held special charters to trade with foreigners were required to be liable for each other’s debts. There were three core features of the 1829 scheme. These were:

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• An insurance fund to which all banks had to pay an assessment;
• A board of commissioners vested with bank examination powers;
• A specified list of investments for bank capital.  

Five additional states, Vermont, Indiana, Michigan, Ohio and Iowa, adopted deposit protection schemes in the US between 1831 and 1858. The objective of the schemes was to protect communities from the severe economic effects of bank failures and to protect individual depositors against losses. Following the banking panic of 1907, eight additional states also introduced formal deposit guarantee systems for state chartered banks. These schemes attempted to establish a safety fund, through assessments on participating banks, which would be available to meet their insurance obligations in the event of bank failures. These various schemes all collapsed when banking crises escalated in the 1920s.

As a result of the proliferation of bank failures in the United States, one hundred and fifty deposit insurance bills were introduced in Congress between 1886 and 1933, which culminated in the establishment of the Federal Deposit Insurance Corporation (FDIC) in 1933. The creation of the FDIC has been described by Milton Friedman as the ‘most important structural change in our (US) monetary system in the direction of

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7 Ibid. ch2.
8 The states that established these schemes were Texas, Oklahoma, Kansas, Nebraska, Mississippi, South Dakota, North Dakota and Washington.
10 An average of 600 banks was suspended each year between 1921 and 1929. Between 1930 and 1934, this average rose to 2250 with 4000 suspensions in 1933 alone. The Bank of United States was the largest bank to have failed up to that time in US history and the effects of its failure were magnified by its name which created the false impression that it was affiliated with the government. See FDIC (n6); see also M Friedman and AJ Schwartz Monetary History of the United States, 1867–1960 (Princeton University Press, Princeton NJ, 1963) 438; also CM Bradley ‘A Historical Perspective on Deposit Insurance Coverage’ (2000) 13 FDIC Banking Review (2) 1.
greater stability since the post-Civil War tax on state bank notes.\footnote{M Friedman The Control of Money: A Program for Monetary Stability (Fordham University Press, New York, 1959) 21. The introduction of deposit insurance has also been described as the ‘most important monument’ of the New Deal regulatory reforms introduced after the Great Depression (1929-33). See EN White ‘Deposit Insurance’ (1995) World Bank Policy Research Working Paper Series, No. 1541.} The FDIC has since remained a model for most countries that have subsequently introduced formal explicit deposit insurance schemes.

### 3.1.2 Europe

Prior to the establishment of the FDIC in 1933, Norway had established a nationwide deposit insurance scheme for savings in 1921, which was followed by a scheme for commercial banks in 1938. Finland and Czechoslovakia also established nationwide deposit insurance schemes in 1924. In Czechoslovakia, deposit insurance was established as one of the measures aimed at resuscitating the banking system, which had been badly affected by the effects of World War I. The scheme was designed to generate savings by increasing the safety of deposits and encouraging prudent banking practice in the country.

In general, deposit protection schemes in Western European countries started between the late 1970s and early 1980s. The introduction of deposit insurance schemes was a result of the occurrence of bank failures in some European economies.\footnote{The United Kingdom experienced a secondary banking crisis in the 1970s. Bankhaus Herstatt failed in Germany in 1974 and Banco Ambrosiano, an Italian Bank chartered in Luxembourg failed in 1982.} The systems that existed at this time have been described as ‘bare-bones’\footnote{G García and H Prast ‘Depositor and Investor Protection in the EU and the Netherlands: A Brief History’ (2003) 32 Journal of European Economic History (2) 307.} because they offered protection only to depositors in the major financial institutions and to those resident in the country offering the guarantee scheme.
The systems were established to ensure a degree of consumer protection and to promote systemic stability. Following the EU directives on deposit insurance and investor protection, member states have been compelled to revise and adapt existing schemes and to create new schemes where none previously existed.

There is no single EU-wide deposit insurance scheme. Rather what exists is the minimum harmonization of basic features of national schemes. In 1986, the European Commission approved a formal recommendation to persuade member states of the need to establish a deposit guarantee scheme. This document included some basic policy recommendations for member states to adopt in their deposit protection schemes. These can be summarised as follows:

- Compulsory membership of the insurance scheme for all banks including branches of foreign banks;
- Such schemes should be established primarily to protect small and weak depositors

The 1986 recommendation, though not a document creating mandatory obligations for member states, was widely accepted and implemented. The recommendation was followed by a proposal for a Council Directive on deposit guarantee schemes in June...

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17 Apart from Austria, Belgium, France, Norway, United Kingdom, Netherlands and Spain which already had deposit protection schemes, Denmark, Ireland, Italy and Luxembourg also adopted the recommendation and established deposit protection schemes.
1992. The proposal was amended in December 1992 and in March 1993. 18 This culminated in the final enactment of the directive in May 1994.

An important innovation in the 1994 EU Directive is the requirement of ‘home country control’. Unlike the ‘bare bones’ systems that previously existed, the directive ensures the protection of depositors of branches operating in a state other than that of its head office. 19

3.1.3 The United Kingdom

Prior to 1982, there was no formal deposit protection scheme for depositors in the UK. 20 In place of a formal deposit protection scheme, the government and the Bank of England rescued failing financial institutions by deciding on appropriate action on an ad hoc basis. 21 When deposit protection was introduced, the main UK banks were opposed to the idea of a deposit protection scheme with a flat-rate assessment method on the ground that it would amount to subsidization of riskier and smaller banks by larger and safer ones. 22

The deposit protection scheme consisted of a Deposit Protection Board that administered the Deposit Protection Fund. The board was set up to protect deposits made with the offices of UK authorised institutions against such institutions’ insolvency. 23 Rather than the sustenance of financial stability, consumer and investor

18 M Andenas ‘Deposit Insurance’ (Oct 1993) 14 The Company Lawyer Digest (10).
20 Deposit protection was introduced by the Banking Act 1979.
protection concerns appear to have influenced the introduction of the scheme although systemic concerns began to be viewed as increasingly significant.24

The need for increased depositor confidence also appears to have facilitated the emergence of deposit protection. The building societies, which had grown rapidly in the 1970s and had started to challenge banks effectively for deposits from the general public, were aware of the need for depositor confidence. Thus, before the introduction of a deposit protection scheme for building societies in 1986, the Building Societies Association and its member societies organised informal rescues to maintain the stability of the building society movement and to protect depositors.25

The deposit protection scheme went through a few changes, which mainly concerned the level of protection offered to depositors. The most radical change to the scheme was effected under the Financial Services and Markets Act 2000, with the creation of a single Financial Services Compensation Scheme to provide compensation for all sectors of the financial market.

The new scheme recognised the increasing disappearance of traditional barriers between financial markets, financial services and delivery. The scheme covers bank deposits, investments and insurance policies, and it is designed to maintain consumer confidence and to offer a certain level of protection by assuring consumers that where a firm has become insolvent or ceased trading, the debts due to them and other proper claims will be met by the industry as a whole.26

25 Campbell and Cartwright (n21)
3.1.4 Other Countries

In Canada, the introduction of a compulsory deposit insurance scheme with a flat rate in 1967 was also met with resistance from the country’s large banks, which protested cross-subsidizing their smaller rivals. Deposit insurance was introduced following the report of the Porter Royal Commission. The commission was set up to review structural and operational issues affecting the Canadian financial system. The commission’s report indicated that the financial system had developed at a pace faster than the state of laws and regulatory practices. As a result of this, the public was not adequately protected from loss in dealing with financial institutions. The Canada Deposit Insurance Corporation (CDIC) was established to ensure the safety of small deposits and improve the standard of deposit-taking institutions in Canada.

In Asia, India was the first country to introduce deposit protection in 1961. This was followed by the Philippines in 1963. The establishment of the Deposit Insurance Corporation (DIC) in India was necessitated by the various bank failures experienced in the country. These include the failure of Travancore National and Quilon Bank in 1938, the Laximi Bank and the Palai Central Bank in 1960. In India, as in most other countries that have established deposit protection schemes, deposit insurance was introduced as a measure of protection for depositors from the risk of loss of savings resulting from bank failure.

The first deposit insurance scheme in Africa was established in Kenya in 1985. The establishment of the Nigeria Deposit Insurance Corporation (NDIC) followed this in

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28 The commission did not expressly recommend the adoption of deposit insurance.
1988. The Collective Deposit Guarantee Fund was introduced in Morocco in 1993 and Uganda established its own deposit insurance scheme in 1994. Tanzania (1994), Sudan (1996) and Zimbabwe (2003) have all introduced deposit insurance schemes. Other African countries such as Cameroon, South Africa, Ghana, Burkina Faso and Gabon have implicit deposit insurance systems. The purpose of these schemes is to promote depositor confidence and to protect the small and uninformed depositors. Most of the deposit insurers are also vested with bank supervisory powers.

While a number of developing countries are currently introducing deposit insurance schemes, other countries, especially the developed countries, are introducing significant modifications and reform to existing schemes. The need for reform can be attributed to two factors. First, the systems are trying to find a response to the ever changing and improving financial environment which has been characterized by trends of globalization, conglomeration and the blurring of traditional distinctions between financial markets, services and delivery. The second factor is the theoretical and policy debate on financial regulation, which has raised awareness on the role of moral hazard and the importance of incentive mechanisms in regulation in general. This has necessitated the need to re-design financial regulatory laws and mechanisms to produce an optimal deposit insurance scheme that will ensure that moral hazard is kept at the barest minimum if not completely alleviated.

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30 See generally —— ‘Deposit Protection in Canada’ (1992) CDIC Available at http://dpc-
31 See Chapter 6 for a historical analysis of deposit insurance in Nigeria.
32 PN Umoh ‘Deposit Insurance: Concept, Practice and Relevance in Africa’ at International
Association of Deposit Insurers (IADI) regional conference on ‘Deposit Insurance in Africa: Issues,
33 Garcia and Prast (n13) 1.
3.2 Concept of Deposit Insurance

3.2.1. Rationale and Objectives

As discussed in the preceding chapter, there are generally two approaches to justifying regulatory policies. These are the public interest theory and the market or capture theory. From a public interest viewpoint, the rationale for the provision of deposit insurance is the protection of small, uninformed depositors as well as the enhancement of economic and financial stability.33

From the market or capture theory perspective, deposit insurance is viewed as another mechanism of regulation brought about as a result of increased pressure on the political authorities by market participants.34 To this extent, the banks with high-risk portfolios will encourage deposit insurance because they will receive a net subsidy at the expense of the safer banks, with an explicit deposit insurance scheme in place.35 Thus deposit insurance has been described as ‘a tax on less risky firms and a subsidy to more risky firms.’36 Proponents of free banking also oppose deposit insurance on the grounds that it destabilizes the financial system by weakening the economy’s incentive structure.37 However, there is no country that operates an unregulated banking model to its full extreme; even countries that are prepared to tolerate occasional bank failures may intervene based on systemic considerations and political

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34 According to White, deposit insurance was adopted in the U.S. only because of ‘the success of a very narrow group of special interests that wanted to tilt the structure of the financial system in their favor.’ See White (n11); see also CW Calomiris and EN White ‘The Origins of Federal Deposit Insurance’ in C Golden and GD Libecap (eds.) The Regulated Economy: A Historical Approach to Political Economy (University of Chicago Press, Chicago, 1994) 145.
pressure. To this extent, regardless of the position one takes on the perceived benefits or otherwise of deposit insurance, it has come to stay mainly as a result of political necessity.

It is still important to determine if deposit insurance is useful or not, so that if it is, its design can consequently be policy and objective driven and also incentive-compatible, to minimize aspects of the deposit insurance problem. Throughout the literature, several reasons have been espoused to justify the existence of deposit insurance schemes. Principal among these are:

- The protection of depositors, especially the small and unsophisticated ones;
- The promotion of financial stability;
- The promotion of competition in financial services by reducing competitive barriers in the deposit-taking industry;
- To mitigate the pressure on government to provide an implicit one hundred percent guarantee and to redistribute the costs of failure;
- The promotion of an orderly payment system;
- Reducing the effects of a recession.

40 Deposit insurance schemes form part of most modern regulatory systems. As such, these objectives are similar to the objectives of financial regulation discussed in Chapter 2.
41 Di Cagnina (n187) ch6.
The working group of the Financial Stability Forum (FSF) in its report also states that the principal objectives for deposit insurance systems are to contribute to the stability of the financial system and to protect less-financially-sophisticated depositors. For the purpose of this thesis, the two main objectives of deposit insurance schemes, which are financial stability and depositor protection, will be considered below.

3.2.2 Deposit Insurance and Financial Stability

There are generally two types of risks associated with failing banks. First, when a bank fails, it is usually unable to honour its contractual obligations and to pay off its depositors in full. Secondly, the failure of one bank may directly or indirectly lead to the failure of other banks. It may directly lead to the failure of other banks if, for example, the failed bank serves as a correspondent for other institutions. It may lead to indirect failure of other banks if it causes other depositors to withdraw their funds in panic from other solvent but illiquid banks. As explained in the preceding chapter, this is generally referred to as the risk of contagion. These two risks, associated with depositor and systemic concerns, have been the major underlying justification for financial regulation and supervision on public interest grounds.

As with the debate on the regulation of banks in general, the financial stability justification for deposit insurance is also controversial. Benston and Kaufman posit that banks are not inherently unstable and that the cost of an individual bank failure is

44 These two objectives are common to most jurisdictions, the other objectives listed above may vary according to national conditions, but are often incidental to the pursuit of financial stability and depositor protection.
relatively small and not greatly different from the failure of any non-bank firm of comparable importance. They argue that in the absence of deposit insurance prudential regulation of banks would be unnecessary, and that regulation is required only because of moral hazard brought about by deposit insurance. Kaufman also concludes in his review of the empirical literature that concerns about the threat of contagion in banking have been greatly exaggerated.

Although Kaufman concludes that the evidence does not support the existence of a threat of contagion in banking, Schoenmaker differs in his empirical analysis of bank failures in the United States between 1880 and 1936. He concludes that the results are consistent with the existence of contagion risk and that an initial failure could generate further failure without intervention by the authorities.

As noted in the preceding chapter, there is another dimension to the debate, which is the 'risk vs. seriousness' of the issue. As long as the threat to financial stability remains, safety net measures such as deposit insurance are necessary for protection against 'low-probability-high-seriousness' risks. Accordingly, financial crises that have occurred in recent decades, particularly in East Asia and the Mexican Peso crisis, have underscored the existence and threat of contagion risk.

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46 The systemic functions of deposit insurance schemes have been developed by Diamond and Dybvig (1983).
47 G Benston and GG Kaufman 'Deposit Insurance in the FDIC Improvement Act: The Experience to Date' (1998) 22 Federal Reserve Bank of Chicago Economic Perspectives (2) 2.
Deposit insurance schemes give consumers the assurance that their deposits are protected and this confidence reduces the incentives for depositors to withdraw their deposits and trigger a run. Thus deposit insurance promotes financial stability by promoting confidence in the financial system, and to this extent it can be considered as a supplement to the lender of last resort function. It is pertinent to note that in terms of preventing depositor runs on banks, it is the knowledge and awareness of the existence of these facilities, as opposed to their mere existence, that serves to promote and sustain public confidence.

Kaufman concedes, ‘for the sake of reality’ that deposit insurance ‘is a political fact of life’ and that even countries with no explicit deposit insurance systems generally have implicit one hundred per cent guarantees.\textsuperscript{51} This fact is buttressed by the increasing number of countries adopting explicit deposit insurance schemes. The increasing popularity of deposit insurance can be attributed to various factors. Deposit insurance promotes political stability as it removes the political pressure that would result if the government allows depositors to suffer large losses. Such losses could potentially threaten the stability of a democratic government.\textsuperscript{52} The rapid globalization of financial markets has also contributed to the increasing adoption of deposit insurance as most countries are unwilling to allow banking panics jeopardize their reputation and international confidence, which could prevent access to international capital markets.\textsuperscript{53}


\textsuperscript{52} JR Macey and GP Miller ‘Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks’ Assets and Liabilities’ (1995) 12 \textit{Yale J\textsc{ournal} on R\textsc{egulation}} (1) 1.

As a result of the near inevitability of explicit deposit insurance, the main concern for policy-makers is not whether deposit insurance should be adopted or not, but how to design and implement an optimal deposit insurance scheme in which the benefits far outweigh the costs.

### 3.2.3 Deposit Insurance and Consumer Protection

Consumer protection is considered to be the principal rationale for deposit insurance schemes. Depositors, as users of banking products and services can be likened to purchasers and consumers of other products and services. Due to problems of information asymmetry, there is little or no information available for potential depositors to assess the financial position of banks before depositing their funds. Even where such information is available, the average depositor may have difficulty in interpreting such information. Thus deposit insurance serves to protect the interests of the small and unsophisticated depositor by guaranteeing sums placed by such a depositor in financial institutions.

Deposit insurance also helps in saving costs that would have been incurred by depositors in monitoring their banks. If all depositors would have to monitor their banks individually, they would incur costs, which would be duplicated in the case of each individual depositor. This would also mean that small depositors would find it more expensive to monitor their banks than big depositors. This cost can be greatly

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reduced and evenly spread by transferring the monitoring function to a centralized body such as the deposit insurer.

Another justification for deposit insurance on consumer protection grounds is that the savings of an average household will often be poorly distributed, with financial wealth concentrated in deposit accounts in one or two banking institutions. This inability to spread savings and investments means that the average family will be worst affected in the event of a bank failure. Hence deposit insurance could be described as a means of guaranteeing the wealth of the average household and providing it with access to a safe means of making payments.57 This consumer protection justification is also motivated by political factors. Governments all over the world fear the political repercussions of the failure of a big bank. This is because the safety of a significant portion of public wealth placed with such banks is perceived to be a responsibility of government. This explains why governments often exert political pressure on regulators to keep large banks afloat.58 Thus, as mentioned earlier, deposit insurance exists mainly as a result of political necessity.

3.2.4 Financial Stability or Consumer Protection?

The case has been made that the purpose of deposit insurance is mainly to enhance macroeconomic and financial stability. This opinion is predicated on the view that deposit insurance only protects small depositors as an incidental benefit and is not the main social purpose of deposit insurance. This view has also been supported by the

58 M Giles 'International Banking: Coping With the Ups and Downs' The Economist (U.S), 27 April 1996.
argument that citizens face many risks from which government is not obligated to protect them.\textsuperscript{59}

While it is accepted that an important function of deposit insurance is to promote financial stability, it is doubtful whether this should be viewed as the most critical function of a deposit insurance scheme. Deposit insurance is a guarantee to depositors that if their banks fail, they would receive a refund of their deposits up to a specified coverage limit. By providing this guarantee, the level of public confidence in the financial system is increased and this reduces the incentives for depositor runs; thus the likelihood of contagion is greatly reduced.\textsuperscript{60} It would thus appear that deposit insurance promotes financial stability as an incidental function, derived from its main function, which is to protect depositors. The reduction of the risk of a systemic crisis has thus been described as the ‘indirect rationale’ for deposit insurance.\textsuperscript{61}

Citizens do face many risks from which governments do not protect them, leaving individuals and groups to protect themselves through private insurance. However, where the life, health, safety and wealth of the public is concerned, it is usual for the government to step in for purposes of licensing and quality control for connected activities that may affect the public.\textsuperscript{62} It is usual practice for manufacturers and service providers to provide warranties for their products and services. This is important especially when the product or service concerned is expensive and sophisticated so that the manufacturer or provider has more information on the quality

\textsuperscript{59} AS Blinder and RF Wescott ‘Reform of Deposit Insurance’ (2001) A Report to the FDIC \url{http://www.fdic.gov/deposit/insurance/initiative/reform.html}, accessed 16 May 2006. White holds an entirely different view and argues that deposit insurance was not adopted to protect the depositor nor to increase the soundness of the banking system, but to satisfy special interests. See White (1995) (n11).

\textsuperscript{60} Llewellyn (1986) (n39).

\textsuperscript{61} Macdonald (1996) (n56) 8.

\textsuperscript{62} Examples include aviation, health services and products. Banking services are equally important because of the special role that banks play in an economy.
than the consumer. This informational deficiency is similar to the problem of information asymmetry that exists between banks and their customers. Consumer protection concerns dictate that governments should intervene to regulate banks and to protect depositors because depositors lack the information and expertise required to monitor banks.

It is also important to note that deposit insurance would not, on its own, achieve the objective of financial stability. As long as deposits are not fully covered, the potential for depositors to run on their banks still remains. Thus, to function effectively, deposit insurance has to be properly co-ordinated with and integrated into the general regulatory framework. Prior to the twentieth century, banking panics were a frequent phenomenon in Europe and in the United States before the advent of Federal Deposit Insurance. Central banks were introduced to eliminate panics and to ensure financial stability and over time, other financial regulatory and supervisory devices have evolved to ensure financial stability.

The justification of deposit insurance schemes on consumer protection grounds has not generated as much debate as the financial stability rationale for deposit insurance. While deposit insurance is usually the only scheme available for the protection and guarantee of depositors’ funds per se, there are, generally speaking, other factors and mechanisms that affect macro economic and financial stability. The contribution of deposit insurance to banking stability has been questioned in the academic literature.

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64 The first central bank was the Bank of Sweden which was introduced over 300 years ago. For a discussion on central banks and bank regulation, see RM Lastra Central Banking and Banking Regulation (Financial Markets Group, London School of Economics, London, 1996); CAE Goodhart The Evolution of Central Banks (MIT Press, Cambridge, 1988).
It has been observed that ‘on the one hand, credible deposit insurance contributes to financial stability by making depositor runs less likely. On the other hand, unless capital positions and risk taking of insured institutions are supervised carefully, deposit insurance may lead to excess risk taking and undermine bank stability in the long run.’

Indeed, an effective system of bank regulation and supervision is a necessary counterpart to deposit insurance in order to mitigate the deposit insurance problem. Deposit insurance schemes exist mainly because bank failures have caused losses and considerable hardship to depositors. If banks never failed, or if they failed without depositors suffering any form of loss, then governments and regulators would be under no political pressure to provide deposit insurance.

Furthermore, in some countries, for example the UK, deposit protection schemes exist mainly to protect depositors. The White Paper on Banking Regulation published in 1985 noted that the aim of the deposit protection scheme was to provide ‘a degree of protection sufficient to prevent severe hardship among the most vulnerable of depositors.’ As deposit insurance is focussed solely on compensation, the deposit protection bodies in these countries are not invested with other powers of financial regulation and supervision. Most financial systems have put in place an effective system of bank regulation and supervision.

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68 'Banking Supervision’ (Cmd 9695, 1985) ch3.5; see also FSMA 2000, s.2(2). In the context of the EU Single market, depositor protection also helps to achieve a level playing field for cross-border banking services. See M Andenas (1995) (n19).
69 Systemic considerations were very important to the adoption of deposit insurance in the United States, where deposit insurance was initially seen as a means of preventing bank runs. See CH Colembe ‘The Deposit Insurance Legislation of 1933’, (1960) 75 Political Science Quarterly 181. However, it has also been noted that ‘although as a strictly political matter, depositor protection was
lender of last resort facility, in addition to deposit insurance, to help banks in crisis management where there is systemic failure.

On one hand, if the principal aim of deposit insurance is to achieve financial stability, it can indeed be argued that there would have been no need for deposit insurance in the first place; since deposit insurance has inherent problems and cost, particularly moral hazard, it would be wise to reject it and adopt other available means of achieving financial stability. On the other hand, if it is recognised that the main reason for deposit insurance is to protect depositors and that other incidental benefits are derived from this, reform measures would be channelled towards minimizing the risks that arise from deposit insurance and the harmonization of other financial safety net features to ensure economic stability.

While there are different jurisdictional approaches to this issue, these objectives are not mutually exclusive and a well-structured and adequately funded deposit insurance scheme can achieve both objectives. The two objectives can be described as complementary, and it has been observed that 'if customers are to have confidence in their banks then those banks must be subject to effective supervision. If the supervision is to be effective, then customers must have confidence, and be dissuaded from withdrawing their funds in the event of a bank facing difficulty. Bank safety and consumer protection are inextricably linked.' However, it is important for policymakers to give relative prioritization to these objectives, as this has fundamental effects on the design and operation of the deposit insurance scheme.

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3.3. Deposit Insurance and Private Insurance

The exact genesis of the concept of insurance is unknown. It has been traced back to the Babylonians and the Town Guilds of Europe in the mid-fourteenth century.\(^{71}\) The history of insurance can also be traced to the contract of marine insurance, which evolved in the early years of the fourteenth century in the commercial cities of Italy. The concept of ‘risk’ was introduced into the ordinary commercial contracts and insurance allowed the early merchants to share this risk either through prior agreements to provide cover for a member who has suffered loss or through a third party known as the insurer.\(^{72}\) Insurance can thus be described as a transfer of risk or collective risk-bearing.

Insurance is a contract of indemnity and it has been defined as ‘a contract by which one party (the insurer) in consideration of a premium, undertakes to indemnify another (the insured) against loss.’\(^{73}\) With modernization and development in commerce and financial markets, the concept of insurance has expanded and grown from marine insurance to such areas as fire and life insurance. Insurers provided cover for those individuals whose wealth was invested in tangible property.\(^{74}\) As a result of the multi-dimensional nature of insurance, it has now become practically impossible to agree on an all-embracing definition of insurance. Indeed, it has been described as a concept, which is better to describe than to define.\(^{75}\)

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73. ibid.
74. Lowry and Rawlings (2005) (n71) ch1.
75. See Sir Robert Megarry V-C in Medical Defence Union Ltd v Department of Trade [1980] Ch 82 at 95.
Although deposit insurance is a peculiar type of insurance, there are certain similarities as well as differences between deposit insurance and conventional insurance practice. It has been observed, in relation to the introduction of Federal deposit insurance in the US that ‘the general argument employed to promote the guarantee plan began with the premise that property can be insured and bank deposits are property. It travelled to the broad assumptions that the principle of the distribution of risk through insurance could be applied to bank deposits.’

Deposit insurance compensates the depositor if the risk protected against (the failure of an insured institution) materialises. The basic elements in the definition of an insurance contract, which are payment of premium and a promise of indemnity upon the occurrence of a special event, are present in a deposit insurance scheme.

An insurance contract must relate to a risk, which involves uncertainty. The insured peril may or may not occur: ‘there must be either uncertainty whether the event will happen or not, or, if the event is one which must happen at some time, there must be uncertainty as to the time at which it will happen.’ Bank failure is an uncertain occurrence and the deposit insurer bears this risk in consideration of payment of premium by participating institutions.

That the deposit insurer is usually conferred with other regulatory and supervisory powers to forestall the occurrence of the event insured against does not make deposit insurance less of an insurance contract. Risk-minimizing powers of some deposit

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77 Llewellyn (1986) (n39).
78 See Channell J.’s definition of an insurance contract in Prudential Insurance Company v Inland Revenue Commissioners [1904] 2 K.B 658, 663.
Insurers can be compared to the practice in general insurance where insurers take steps to mitigate the risk, for example, a term requiring the insured to install sprinklers in the insured premises; a term requiring that the insured vehicle should be fitted with approved locks and alarm systems; or a term restricting the use of an insured car.

These basic similarities notwithstanding, deposit insurance differs from regular insurance in many respects. The first point of departure is that while the latter’s objective is to reduce the liability of the insured in the event of an adverse outcome, deposit insurance works to reduce the risks associated with bank panics.

In ordinary insurance, the premium is paid by the insured whereas in deposit insurance, the bank, not the depositor, pays the cost of the insurance. The effect of this is that there are more parties involved in the contract of deposit insurance than there are in ordinary insurance. The doctrine of privity of contract, which bars a person from enforcing a contract to which he is not a party is fundamental to the contract of insurance. In deposit insurance however, the depositor is not, strictly speaking, a party to the contract even though the scheme exists largely for his benefit.

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80 Kler Knitwear Ltd v Lombard General Insurance Co. Ltd [2000] Lloyd’s Rep IR 47
82 Farr v Motor Traders’ Mutual Insurance Society [1920] 3 KB 669.
86 It is also possible in general insurance to insure against third party risks. See Williams v Baltic Insurers Association of London Ltd [1924] 2 KB 282.
87 Vandepitte v Preferred Accident Insurance Corporation of New York [1933] AC 70. This principle has however been varied in the UK by the Contract (Rights of Third Parties) Act 1999.
88 In Paul v Germany (C-22/02) (Unreported, October 12 2004), the European Court of Justice held that the Deposit Guarantee Directive of 1994 did not confer any individual rights on depositors even
Furthermore, while general insurance only protects the insured against the occurrence of events, which are independent or fortuitous, depositors under a deposit insurance scheme would still be covered even where bank failure is a result of mismanagement or excessive risk-taking. Bank failures tend to occur in waves, partly in response to a severe recession or to some other macroeconomic shock or even to legal and supervisory inadequacies. Bank failures can also be contagious when the failure of one bank brings down its counterparties. Also, to the extent that where the deposit insurer is conferred with intervention powers, the timing of such intervention can determine the extent of loss which occurs when a bank fails, bank failures cannot be described as entirely fortuitous events.

Deposit insurance can be described as a hybrid of a contract of guarantee and insurance. To this extent, it acts as a form of guarantee insurance or a surety because the deposit insurer assures the depositing public that their banks will perform their obligations while also undertaking to indemnify the depositors, to an agreed limit, in respect of any loss that may be incurred in the event of insolvency of a financial

though the directive has as one of its objectives the protection of depositors. See 'No Recourse Against Supervisory Authority' (2004) 153 EU Focus (5); See also the House of Lords decision in Three Rivers District Council and others v Governor and Company of the Bank of England (No. 3) [2000] 2 WLR 15 (HL).

89 This is known as the doctrine of ‘causation’, where only the proximate cause of a loss is to be looked to. The loss must have been caused by a peril, which the insurer contracted to cover. Where the insured risk materializes as a consequence of the insured’s action, the court will have to decide if the action was negligent, reckless or intentional. See Harris v Poland [1941] 1 KB 462; also Soft v Prudential Assurance Co Ltd [1993] 2 Lloyd’s Rep 559. On causation, see generally, HLA Hart and T Honore Causation in the Law (Clarendon Press, Oxford, 1985); on causation in insurance law, see J Lowry and P Rawlings ‘Proximate Causation in Insurance Law’ (2005) 68 Modern Law Review 310.


92 It is often a question of fact whether a particular contract is one of guarantee or of insurance. For judicial guidance, see Trade Indemnity Co. v. Workington Harbour Board [1937] AC1; see also Romer IJ’s judgement in Scatton v Heath [1899] 1QB 782 (Reversed in [1900] AC 135 on other grounds). In each case, the question would depend on the expressed intention of the parties. See Lord Fisher in Dane v Mortgage Insurance [1894] 1QB 54, 60.
institutions. Unlike in general insurance where the insured is protected against losses due to defined risks, with certain policy exclusions incorporated in the terms, explicit deposit insurance is a guarantee to reimburse depositors' funds regardless of the cause of bank failure.

The major difference between deposit insurance and general insurance appears to be that deposit insurance schemes are governed by clearly laid out rules and procedure which are found in the statute establishing the scheme, whereas general insurance practice is governed by a combination of statutes, codes of practice, terms and conditions and judicial pronouncements, which depend on the facts of each case.

3.4 Forms of Deposit Protection

Conceptually and in practice, deposit insurance schemes generally take two forms: the Implicit Deposit Protection Scheme (IDPS) and the Deposit Insurance Scheme (DIS), which is known as explicit deposit insurance.

3.4.1. Implicit Deposit Protection Scheme (IDPS)

Implicit deposit protection refers to an implied protection of bank depositors in the absence of any formal deposit protection arrangements. Where there is no legal obligation to protect deposits, government can elect to protect depositors of a failed bank because it believes that the attainment of some public policy objective, for example economic development and social justice, requires such an action. The provision of implicit deposit insurance can also be a consequence of political or

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market pressure on the government. Implicit deposit insurance is characterized by discretion; the government is usually at liberty to decide whether or not to grant any relief to depositors and the amount of such relief. The basic characteristics of implicit deposit protection are:

- There is no enabling law such that legal obligation is absent and assistance can only be predicted by past behaviour of government or by statements of officials;
- There are no legislated rules regarding the coverage limits and form of compensation;
- There are no earmarked funds for the purpose of deposit protection.\(^{95}\)

The provision of implicit deposit insurance is usually channelled through ad hoc institutions or arrangements. The respective ad hoc bodies usually determine the extent and form of the protection offered. There are usually no pre-existing laws to guide the general administration of the scheme, although prior conduct in similar circumstances may serve as precedence. The government makes the decision, on a case-by-case basis, on the form in which protection is to take and the manner in which it will be financed. The funds for depositors’ compensation are usually sourced through the central bank or through the government’s contingency expenditure provision in the budget. It has been argued that implicit deposit insurance exists to the extent that the political incentives that shape a government’s reaction to crisis make a taxpayer bailout of insolvent banks seem inevitable.\(^{96}\)

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Implicit deposit protection can also be implemented through the use of stringent prudential regulations, monitoring and supervision and failure resolution options that ensure depositors’ protection.\textsuperscript{97} In an implicit deposit protection arrangement, government can provide protection to depositors of failed or failing financial institutions in three basic ways. The first and most commonly used method is the direct payment of funds to depositors or the arrangement for a failed bank’s deposits to be assumed by another bank. A second method is for the government to arrange and financially support another solvent bank to merge with or acquire a failing bank.\textsuperscript{98} The third alternative is for the government to directly rehabilitate the failing bank. This could be through direct equity capital injection or by acquisition of the failing bank’s non-performing assets at book value.\textsuperscript{99}

With the second and third options, which will invariably involve rehabilitation, the government is likely to emerge as the controlling shareholder in the concerned bank; it would thus have effectively nationalized the bank.\textsuperscript{100} Where the rehabilitation is successful and the bank starts operating at a profit again, the government will be able to recoup the funds invested to rescue the failing institution.

\textbf{3.4.2 Explicit Deposit Insurance}

Explicit deposit insurance is usually provided in the form of a deposit insurance scheme (DIS), and is created by a legal instrument, a deposit insurance law, which

\textsuperscript{98} Where this method is adopted, the government or relevant authority will be acting to prevent the failure of the ailing bank rather than to compensate depositors for loss of funds.
\textsuperscript{99} MacDonald (1996) (n56).
\textsuperscript{100} Taylor and Mas (1990) (n39).
sets out the rules governing the operation of the scheme.\textsuperscript{101} The deposit insurance law states the objectives of the scheme and defines the financial institutions and categories of deposits covered by the scheme. Typically, the law also states, inter alia, whether participation in the scheme will be compulsory or voluntary, the method of funding the scheme and the failure resolution devices to be used by the deposit insurer.

Coverage of insured deposits under a DIS can either be limited,\textsuperscript{102} one hundred percent or discretionary.\textsuperscript{103} Under the limited coverage scheme, deposits are guaranteed up to a maximum amount prescribed by law. When an insured institution fails, the deposit insurer is obliged to pay off depositors up to the stipulated maximum amount. The purpose of a limited coverage scheme is to protect small depositors when banks fail. Under a limited coverage scheme, uninsured depositors, shareholders and general creditors are not protected and the deposit insurance law does not confer on the deposit insurer the power to rehabilitate failing banks or to facilitate mergers. To do so will be extending de facto protection to uninsured depositors as in an implicit deposit insurance scheme.

The one hundred percent coverage deposit protection scheme involves the full guarantee of all insured deposits. The deposit insurer is allowed to employ different methods of failed bank resolution including financial assistance, mergers and rehabilitation of failing banks. This type of deposit insurance scheme is rarely adopted

\textsuperscript{101} For example the Canadian Deposit Insurance Corporation (CDIC) Act 1967, the Federal Deposit Insurance Corporation (FDIC) Act 1933 and the Nigerian Deposit Insurance Corporation (NDIC) Act 1989. In countries that practise integrated financial regulation and supervision, the enabling law for deposit protection schemes is usually contained in the general financial services law. See for example the Financial Services and Markets Act (FSMA) 2000.

\textsuperscript{102} Explicit limited coverage deposit insurance is the most common model adopted by countries with DIS.

\textsuperscript{103} Issues relating to deposit insurance coverage are also discussed in the next chapter.
in practice. The full coverage of the deposit protection scheme can either be provided for by statute or operate as government policy. A one hundred percent coverage deposit insurance scheme would create a very high level of moral hazard risk in the financial system.

A discretionary coverage deposit insurance scheme is similar to a limited coverage scheme in that deposits are only guaranteed up to a prescribed limit. However, with discretionary coverage, the deposit insurer has the power to extend its coverage under certain special circumstances. These special circumstances would be:

1. The banking system has been affected by a loss of public confidence and as such is at risk of contagion and
2. The need to protect against bank runs outweighs the risk of moral hazard that will result from extending coverage of insurance to uninsured depositors.

In exercising its discretion to extend coverage, the deposit insurer can arrange or give financial assistance for the merger or rehabilitation of a failing bank. It can also make use of a purchase and assumption transaction to rescue a failing institution.

A deposit insurance scheme with discretionary coverage operates as a limited coverage scheme under normal circumstances. The special circumstances can however convert its functions into a full coverage deposit protection scheme.

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104 This was the system of deposit insurance practised in Argentina between 1946 and 1971; Japan, Mexico, Taiwan, Turkey and Sweden have also changed from a blanket guarantee system to a limited explicit system.
105 Japan, Mexico, Taiwan and Turkey.
108 This involves an arrangement with another solvent bank to assume all of a failing bank’s deposits and acquire all or some of the failing bank’s assets in return for a cash payment by the insurer. This method is also used where implicit deposit protection is provided.
109 This is the type of deposit insurance practised in the US where the FDIC is given several options to resolve institution failures such as selling deposits and loans of failed institutions to another institution. This is also the practice of the NDIC in Nigeria.
3.4.3 Advantages and Disadvantages of IDPS and DIS

One obvious advantage that an explicit deposit insurance scheme has over implicit deposit insurance is certainty. An explicit scheme provides legal certainty and because its operations are rules-based, the handling of failing banks and the protection of depositors would be faster, smoother and generally more predictable and consistent. Certainty is also ensured because an explicit scheme is usually administered by an agency or body solely dedicated for this purpose. Implicit protection, on the other hand, is usually administered by ad hoc bodies whose decisions are based on discretion.

It has been shown that implicit deposit protection systems are more prevalent in developing countries. In these countries, most of the banks are government owned or have strong ties to government. Consequently, the government is expected to interfere where these banks fail; in such cases, private banks, with no state ties, may be allowed to fail.\textsuperscript{110}

In contrast to implicit deposit insurance, explicit deposit insurance can be provided at a cheaper and defined cost to the government and the taxpayer. Implicit deposit insurance is usually financed by government’s contingency funds, thus the tax-payer invariably bears the cost. Also, because an explicit system would have its own dedicated funds, it would be capable of eliminating time delays associated with the determination of funding sources. Where implicit protection is practised, delay will be inevitable, as most national laws would require parliamentary approval for funds to be utilized for the purpose.
Implicit deposit protection exposes the government to intense political pressure and lobbying. In this regard, the European Shadow Financial Regulation Committee (ESFRC) has noted that 'the practice of bailing out institutions creates expectations of official support beyond deposit insurance limits, thereby distorting market incentives and undermining financial discipline (the so called moral hazard problem). Market discipline is jeopardized because bank managers are encouraged to take excessive risk with the knowledge that they will benefit from a government bail-out if their institutions fail.

The various legal and administrative constraints involved in the operation of a DIS can however make it a more expensive option of deposit protection. With implicit deposit insurance, there could be more options available because of the high degree of discretion involved. Implicit protection gives the government flexibility to assess and respond accordingly to individual cases of bank failure. Most deposit insurance laws mandate the deposit insurer to pay off depositors in cash but with implicit protection, payments can be made in form of cash or other government securities. Payments can also be prioritized and spread out over a period of time. The administrative and operational costs involved in maintaining a deposit insurance agency, especially where there is a long and uninterrupted period of banking and economic stability, also makes explicit deposit insurance potentially more expensive than implicit protection.112

110 Kyei (1995) (n95) 2.
111 'A New Role for Deposit Insurance in Europe' European Shadow Financial Regulatory Committee Statement No.5, 18 October 1999.
112 Depending on the source of funding an explicit DIS, it is possible that the government contributes little or no funds to the scheme; in the UK for example the Financial Services Compensation Scheme (FSCS) is funded by the industry. However, implicit protection is usually funded by the government.
Explicit deposit protection also creates the risk of moral hazard by encouraging excessive risk-taking which is often not checked by depositors as they become indifferent to the financial and risk positions of their banks thus ignoring the use of available information in the placement of their funds. Moral hazard can however be checked if the extent of deposit insurance coverage is limited.

The primary objective of both systems of deposit insurance is to protect small depositors and to prevent systemic runs. However, an explicit limited coverage deposit insurance scheme will serve this purpose better. Where an explicit DIS is in place, the protection of small depositors becomes a legal obligation. The deposit insurer is mandated to protect insured depositors and is given reasonable discretion to extend this protection to uninsured depositors. Conversely, arrangements involving the rescue or rehabilitation of failing banks would invariably result in the provision of full coverage to all categories of depositors rather than restricting protection to small and uninformed depositors, who are unable to assess and monitor the financial risks involved with the placement of their money in particular banks and who are most likely to be affected by the effects of bank failure. The ESFRC, in its statement of 18 October 1999 noted that deposit insurance should play a role primarily in the liquidation of insolvent banks without the need for bailouts. The committee held the view that uninsured depositors and other creditors should not be protected by deposit insurance. In this regard, it should be noted that explicit deposit insurance schemes, governed by clearly laid out laws and regulations, ensure transparency and public trust. In most countries there are strong links between politicians and major shareholders of commercial banks. With an explicit system it will therefore be

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111 MacDonald (1996) (n56).
114 Implicit deposit insurance invariably provides support for shareholders of the affected banks as well. This is in addition to the protection they already enjoy under the limited liability principle.
difficult for the government to justify the motives of deposit protection where such protection is extended to cover failing institutions to which it has links.

The advantages of an explicit deposit insurance system outweigh that of an implicit system. The working group of the Financial Stability Forum in its report rightly posit that:

- A deposit insurance system is preferable to implicit protection if it clarifies the authorities’ obligation to depositors and limits the scope for discretionary decisions that may result in arbitrary actions.
- To be credible and to avoid distortions that may result in moral hazard, such a system needs to be properly designed, well implemented and understood by the public.
- A deposit insurance system needs to be part of a well-designed financial safety net, supported by strong prudential regulation and supervision, effective laws that are enforced and sound accounting and disclosure regimes.\(^{115}\)

### 3.5. The Deposit Insurance Problem

Although relatively straightforward as a concept, experience has shown that the implementation and practice of deposit insurance is complex. This demonstrates why deposit insurance has assumed centre stage in the academic literature and international debate.\(^{116}\) It also explains why even the oldest deposit insurance schemes are still constantly undergoing modifications.

\(^{115}\) FSF (2001) (n43).
While the need to continuously evaluate and modify deposit insurance schemes is partly due to the dynamic nature of banking business, it can be mainly attributed to the problems which are intrinsic to the existence of deposit insurance. These problems border on the need to ensure that deposit insurance schemes are designed to eliminate perverse incentives, which are capable of exacerbating the problems which deposit insurance was intended to solve in the first place. The two main aspects of the deposit insurance problem, which are moral hazard and the principal/agent problem will now be considered.

3.5.1 Moral Hazard

The existence of any form of insurance is believed to create moral hazard. Moral hazard in general insurance has been defined as 'the risk that the proposer will in some way act dishonestly in relation to the insurance policy, in particular the risk that he will make false claims.'117 This definition is, however, not all-embracing; it is easier to identify what constitutes moral hazard than to attempt a general definition.

Moral hazard refers to facts which may influence the behavioural pattern of the insured, such that the likelihood of the occurrence of the risk insured against is greatly increased. In other words, moral hazard refers to the adverse effects, from the point of view of the insurer, which insurance may have on the insured’s behaviour.118 Accordingly, such facts as the insured’s claims history and prior refusals of cover:119

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118 Mac Donald (1996) (n56).
119 See Glickman v Lancashire & General Assurance Co [1927] AC 139; London Assurance v Mansel (1879) 41 LT 225.
the insured’s criminal record and integrity; and other factors such as sex, disability or age of the insured could constitute moral hazard.

In relation to financial regulation in general, moral hazard refers to the consequences of the fact that the insured no longer needs to fear harm if the risk insured against comes to pass. As noted earlier, private insurance only covers the insured from losses arising out of defined risks, and as such preventable losses would not be covered. Deposit insurance however covers the depositor regardless of the cause of bank failure, thus the insured depositor no longer has an incentive to take precautions to avoid the harm of bank failure, or to monitor the risk behaviour of banks, or demand interest rates that correspond with that behaviour.

Moral hazard creates the incentive for economic agents to maximise their own utility at the expense of others in situations where they do not bear the full consequences of their actions. It is the incentive for insured financial institutions to engage in riskier behaviour than would be obtainable in the absence of insurance. Thus moral hazard has been defined, in the context of deposit insurance, as having two components: 'first, potential incentive to management to take excessive risk due to the promise of a government bail-out; and second, the consequent risk to the public purse due to the potential expense.'

121 See generally Lowry and Rawlings (2005) (n71) ch4.
124 K Alexander ‘Corporate Governance and Banks: The Role of Regulation in Reducing the Principal-Agent Problem’ (2006) 7 Journal of Banking Regulation (1/2) 17.
126 J Norton and others ‘Legal Aspects of Depositor Protection Schemes: Comparative Perspective’, International Seminar on Legal and Regulatory Aspects of Financial Stability, Basel, Switzerland,
The presence of moral hazard is generally engendered by the following factors:

- A shareholder's loss and liability is limited to the amount of his investment in the event of a bank failure. There is a strong incentive for management of insolvent or failing institutions to favour risky behaviour; where a loss occurs, it is passed on to the insurer and where profits accrue, the shareholders enjoy the benefit;

- Deposit insurance premiums have been unrelated to, or have not generally reflected the risk posed by a particular bank (unlike other forms of insurance). Since insured financial institutions do not pay increased deposit insurance premiums when they adopt risky policies, the owners keep all the increased returns that may accrue from increased risk;

- If deposit insurance means that depositors no longer feel obliged to assess the risk involved in depositing funds with a particular bank, they are likely to base their decisions solely on the attractiveness of the interest rates on offer. The effect of this is that moral hazard will be increased as the normal impact of market forces in promoting prudent financial behaviour is reduced and unsound banks may attract more deposits.

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130 MacDonald (1996) (n56).
It follows from the above that moral hazard in deposit insurance is, generally speaking, triggered by the actions of three agents, which are: the insured banks, the insured depositors and the regulator (through its premium assessment policy and regulatory forbearance).\textsuperscript{131}

President Roosevelt expressed initial reservations on the adoption of explicit deposit insurance in the United States in 1933 because he considered it ‘would put a premium on unsound banking in the future.’\textsuperscript{132} Moral hazard is believed to be inherent in deposit insurance. However there is no consensus on the extent of its effects in practice. It has been argued that the relative absence of bank failures in the United States after the establishment of Federal Deposit Insurance fostered the illusion that deposit insurance is a low cost way of preventing banking crises. Confirming President Roosevelt’s fears, this illusion was dispelled following the Savings and Loans crises in the 1980s, revealing how substantially deposit insurance had exposed taxpayers to loss from risk-taking at insured institutions.\textsuperscript{133} Conversely, it has also been posited that the introduction of explicit deposit insurance can be linked to the reduction in bank risk taking in the EU. This argument is based on the view that in the absence of explicit deposit insurance, European banking systems have been characterised by implicit insurance because of the expectation of public intervention at times of distress. Hence, the introduction of an explicit system would limit the scope of the safety-net and consequently, the potential for moral hazard.\textsuperscript{134}

\textsuperscript{131} This is known as ‘regulatory moral hazard’. See Ely (1999) (n67).
\textsuperscript{133} De Miercand Kunt and Kane (2002) (n42).
Moral hazard is intrinsic to the existence of deposit insurance although its scope and effect may be in debate. Hence it is important to ensure that the benefits of a deposit insurance scheme outweigh its potential costs by creating appropriate mechanisms to mitigate the effects of moral hazard.

3.5.2 Limiting Moral Hazard

There are several measures that are available in general insurance practice to tackle the risk of moral hazard but not all of them can be adapted to deposit insurance. Therefore, some mechanisms have been developed specifically to tackle the problem of moral hazard in deposit insurance. These include narrow banks, risk-based premiums, coinsurance, an improved corporate governance regime, market discipline by uninsured depositors and other creditors, and regulatory discipline by the supervisory authorities and deposit insurers. Some of these measures of checking the effects of moral hazard will be considered below.

3.5.2.1. Narrow Banking

The concept of narrow banking involves the creation of low-risk banks by separating insured deposits from risky lending and investment. Narrow banks can generally be referred to as banks that specialize in deposit-taking/payment activities but are prohibited from lending activity. Such banks are only allowed to invest in safe and liquid assets. The purpose is to offer depositors an essentially risk-free

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135 Also known as 100 percent Reserve Banking.
deposit account. It involves a high degree of restraint on banking activity and it has been described as taking 'the regulation of banking to its very limit.'

Narrow banking has been proffered as a solution to the moral hazard problem. Moral hazard exists because banks have the latitude to invest depositors’ funds and there are incentives for them to invest in risky assets. Hence the moral hazard problem would be solved if banks are required to invest only in safe assets. The proposal involves a separation of the transaction and intermediation functions of banking business. It has been argued that this would eliminate concerns that ‘depositors’ funds either would be used to bail out risky non-bank activities or unfairly channelled to customers of non-bank affiliates.

Under a narrow banking system, while regulation attempts to ring-fence insured deposits and restrict their use, existing restrictions on bank activities and investments relating to uninsured deposits will be removed. To this extent, it has also been described as ‘an interesting combination of heightened regulation, for narrow banks with insured deposits, and reduced regulation for other banks without insured deposits.'

Ordinarily, the concept of narrow banking appears to eliminate the problem of moral hazard associated with deposit insurance. Banks would be prevented from using insured deposits to engage in high-risk activities and banking stability would be

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139 It has been argued elsewhere that banks can only function efficiently when both functions are combined. See A Kashyap and others ‘Banks as Liquidity Providers: An Explanation for the Coexistence of Lending and Deposit-taking’ (2002) 58 Journal of Finance (1) 33.


141 Macey (2001) (n122) ch3.
sustained because deposits are fully backed by safe assets. Thus there is no reason for depositors to lose confidence or even fear a bank failure. By restricting banks to only high quality debt of short duration, potential losses associated with credit and interest rate risks are virtually eliminated. Credit or default risk will be reduced by eliminating all private sector lending with the exception of lending to other banks.

Narrow banks would only be allowed to invest in low-risk financial assets, of short to medium-term maturity, which would match the maturity of their deposits. This means that the risk factor associated with bank deposits is removed thus the need for deposit insurance would also be obviated. If runs on narrow banks occurred at all, the banks would be able to meet them by liquidating a portion of their assets without delay, significant cost or disruptive effects on capital markets.

Narrow banking is based on the reasoning that bank failures occur because banks invest in assets that lose value over time. This proposition however neglects the problems of excessive risk-taking by bank managers and the failure of regulatory authorities to curb such risk-taking. In relation to deposit insurance, this problem is particularly caused by the existence of wrong incentive mechanisms for bank managers, regulators and depositors. Narrow banking is aimed at eliminating the consequences of the problem and not the causes of the problem. The solution does not address the issue of why banks take excessive risks by investing in assets that lose value and why regulators have failed to stop this trend. Because the narrow banking

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144 Deposit insurance would be needed only for failures caused by fraud and other external factors. For a contrary view, see JB Burnham ‘Deposit Insurance: The Case for the Narrow Bank’ (1991) 14 Regulation (The CATO Review of Business & Government) (2) 35.
concept fails to recognise the role of incentive mechanisms in the behavioural pattern of bank managers, regulators and depositors, it is likely to throw up more problems than solutions.146

The narrow banking concept has the tendency to create a two-tiered regulatory system. While narrow banks would attract a lot of savings because of the security they provide, more depositors could also be attracted to the unregulated banks because of the higher interest rates that would be on offer. These unregulated institutions face the risks and consequences of instability and failure that banks and depositors face in the absence of deposit insurance. If enough public wealth is concentrated in these unregulated banks, a failure could expose the economy to the danger of disruptive banking panics and financial instability.147 Furthermore, if these banks were to be insured, they would be affected by the risk of moral hazard, from which the narrow banks would be immune.

Narrow banks, by definition, cannot meet all of the demands of traditional banking services. Implementation of the narrow banking proposal would therefore have adverse consequences on the financial intermediation role of banks. The concept has the potential of reducing the supply of credit to borrowers. Most economies rely on microfinance because the majority of borrowers lack direct, cost-effective access to the capital market. Where narrow banks attract more deposits as a result of the security they offer, small and medium scale borrowers would be denied access to credit because deposits placed in narrow banks would be channelled solely into liquid

147 Macey (2001) (n122).
government and high-quality corporate obligations. In the absence of narrow banks, there would be an unrestricted and cheaper access to credit while deposit insurance would serve to mitigate the effects of harmful bank runs that may occur as a result of deposit-funded lending.

Narrow banking has the potential of leaving the regulatory system susceptible to a high level of political pressure and manipulation since regulators or legislators determine what constitutes a ‘safe’ asset for narrow banking purposes. Deposit-funded lending is generally more profitable and as such, owners of narrow banks might exert political pressure in order to obtain relief from asset restrictions. Policy makers may be tempted to define these assets for political and social, as well as prudential reasons. Narrow banking could thus become an instrument for government credit allocation.

It appears from this that the costs of introducing a narrow banking policy far outweigh the benefits that would be derived from it. Narrow banking would not effectively solve the problem of moral hazard or improve the safety of the banking system but would only shift the risk to another part of the financial system.

3.5.2.2. Coinsurance

Coinsurance involves the sharing of risk between the insurer and the insured, with only a proportion of deposits covered per depositor as opposed to one hundred percent.

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149 Ibid.
coverage. The insured is required to bear an agreed part of the risk insured against, as deposits are only insured in proportion up to different amounts. Unlike the narrow banking concept, the principle of coinsurance is aimed at creating the right incentive for depositors. The aim is to enforce market discipline through depositors, by creating the incentive to assess and monitor the risk position of their banks and place their funds accordingly.

The Financial Stability Forum (FSF) in its report notes that the use of coinsurance, whereby a pre-specified proportion of deposits is insured, helps to foster market discipline. The report however notes that ‘even under a coinsurance system, individuals who have small account balances may not exercise market discipline because of a lack of financial incentives or sophistication, or because the costs of doing so exceed the benefits.’

Where coinsurance is adopted in its traditional form, the potential for bank runs might be exacerbated as some part of every deposit would be uninsured. Depositors would therefore be concerned about the uninsured portion of their deposits. The small and unsophisticated depositor would also be left unprotected thus defeating one of the traditional justifications for deposit insurance. This can however be addressed by insuring deposits in full up to a certain limit and then introducing coinsurance after this limit.

154 The coinsurance element of the U.K. Compensation Scheme was partly responsible for the recent run on Northern Rock.
In determining an appropriate level of coverage, it would be helpful to ascertain the average size of a nation’s individual deposit account and to relate the maximum level of coverage to this amount. These limits will vary according to country-specific circumstances. Economic data such as per capita national income and average annual disposable income can be used to calculate this amount. Accordingly, the highest levels of insurance coverage are found in the most developed countries while the developing countries have the lowest levels of coverage. Coverage limits involve a trade off between achieving banking stability through depositor protection, and retaining the incentives for depositors to monitor banks’ risks.

Considering the problem of information asymmetry, it is doubtful whether or not it is realistic to expect small and uninformed depositors to carry out any form of risk monitoring on their financial institutions even with the imposition of coinsurance. It is more difficult and expensive for potential depositors to assess the financial condition of banks than it is for purchasers of other goods to verify quality before purchasing the products. Information on the risk portfolio of financial institutions is scarcely available and even where it is available, the average small depositor does not possess the necessary sophistication to interpret such information and make informed decisions thereon. A potential danger in requiring small and uninformed depositors to monitor their institutions is that these depositors can take actions based on faulty conclusions and this in itself can trigger a run. According to Campbell and Cartwright, "possible indicators of risk, such as the level of interest paid might be

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156 MacDonald (1996) (n56) 17.
157 Ibid.
158 Demirgüç-Kunt (2005) (n152).
misleading. For example, building societies in the UK have traditionally paid higher rates on interest on savings than banks, but have seldom been regarded as high risk. It is the bank regulator who will be in the best position to judge the levels of risk.'

Where limits are fully covered up to a sufficient amount that would ensure that small depositors enjoy one hundred percent coverage and coinsurance introduced for larger deposits, market discipline will be fostered by the larger depositors who are presumed to have better access to, and better use of the relevant information to exercise market discipline than small depositors.

3.5.2.3. Risk Based Premiums

The Financial Stability Forum (FSF) in its report states that ‘policy makers have a choice between adopting a flat-rate premium system or a premium system that is differentiated on the basis of individual-bank risk profiles. The primary advantage of a flat-rate premium system is the relative ease with which assessments can be calculated and administered. However, in a flat-rate system, low-risk banks effectively pay for part of the deposit insurance benefit received by high-risk banks.’

The logic behind a risk-based system of assessing deposit insurance premiums is simple: to remove the incentive for banks to take excessive risk, knowing that a high-risk posture would attract a higher premium. This makes risky business more

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expensive for banks and this additional cost would serve as a source of market discipline that would reduce incentives for excessive risk taking.

A risk-adjusted system of assessing deposit insurance premium is desirable from an equitable point of view, as it reduces the cross-subsidy between banks.\textsuperscript{162} In a competitive market without deposit insurance, depositors would choose among competing institutions on the basis of their soundness. Riskier institutions would only be able to attract deposits by paying higher interest rates and this increased cost of funds to risky institutions would act as an incentive towards reducing excessive risk taking.\textsuperscript{163}

In the United States, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) 1991 introduced the concept of charging premiums based on risk factors. The discussion on moral hazard has focused less on how it relates to or can be solved by consumers but more on how it relates to banks and their officers. The aim is to provide an incentive for banks to avoid the adoption of high-risk policies. As the discussion in the U.S. did not focus on the introduction of coinsurance but on risk-based premiums, instead of charging the depositor with the responsibility to monitor the risk levels of the banks, it is the FDIC that would calculate the risk factors and charge premiums accordingly.\textsuperscript{164}

The argument for risk based deposit insurance premiums is cogent and consistent with sound insurance practice. If banks are made to bear the cost of excessive risk-taking, they will appropriately balance the trade-off between risk and return. However, it

appears that risk-based deposit insurance is not enough to tackle moral hazard, and it might be more difficult to implement in practice than it is to postulate in theory.

For deposit insurance pricing purposes, it is practically difficult accurately to ascertain risk. Deposit insurance premium can fully reflect risk only under full information conditions. The nature of a bank’s portfolio is difficult to determine because the nature of banking is characterised by private information or information asymmetry. The opaque nature of bank contracts explains the extensive debate on how best to make the Basel capital requirements reflect risk more accurately.

Furthermore, banks are usually classified as ‘high-risk’ based on their interest rate policies but interest rate related risk is distinct from credit risk. The former is clearly more measurable than the latter, but even in this case, ‘it is easier to determine that one institution faces greater risk than another than it is to determine how great that risk is.’ Risk based premiums can effectively deal with perverse incentives where the deposit insurer has the information and capacity to observe the investment strategy of banks and calculate premiums to reflect this.

It is important to distinguish the risks of bank failure from conventional insurance risk. In general insurance, there are various indices available to the insurer to

166 This refers to a situation where the relevant information upon which a transaction or contract is based is known to only one of the parties.
167 See Chapter 2.
169 In conventional insurance, the risk of the insured event occurring and the risk of loss to the insurance company are invariably the same: when the event occurs, in the absence of any vitiating element, the insurer must pay the contractual sum.
calculate premiums based on risk. However, deposit insurers have considerable control over the extent of their losses when an insured event is imminent. Strictly speaking, the losses of the deposit insurance system are not solely determined by the risk-posture of insured institutions because losses are more a function of the timing of closure of a failed bank.\textsuperscript{170}

In addition to the introduction of risk-based premiums, deposit insurers should improve on their ability to detect early signs of a failing bank and to act promptly and effectively.\textsuperscript{171} The European Shadow Financial Regulatory Committee (ESFRC) recommends that a system of prompt corrective action (PCA) should be put in place as part of the supervisory process in EU member states. PCA involves an approach in which certain values of indicating the financial viability of a bank trigger pre-determined supervisory action. The committee notes that PCA would help to reduce the probability of a sudden banking crisis.\textsuperscript{172}

Even where the indices are available for the calculation of risk, the main problem that would be encountered, in practice, with risk related premiums, is the difficulty of measuring risk ex-ante. The complexity involved in calculating banking related risk ex-ante makes it difficult for deposit insurance premiums to be related objectively to risk.\textsuperscript{173} As a result of financial innovation, new sources of risk continue to emerge over time thus leaving a time lag before they can be incorporated into the calculation.

\textsuperscript{170} Horvitz (1983) (n163); Baer (1990) (n91).
\textsuperscript{171} G Bierwag and GG Kaufman A Proposal for Federal Deposit Insurance With Risk Sensitive Premium (Federal Reserve Bank of Chicago, 1983).
of insurance premium. The implication of this is that the premium will be adjusted at a time when the bank is already experiencing liquidity problems. It has been noted that because ‘a risk-based system would force banks to pay higher premiums only when they encountered difficulty and consequently became more risky, such a system probably would exacerbate the risk of bank failure’.

Risk-based deposit insurance systems are also susceptible to subjective judgement and political manipulation. Most national laws give the deposit insurer the ultimate discretion to set and adjust insurance premiums as deemed necessary. McCoy notes that ‘at best, this discretion can result in inconsistency; at worst, it can result in retaliation; or, conversely, persistent undercharges.’ Banks also place constant political pressure on deposit insurers to keep the amount of deposit insurance premiums low.

Risk-related insurance premiums are desirable for the reasons stated earlier and a step in the right direction towards creating an incentive-compatible deposit insurance system. However, the problem of determination and calculation of the degree of risk ex-ante means that its efficacy as a solution or remedy to moral hazard is limited. Moral hazard incentives could be further engendered where mispriced deposit insurance under a risk-based system leads to subsidies for bank owners and managers, as they become the main beneficiaries of deposit insurance. Furthermore, an upward adjustment of premium by the deposit insurer to correspond with risk, may amount to a tacit approval of high-risk strategies of certain banks by the regulators.

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It is pertinent to note that the determination of insurance premiums based on risk is an information-intensive exercise, which can only be successful in a strictly monitored and supervised banking sector.\textsuperscript{178} In developed nations with sophisticated and advanced regulatory and supervisory mechanisms, it is possible to develop a workable model for risk-related insurance where the benefits would outweigh any disadvantages.\textsuperscript{179} The problem of calculating risk ex ante can also be solved by increasing the frequency at which premiums are paid to allow prompt adjustment of a bank’s insurance premium as soon as its risk position changes.

An example of an attempt to develop a workable model for determining risk in order to assess insurance premium is the requirement under the FDCIA for the FDIC to implement risk-adjusted premium.\textsuperscript{180} Section 302 (a) of the Act stipulates that risk-based premiums can be assessed based on:

(1) The probability that the deposit insurance fund will incur a loss with respect to the institution, taking into consideration the risks attributable to:

(I) different categories and considerations of assets;

(II) different categories and considerations of liabilities, both insured and uninsured, contingent and non-contingent; and

(III) any other factor the FDIC determines are relevant to assessing such liability

(2) The likely amount of any such loss; and

\textsuperscript{176} MerGrv (2006) (n132) 18.
\textsuperscript{177} Ibid.
\textsuperscript{178} Blair and Fissel (1991) (n165).
\textsuperscript{179} See Chapter 5.
\textsuperscript{180} The FSF Report notes that differential or risk-adjusted premium assessment systems may be difficult to design and implement in new systems and in emerging or transitional economies.
Despite the innovation of these obviously sophisticated indices, FDIC insurance is still viewed as under-priced and thus still poses the threat of moral hazard.\(^\text{182}\)

For newly developed systems, it is important to apply ‘simplicity and gradualism’ in applying a risk-adjusted method of assessing deposit insurance premiums. This is because new systems have to develop capacity for risk-monitoring and measurement of banks’ investment strategies. Newly established systems should adopt a flat-rate system that can be changed gradually through time as need, experience, and capacity dictates.\(^\text{183}\)

### 3.5.2.4. Effective Regulation and Supervision: Early Detection and Prompt Corrective Action

Moral hazard risk can be counteracted by a closer and more effective regulatory regime. This involves an effective system of prudential regulation which incorporates improved off-site and on-site surveillance and examinations,\(^\text{184}\) sound corporate governance and effective internal control mechanisms. This should be accompanied

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\(^{181}\) 12 USC § 1817 (b) (1) (c).


by legal provisions for early intervention and prompt corrective action (PCA) to prevent harmful regulatory forbearance.\textsuperscript{185}

PCA mechanisms formalise specific ratio tripwires for mandatory supervisory action. PCA has been adopted in the United States where increasingly stringent regulatory restrictions apply to banks as their solvency deteriorates. Supervisors are mandated to take actions which include increased monitoring, increased capital requirement, restructuring and closure of the distressed bank.

It has been noted that the most effective counterforce to moral hazard is a strong capital position: ‘because losses will be absorbed first by bank capital, the likelihood (other things being equal) that they will be shifted to the FDIC diminishes as the capital of the bank increases.’\textsuperscript{186} The approach is also to ensure that moral hazard is neutralized by increasing the risk position of those who are best placed to influence banks’ behaviour. Moral hazard incentives have been found to be particularly strong for under capitalized banks.\textsuperscript{187} Increased capital requirements would encourage shareholders to have greater interest in the prudential management of banks because there is more equity at risk.

The application of a strict capital adequacy regime can achieve a result similar to that intended by risk-adjusted premiums if relatively high-risk banks are required to place their capital at risk.\textsuperscript{188} A combination of risk-adjusted premiums and risk-adjusted capital standards is more effective at combating moral hazard than any one form of

\textsuperscript{185} For analysis of the relationship between forbearance and PCA, see K Narayana and I Shim ‘Forbearance and Prompt Corrective Action’ (2007) 39 Journal of Money, Credit and Banking (5) 1107.

\textsuperscript{186} Hanco (1999) (n123); Di Cigno (1990) (n129) ch6.

risk adjustment.\textsuperscript{189} This is not to say that the implementation of risk-adjusted capital standards, like risk-adjusted premiums, would not encounter practical problems. It is possible for depositors to use public information on capital ratio and insurance premium to judge the financial position of banks. This information can trigger a run on weak but solvent institutions, leading to failure. The deposit insurer eventually shoulders the resultant costs of such failure.\textsuperscript{190}

A strengthened supervisory regime should include early warning mechanisms in addition to efficient reporting and accounting requirements. In particular, legal requirements for independent audits and public disclosure of financial statements have been shown to be effective in curbing moral hazard.\textsuperscript{191} The use of general market data to predict the future soundness of banks should be employed to detect banks with potential liquidity problems. Increased capital requirements would also lengthen the period between the time a bank starts to experience liquidity problems and when it finally becomes insolvent. The use of early warning and intervention mechanisms would enable the deposit insurer to detect problems early and have adequate time to apply the necessary rescue or resolution procedure, thus minimizing the costs and effects of failure.\textsuperscript{192}

It is important that the deposit insurer is empowered by the relevant law to apply legal sanctions against certain activities of bank management such as conflict of interest, insider dealing, negligence, fraud and failure to comply with regulatory requirements.

\textsuperscript{188} Diz (2004) (n183).
\textsuperscript{190} MD Flood ‘Deposit Insurance: Problems and Solutions’ (Jan/Feb 1993) 75 Federal Reserve Bank of St. Louis, 28.
This is particularly crucial where such action has led to failure of an institution and loss to the deposit insurer.\textsuperscript{193} The exclusion of deposits belonging to senior executives, directors and major shareholders (and of their close relatives and associates) from the benefits of deposit insurance is also a means of discouraging imprudent behaviour.\textsuperscript{194}

Although depositors are in a relatively weak position in terms of bank monitoring, they still remain an important source of market discipline. It has been observed that 'the predominance of insured deposits typically observed in banks' funding structure implies that even relatively minimal responsiveness by these deposits to a bank's condition could have substantial implications for the bank's cost and supply of funding.'\textsuperscript{195} As noted earlier, it is important that depositors' actions to move their funds between different financial institutions are well informed and not based on false information or perception.

Large depositors, shareholders, and other unsecured creditors of banks also have an important role to play in limiting the effects of moral hazard. Deposit insurance features such as coinsurance and coverage limits create incentives for uninsured large depositors to demand risk premiums. In the United States, evidence shows that uninsured depositors demand higher returns on their accounts to reflect risk. They also tend to move their deposits to banks that they perceive to be safer.\textsuperscript{196} There is a risk that a mass withdrawal of funds by uninsured depositors could trigger a bank run.

\textsuperscript{192} Goodman and Shaffer (1984) (n175).
\textsuperscript{193} This is similar to the right of subrogation in general insurance contracts.
\textsuperscript{194} Moore (1996) (n56); FSF (2001) (n43) 8-9; see also Chapter 4.
\textsuperscript{196} McCoy (2006) (n32).
Although this has only occurred in one instance in recent U.S. banking history, the risk remains potent and as such, reliance on uninsured depositors as a source of market discipline should be placed within reasonable limits.

### 3.6 The Agency Problem

The agency problem is closely related to the issue of moral hazard in deposit insurance. The term has been defined to refer to ‘situations in which an agent binds the principal but acts in a manner not in the best interests of the principal, either because the two parties’ compensations are not aligned or because the principal lacks the information or power needed to effectively monitor and control the actions of the agent.’ Thus, moral hazard has been explained, in the context of the principal-agent issue, as a form of post-contractual opportunism where the agent sets out to pursue self-serving goals at the expense of the principal.

Principal-agent problems are attributable to two sources: imperfect information and misaligned incentives between the principal and the agent. Imperfect information occurs because the principal cannot effectively monitor the agent’s actions. This is due to the problem of information asymmetry. Regulators (agent) are assigned the task of bank supervision because they have knowledge of, and can interpret the information that is required to monitor the activities of financial institutions. In

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197 Large depositors withdrew about $10 Billion in deposits, which eventually contributed to the failure of Continental Illinois National Bank and Trust Company in 1984.

198 Even though Continental Illinois is the only recent U.S. example of a run triggered by large uninsured depositors, it remains the largest institution ever to have been rescued by the FDIC and its collapse has created far reaching implications for the US banking system and regulation. See generally Wharton Financial Institutions Center The Collapse of Continental Illinois National Bank and Trust Company: The Implications for Risk Management and Regulation The Wharton School, University of Pennsylvania. Available at [http://fic.wharton.upenn.edu/fic/case%20studies/continental/20full.pdf](http://fic.wharton.upenn.edu/fic/case%20studies/continental/20full.pdf) Accessed 18 November 2007.

199 Hane (1999) (n123).

performing this function, their aims are not necessarily aligned with that of the taxpayer or depositor (principal).²⁰²

Deposit Insurance is viewed as constituting a multiparty principal-agent contracting problem.²⁰³ Unlike general insurance contracts, deposit insurance involves various contracting parties that include banks, depositors, supervisors and taxpayers.²⁰⁴ It has been posited above that the risk of moral hazard and any resultant loss can be mitigated if deposit insurers and other supervisors adopt an early detection and resolution mechanism. It has however been noted that even where problems are detected early, it is possible for regulators, as agents of the tax-payer, to ignore early warning signs and delay taking appropriate action either to cover up their own inadequacy or in the hope for an improvements in the economy.²⁰⁵

The delay by regulatory authorities may result in a situation where the institution’s losses surpass the value of its shareholder-contributed net worth, thus placing the cost of the supply of risk capital on the tax-payer.²⁰⁶ This situation may be partly caused by the fact that operating losses still accrue during the period of the delay. Thus deposit insurance creates a contract where the agent (regulator) pursues policies not in the interest of the principal (tax-payer).²⁰⁷

²⁰¹ *Ibid.* However, in a strict legal agency relationship, an agent is under a duty to keep his principal informed about matters that are of his principal’s concern and not to let his interests conflict with that of his principal.
²⁰⁵ Kane (1995) (n93); see also AWA Boot and AV Thakor ‘Self-interested Bank Regulation’ (1993)
²⁰⁶ American Economic Review (2) 206.
²⁰⁸ The ‘principal’ in a deposit insurance scheme varies according to country models. This is determined by the method of funding.
The agency problem can also be explained in terms of the owner/management dichotomy that exists in financial institutions. Owner/managerial risk aversions may also trigger the excessive risk-taking factor associated with deposit insurance. While managers (as agents of the shareholders) of troubled financial institutions may want to preserve the benefits of control, their career paths and reputation by adopting low-risk policies, the shareholders (principal) may prefer high-risk policies as they will have nothing to lose. Conversely, where the institution is solvent, managers may favour a more risky position than shareholders, where their pay is tied to growth rather than profit. Managers also possess information that is not available to either the shareholder or the depositing public.

Efforts to solve the agency problem should be geared towards designing a contract that aligns the motivation of the agent with that of the principal, thus ensuring that the agent pursues the principal’s goals. This can only be achieved within an improved regulatory framework and supervisory environment. A strict corporate governance regime, which places a high level of corporate social responsibility on bank managers, should strive to align the interests of shareholders, depositors and creditors. Excessive risk-taking strategies can be curbed by the promulgation of laws creating civil and criminal liability for managerial actions. The law should give regulators the discretion to apply administrative penalties and civil sanctions for breach of regulatory provisions. It is however important that this discretion is kept within reasonable bounds so that it does not result in arbitrariness and possible violation of

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210 Demsetz et al have shown that the owner-shareholder agency problem is only present in a small number of banks: those with no insider holdings. Thus an alignment of objectives can be achieved in these banks if the shareholding structure is varied. See Demsetz (1997) (n208).
human rights provisions such as the rights to fair hearing, appeal and review of administrative actions. 

Bank shareholders are generally considered to be a source of moral hazard mainly because of the limited liability rule. In curtailing moral hazard, double liability laws for bank owners that make shareholders liable for a portion of depositor losses in the event of a bank failure would serve to increase the incentives for shareholder monitoring of bank management. It has been observed that 'double liability transforms shareholders from investors seeking to advantage themselves at the expense of other investors by increasing the riskiness of the banks in which they have invested into investors who benefit themselves by decreasing the riskiness of these firms.' Evidence from the U.S. suggests that risk-taking was reduced in banks chartered in states with double liability laws prior to the Great Depression. Thus while deposit insurance serves to prevent bank runs and to preserve public confidence in the banking system, a regime of double liability can serve to mitigate the incentives for excessive risk-taking created by deposit insurance.

To reduce the effects of the principal/agent problem and losses that may be associated with it, some countries have introduced risk-based capital standards, which are to be readjusted whenever they are rendered ineffective by regulatory standards. In the US, the capital based PCA rules adopted in the FDCIA are aimed at reducing the effects of

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both moral hazard and the principal/agent problem. The Act imposes a duty on regulators to act promptly to resolve problem banks by closing institutions whose capital position fall below a specified minimum and increasingly tight regulatory restrictions on banks as their capital standards decrease. The Act also places restrictions on Federal Reserve advances to undercapitalized banks and mandates a least cost resolution of failed banks and thrifts except where there is a threat of systemic risk.\textsuperscript{215} The Depositor Preference Act of 1993 also gives additional protection to depositors and tax-payers by giving priority to the claims of the FDIC over that of non-deposit creditors in bank liquidations.

This emphasizes the importance of the legal and supervisory environment in the successful design and implementation of a deposit insurance scheme. Although most countries that have adopted deposit insurance have laws that impose duties on company directors and agents in general, as well as legal procedure for reviewing the actions of administrative bodies, it is important to have banking sector specific laws to tackle the moral hazard and agency problems.\textsuperscript{216} It is pertinent to note that effective regulation and optimal deposit insurance entails more than the promulgation of banking laws. These mechanisms must be instituted within an environment which is conducive for enforcement, with integrity, freedom from political interference, government accountability to the public and strong rule of law.

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\textsuperscript{216} This is because of the failure of the common law in achieving effective regulation (discussed in the preceding chapter). It is also doubtful whether the principal-agent relationship that exists in a financial regulatory perspective will fall under the legal definition of an agency relationship so as to attract the imposition of fiduciary duties. See Lord Upjohn in Philips v Boardman [1967] 2 AC 46, 127.
3.7 Provisional Conclusion

Deposit insurance is a doubled-edged device. While it can contribute to financial stability it can also create adverse effects. Although explicit deposit insurance is being adopted by an increasing number of countries, most jurisdictions still operate implicit deposit protection schemes. While countries in Europe,217 the Western hemisphere and Asia have established deposit insurance schemes, only a few countries in Africa, the Middle East and the developing world in general have established successful deposit insurance schemes.

One major challenge facing policy makers in these countries is how to avoid the moral hazard and agency problems associated with deposit insurance. It is imperative that a deposit insurer has in place a mechanism to control its risk. Unfortunately, most of the devices to counteract deposit insurance risk are not without their own inadequacies.

Mechanisms for counteracting the deposit insurance problem have been considered in this chapter. It appears that the most effective way of limiting moral hazard is an approach which seeks to increase the risk exposure of those who are in a position to influence banks’ behaviour, with an effective mechanism for handling troubled banks and resolving failed banks to reduce the incentive for regulatory forbearance. This can only be achieved by a properly designed and well implemented deposit insurance system, which would preserve the benefits of financial stability and depositor protection, without increasing moral hazard or reducing market discipline. Hence the deposit insurance problem can generally be considered as a problem of design.
It would appear that the level of legal, economic and financial development attained by a country is partly responsible for the successful design and implementation of a deposit insurance scheme.\textsuperscript{218} In countries lacking the relevant legal and institutional infrastructure, explicit deposit insurance might offer no significant advantage over an implicit system. The success of an explicit deposit insurance system is strongly dependent on the quality of banking regulation and supervision\textsuperscript{219} and the appropriate design of the fundamental features of the scheme. The major design and policy considerations in achieving an optimal deposit insurance scheme are considered in the next chapter.

\textsuperscript{217} Most European Countries adopted deposit insurance in compliance with the 1994 EU Directive.

\textsuperscript{218} I. Laeven and others (2006) analysed data from 181 sample countries; the countries were partitioned into 4 groups based on per capita income to show that the propensity to adopt deposit insurance rises with income.

\textsuperscript{219} R Cull and others ‘Deposit Insurance and Bank Intermediation in the Long Run’ (2004) BIS Working Papers No 156.
4.0. Introduction

The working group of the Financial Stability Forum (FSF), in its report, recommends that as part of a self-assessment process in the implementation of a deposit protection scheme, policy makers should focus on issues such as the mandate, powers and structure of the deposit insurance system. The report also notes that in recognition of the interconnectedness of a deposit insurance system with other safety-net functions, it is critical to address interrelationship issues among financial safety-net participants.¹

Although deposit protection schemes are generally desirable, they need to be properly managed and operated under a tight regulatory and supervisory regime to avoid the disadvantages associated with them. This can only be achieved if deposit protection is delivered through appropriate and cost-effective structures that are properly designed and integrated into the larger supervisory framework. The potential for moral hazard and other perverse effects underscore the need for appropriate balance in developing incentive-compatible deposit insurance schemes.

These structural and design issues are considered in this chapter. While constant reference is made to the work of the FSF (FSF Report), the intention is not to develop another set of ‘best practice’ principles. The aim is to formulate the relevant factors to be taken into consideration, the various options open to policy makers, and the trade-offs involved in the design or reform of deposit insurance schemes.

4.1. Public Policy Objectives

It is important for countries transiting from an implicit blanket guarantee of deposits to an implicit DIS and those contemplating the reform of existing systems to fully consider the public policy objectives of introducing the scheme and tailor design features as well as reform measures to suit these objectives. In order to achieve an efficient and incentive-compatible design, the goals of the scheme must be consistent with its design and structure, and also with country-specific factors.

The FSF report notes that the first step in designing a deposit insurance system is to understand the public-policy objectives, which it is expected to achieve, and these objectives must be well understood. The choice of how a deposit insurance scheme is to be designed and operated depends on country-specific factors, which include historical, legal, political and financial variants. It has been aptly observed that ‘the historical evolution of banking in any country provides or can provide the rationale for, and methodology of prudential regulation of banking in that country.’ However, in most of the countries with recently adopted explicit deposit insurance schemes, it has been shown that the necessary internal political, economic and other factors have

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2 See IADI Core Principles for Effective Deposit Insurance Systems (2008) http://www.iadi.org/Lists/Announcements/Attachments/64/FSF%20-
4 Policy makers should give consideration to institutional factors such as the state of the legal system, the state of the prudential regulatory and supervisory system, and the level of economic development.
been undermined by pressure to emulate developed-country safety net arrangements without recourse to idiosyncratic differences in public and private contracting environments.\textsuperscript{6}

The objectives of a deposit insurance scheme discussed in the preceding chapter are not universal. However, a well-designed deposit insurance scheme should strive to achieve the two main objectives, which are: the protection of small and unsophisticated depositors and the promotion of financial stability.\textsuperscript{7} Deposit insurance should also enhance the ability of regulators to achieve other related policy objectives.\textsuperscript{8} These objectives must be construed in relation to the public and individual contracting environments and requirements.

The FSF report recommends that policy makers in countries seeking to adopt or reform deposit insurance systems should conduct a ‘situational analysis’ to guide their decision-making. The factors to be taken into consideration include: (a) economic factors, the state and structure of the banking system and public attitude and expectations, and (b) the state of legal, prudential regulatory, supervisory, accounting and disclosure regimes.\textsuperscript{9} When experts recommend deposit insurance, they do so with the presupposition that countries have the appropriate institutional framework and

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\textsuperscript{5} GO Nwankwo \textit{Prudential Regulation of Nigerian Banking} (University of Lagos Press, Lagos, 1990).


\textsuperscript{7} Objectives of deposit insurance schemes around the world are broadly similar; these are the promotion of financial stability and confidence in the banking system, protection of unsophisticated depositors and the provision of orderly resolution mechanisms for failed institutions.


\textsuperscript{9} FSF Report (n1), 12.
\end{flushleft}
they fail to consider the impact of differences and imperfections in their contracting environments.\textsuperscript{10}

Countries wishing to adopt deposit insurance should first address weaknesses in their institutional environment.\textsuperscript{11} An advantage of an explicit deposit insurance scheme is that it is backed by law, which provides certainty in its operation. A sound legal regime is a prerequisite for effective and efficient supervision. Regulation cannot exist in a vacuum and the coercive element in law is necessary for the enforcement of regulatory requirements and the imposition of sanctions. The FSF report suggests that a situational analysis should focus on 'the level of enforcement, the efficiency of the judicial system, and the effectiveness of creditors' redress mechanisms'.\textsuperscript{12} The deposit insurer needs to be backed by a strong legal system for early intervention and prompt corrective action, and for an orderly resolution process. It is also important that the functions of the deposit insurer do not violate existing laws, especially human rights legislation.

A strengthened prudential regulatory regime would ensure accountability, effective corporate governance and risk-management. Elements of the legal, regulatory and supervisory framework that would ensure the smooth operation of a deposit insurance scheme include sound accounting and financial reporting schemes, effective licensing or chartering regime and regular examinations.\textsuperscript{13}

\begin{flushleft}
\textsuperscript{12} FSF Report (n1) 13.
\textsuperscript{13} Ibid.
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4.2. Institution/ Organizational Structure

Issues regarding institutionalization of deposit insurance do not revolve around whether deposit insurance should be explicit or implicit, but whether a separate and autonomous institution or agency is required to administer the scheme or the deposit insurance function should be assigned to an existing regulatory entity.\(^{14}\) The law establishing a deposit insurance scheme should provide for the means and mode of its administration. The institutional framework of a deposit insurance scheme is critical for the achievement of its aims. Consequently, the nature of a deposit insurer’s mandate plays a significant part in the institutional set-up.\(^{15}\)

The report of the FSF Working Group notes that the deposit insurer can draw on skills and staff resources of a larger organization if the deposit insurance function is assigned to an existing entity, for example adding a department to the Central Bank.\(^{16}\) This would also enable the deposit insurance scheme to cut back on administrative and other operational cost that would have been incurred with the establishment of a separate agency. Another advantage of incorporating a deposit insurance scheme into an existing supervisory body is that it promotes cohesion between policies. Since the deposit insurer is part of a wider regulatory body, it will be very unlikely that the supervisory policies of the deposit insurer will differ from that of the wider body.

The main disadvantage of incorporating the deposit insurance function into a larger organization is that the organization may find it difficult to separate its other


responsibilities and interests from that of the deposit insurer,17 potentially leading to a conflict of interest.18 To carry out its functions effectively, a deposit insurer requires independence as well as a separate legal personality.19 In times of crisis, supervisory authorities come under intense political pressure, which can sometimes lead them to make decisions that are not in the overall interest of a stable and sound economy. Independence of the deposit insurer would place it in the best position to withstand such pressure.20 Creating an independent agency would also avoid harmful regulatory forbearance on the part of supervisors. Supervisors have strong incentives to delay bank closures or to take other decisive action because closure would indicate a failure on their part, impacting negatively on their reputation.21

It follows from the above that it is generally preferable to have a separate and independent institution to administer a deposit protection scheme. In practice, most countries that have introduced explicit deposit insurance schemes have established designated bodies to administer the schemes.22 Whether or not the deposit insurer is a separate organisation, it is vital that the system is explicitly defined in law and regulation, and the deposit insurer should be independent from political interference and industry domination. It should also be accountable for its actions, especially its

16 FSF Report (n1), 18.
17 Ibid.
22 Alexander Kyer ‘Deposit Protection Arrangements: A Survey’ (1995) IMF Working Paper WP/95/134. These schemes are often managed by a government agency or by a public-private partnership. Switzerland, Germany and Argentina manage their schemes privately.
mistakes. Where the deposit insurance function is designated to a separate body, particular attention must be paid to the balance of power among the financial safety-net authorities. Potential conflict of interests arising from varying incentives can create friction, thus policymakers should address interrelationship issues in the design of deposit insurance systems.

4.3. Ownership

Ownership of a deposit insurance scheme can take three basic forms: public\textsuperscript{24}, private\textsuperscript{25} or joint (public and private)\textsuperscript{26} ownership. A fourth approach has been adopted in Slovenia where the scheme consists of the banks themselves, with no special fund established but only the legal obligation by which banks guarantee to pay deposits.

Where the scheme is publicly owned, the government or relevant agency holds the equity. The government may however make a decision to establish a deposit insurance scheme but leave its ownership and management to participating banks. Alternatively, the deposit insurance scheme may be jointly owned and shares will be held in a specified ratio while the management is made up of representatives of both parties.\textsuperscript{27}

\textsuperscript{23} G Garcia 'Deposit Insurance: A Survey of Actual and Best Practices' (1999) \textit{IMF Working Paper WP/99/54}. Accountability can be achieved by requiring the issue of an annual report, independent audit report and periodical reports to parliament. Independent dispute settlement mechanisms can also be established.

\textsuperscript{24} Practised in the US, Canada, Nigeria and other countries.

\textsuperscript{25} Practised in Brazil, Finland and France. In Brazil, the decision to privatize the deposit insurance scheme was based on the consideration that a government owned entity may imply a blanket guarantee of deposits.

\textsuperscript{26} Practised in Japan, Greece, Spain and Argentina

\textsuperscript{27} PN Umoh 'Deposit Insurance: Concept, Practice and Relevance in Africa' (June, 2004) 14 \textit{NDIC Quarterly} (2).
Proponents of private sector owned deposit insurance argue that it encourages efficiency by ensuring freedom from political interference, flexibility in monitoring and risk control, and a better incentive structure for mitigating moral hazard.\textsuperscript{28} Despite the perceived merits of private deposit insurance, it is doubtful whether such a system would be able to provide the same level of public confidence as a government backed scheme. It has been rightly observed that ‘...the government may have a natural advantage in providing deposit insurance because private companies that have no power to tax would have to hold reserves in order to make their promises credible.’\textsuperscript{29} Other possible drawbacks of a private scheme include the lack of regulatory authority, lack of risk measurement information and adverse selection.\textsuperscript{30}

4.4. Mandate and Powers

A mandate has been defined as a set of official instructions or statement of purpose.\textsuperscript{31} In this regard, power can be seen as the legal discretion and empowerment to carry out instructions under a mandate.\textsuperscript{32} The mandate of a deposit insurer should be expressly specified in law so that its role within the financial safety net is clarified.\textsuperscript{33} The FSF report notes that a clear mandate reinforces the stability of the financial system and contributes to sound governance and greater accountability.

\textsuperscript{31} FSF Report (2001) (n1), 17. In private law, a mandate can be defined as an authority given by one person to another to take some course of action. See EA Martin (ed.) A Dictionary of Law (5\textsuperscript{th} ed., Oxford University Press, Oxford, 2002).
\textsuperscript{32} This is known as incidental power, which exists because it is necessary to the accomplishment of an express purpose. BA Garner (ed.) (2004), Black’s Law Dictionary (8\textsuperscript{th} ed., Thomson West, St Paul, 2004) 1207.
The mandate and powers of a deposit insurer can be interpreted either broadly or narrowly. Where it is narrowly interpreted, the deposit insurer takes a passive role, only managing the insurance funds and paying depositors when a failure occurs.\(^{34}\) This is typical of privately run schemes with less proactive responsibilities and is generally referred to as the pay-box model of deposit insurance. Where a deposit insurer has been given a broader mandate, it is referred to as a 'risk-minimizer', usually empowered to perform other functions such as supervision, intervention and resolution. It is also possible that the deposit insurer’s mandate may fall somewhere between these two classifications.\(^{35}\)

It has been opined that a wider mandate enables the insurer to protect the insurance fund and that the role of deposit insurance in the promotion of systemic stability and strengthening the financial sector is achieved when it effectively enforces prudential supervision and regulation on its members.\(^{36}\) It can however also be argued that because the mandate of a pay-box system is restricted, such a mandate could be more easily fulfilled as the deposit insurer only has to concentrate on one thing, which is the reimbursement of guaranteed sums.

The FSF report notes that even though pay-box systems are largely confined to the payment of depositors’ claims and normally do not have prudential regulatory or supervisory responsibilities, they require appropriate authority as well as access to


\(^{35}\) These deposit insurers are given ‘more than pay-box’ powers but not full risk minimizing powers.

deposit information and adequate funding, for the timely and efficient reimbursement of depositors when banks fail.\(^{37}\)

Generally, all forms of deposit insurance systems serve the twin purpose of financial stability and depositor protection. However, it appears that the extent of a deposit insurer’s mandate and consequently its powers will depend on the perception of the role of deposit insurance in weakening market discipline incentives and the need to give the deposit insurer the necessary powers to deal with the risks which might result to both the insurance fund and the banking system.

Although no particular type of mandate is generally preferable,\(^{38}\) it is important that:

I. The mandate and powers of the deposit insurer is in accordance with the public policy objectives of the deposit insurance scheme;

II. The mandate is specified, without any ambiguity, in law and in policy. It should be specified and clearly understood by the deposit insurer, financial institutions and depositors before any crisis occurs rather than at a time of crisis;

III. The roles and powers of other members of the financial safety-net should be considered. While safety-net players should complement each other, unnecessary overlap and possible regulatory gaps should be avoided;

IV. The deposit insurer should be properly structured and adequately equipped in accordance with the specified mandate.\(^{39}\)

\(^{37}\) FSI, Report (n1) 17.

\(^{38}\) In developed countries that operate the pay box model, for example the UK, the deposit protection scheme is usually part of a wider and well structured financial supervisory regime where supervisory functions are effectively separated. However, in developing economies with weak supervisory and safety-net structures, it is desirable that the deposit insurer is conferred with additional regulatory and supervisory powers to protect the insurance fund and to counter moral hazard.
4.5. Coverage

Deposit insurance coverage can be determined in terms of level and scope. In the preceding chapter, it was suggested that the level of deposit insurance coverage should be limited in order to reduce the risk of moral hazard. However, before determining the level of coverage, it is important to determine and possibly limit the scope of deposit insurance coverage. Policy makers need to determine who and what should be covered by a deposit insurance scheme.

The FSF report recommends that policy makers should define clearly in law or by private contract what is an insurable deposit. Factors to be considered include the relative importance of different deposit instruments, the inclusion of foreign-currency deposits and the deposits of non-residents in relation to the public policy objectives of the system.\(^{40}\)

The risk of moral hazard would be exacerbated if deposit insurance is extended to cover all forms of deposits and depositors as well as shareholders and other creditors. The primary rationale for deposit protection schemes is the protection of small and unsophisticated depositors who are considered to be in a vulnerable position and unable to bear financial loss. Small businesses and private individuals of relatively modest means will fit into this category.\(^{41}\)

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\(^{40}\) Where the deposit insurer is structured as a pay-box, it needs powers for verification of depositors’ claims, assessment and collection of deposit insurance contributions, and for depositor payouts. However where the deposit insurer is given a risk minimizing mandate, it needs greater powers, which include control of entry and exit in the deposit insurance scheme, bank examination powers, and intervention and failure resolution powers.

Deposit insurance schemes should exclude depositors who are capable of monitoring the financial condition of a bank and exerting market discipline. Examples of such deposits that should be excluded include: deposits of other banks and financial institutions; deposits of government authorities and agencies; deposits of corporate bodies; deposits of directors, shareholders and managers of a failed bank; deposits of companies that belong to the same group as the bank and deposits arising out of transactions in connection with which there has been a criminal conviction for money laundering. The scope of deposit insurance coverage varies according to country-specific objectives and it usually reflects the emphasis on the principal purpose of deposit insurance, i.e. stability versus protection of small and unsophisticated depositors.

According to the European Shadow Financial Regulatory Committee (ESFRC), uninsured deposits and other liabilities should be ‘credibly uninsured’. The ESFRC contends that holders of such claims should not expect to be covered by deposit protection arrangements in the event of a bank failure. Exclusion of sophisticated depositors from the scope of deposit insurance coverage would encourage these depositors to exert market discipline by demanding higher deposit rates from weaker banks in compensation for the higher risk of loss that they face or by withholding their funds from such banks. The aim is to ensure that private monitoring, when

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42 R MacDonald ‘Deposit Insurance’ (1996) *Handbook on Central Banking* No. 9, Centre for Central Banking Studies, Bank of England. MacDonald also suggests that it may be equitable to extend coverage to shareholders where their shareholding is so small that it is impossible to influence any decision of the bank. See also Chapter 4 of the Financial Services Authority Handbook, *Compensation Sourcebook* (Comp). 
43 Blair (n.20). 
44 Some countries practice the so called ‘too big to fail’ principle, which is the practice of protecting uninsured depositors, creditors and others when banks that are considered as large and of strong economic importance fail. 
45 European Shadow Financial Regulatory Committee (ESFRC) Statement No. 5 (October 1999). 
large depositors, subordinated debt holders and correspondent banks realise that their funds are at risk, complements official supervision.\textsuperscript{47}

Insurance coverage limits can also be construed in terms of the maximum amount of coverage available to an individual depositor. Policy makers should decide whether coverage limits should apply to individual account deposits or to the aggregate of all account deposits held by an individual depositor. Sound practice appears to be that coverage limits should apply to the aggregate of all deposits held by an individual depositor. This would give an incentive to depositors to monitor their banks, reduce failure resolution costs and most importantly, ensure that deposit insurance coverage protects ‘truly small savers’.\textsuperscript{48}

It has been argued that deposit insurance coverage should be extended to savings and time deposits. Although these deposits are conceptually easier for banks to manage than demand deposits, they should nevertheless be protected, as doing so would provide a degree of consumer protection, encourage a positive attitude toward saving, change social behaviour, help to create a middle class, and raise the national savings rate.\textsuperscript{49}

It is pertinent that the coverage limit is clearly prescribed in law without ambiguity and before any crisis occurs. This is because of the difficulties that would be encountered in applying retroactive legislation. The law should specify how jointly owned deposits should be treated as well as deposits held in a trust or agency relationship or under an assignment. The importance of this was illustrated by the case

of Deposit Protection Board v Dalia.\textsuperscript{50} Following the failure of the Bank of Credit and Commerce International (BCCI) in 1991, some depositors tried to reduce their deposit levels by assigning part of their deposits to relatives and close friends so as to maximise compensation that would be recovered from the Deposit Protection Fund. The Banking Act 1987 (Meaning of Deposit) Order 1991\textsuperscript{51} was made so that assignments of deposits made after July 30, 1991 and after the initiation of winding up proceedings would not qualify for compensation. The Deposit Protection Board rejected the claims brought under assignments that were made prior to the 1991 Order on the ground that they did not qualify as depositors within the purview of Section 58 (1) of the Banking Act 1987.

The House of Lords held that the word ‘depositor’ should be given its ordinary meaning as the person who made the original deposit. Although the Act provided no express definition, the court construed Sections 5 (3); 60 (2) and 60 (6) (c) as all referring to ‘depositor’ as the person who made the original deposit.

This lacuna in the law has now been dealt with by Section 214 (1) (f) of the Financial Services and Markets Act (FSMA) 2000, which provides ‘for a claim to be entertained only if it is made by a specified kind of claimant.’ Section 214 also provides for ‘limiting the amount payable on a claim to a specified maximum amount or to a maximum amount calculated in a specified manner’; and ‘for payments to be made, in specified circumstances, to a person other than the claimant’.\textsuperscript{52} Chapter 4 of

\textsuperscript{50} G Garcia ‘Deposit Insurance: Obtaining the Benefits and Avoiding the Pitfalls’ (1996) IMF Working Paper No. 96/83.

\textsuperscript{51} [1994] 2 A.C. 367. Also known as Deposit Protection Board v Barclays Bank Plc.

\textsuperscript{52} S 214 (1) (j) and (k), FSMA 2000.
the Compensation Source book (Comp) goes further to define ‘eligible claimant’ by listing a table of exceptions.53

The FSF report notes that coverage limits can also be applied per bank or across all member banks. It points out that even though coverage limitation across all member banks is likely to instil more market discipline, depositors who have diversified their risks among member banks may be affected by multiple bank failure and this may increase the risk of further collapse.54 The deposit insurer would also require extensive information on depositor accounts in all banks to be able to administer this form of limited coverage insurance. This would result in additional costs and administrative difficulties for the deposit insurer. The report concludes that it is preferable to apply deposit insurance on a ‘per depositor per bank’ basis.

Coverage can also be restricted in terms of the financial institutions that are covered. In some countries, deposit insurance covers only depositors of commercial banks. Deposit insurance coverage should be extended to cover all institutions that are authorized to take deposits from the public. If certain institutions are excluded and they experience runs, this may be contagious to insured institutions because some depositors may not be able to differentiate between insured and uninsured institutions in time of crisis.55

Finally, coverage can be defined in terms of the treatment given to foreign bank deposits. Such deposits include deposits payable in foreign currency, deposits in domestic branches of foreign banks and deposits in foreign branches of domestic

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54 FSF Report (n1), 24.
banks. Policymakers have to decide whether responsibility for foreign deposits should be placed on the home or host country. In the past, the dominant practice was to exclude such deposits from deposit insurance arrangements because they were not part of the domestic payments system, the domestic supply or domestic savings. They were also excluded to prevent double insurance because they might already be protected under another national insurance scheme.56

This position has significantly changed in the European Union where the concept of ‘home country control’57 has now been introduced and the deposit protection scheme of each member state is now required to cover the branches of the state’s banks in all other member states.58 This change reflects the commitment of the EU to establish a single market in financial services so that banks in member states can carry out business effectively on a cross-border basis and consumers can have access to more competitively priced financial services and products.59

The concept of home country control, introduced by the 1994 directive was triggered by the failure of Bank of Credit and Commerce International (BCCI) in 1991.60 BCCI was registered in Luxembourg but had its operational headquarters in London and subsidiaries in sixty nine countries. The uncertainty and legal division in responsibility between authorities in London and Luxembourg left the activities of BCCI inadequately supervised. The closure of BCCI’s operations in London, in July 2001, led to a panic withdrawal of funds from small and medium sized UK banks.

56 MacDonald (1996) (n42).
57 Also known as the country of origin rule.
58 See Directive 94/19/EC.
The closure of the headquarters in Luxembourg also led to the failure of its branches abroad. Under the new principle of home country control, all depositors in the EEA whose banks are domiciled in a member state are protected according to the provisions of the deposit protection scheme of that member state. Thus UK depositors of a UK branch of a bank registered in Luxembourg would be covered, not under the UK deposit protection scheme, but that of Luxembourg. Equally, legal responsibility for supervision and authorisation of branches is placed on the home country supervisor. In order to develop co-operation between home and host country supervisors and to ensure effective cross-border financial supervision, attempts are being made to integrate the roles of home and host state supervisors in the supervision of branches. The aim is to achieve a convergence in the allocation of supervisory responsibility.

MacDonald notes that the level of deposit insurance coverage provided under a home country scheme could be more generous than that provided by the host country. Policy makers may wish to consider preventing the branches of foreign banks from offering more generous compensation than locally incorporated banks in order to ensure fair competition.

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63 Subsidiaries are however treated as domestic institutions and are supervised by the host country supervisor. They are also covered under the host country deposit protection scheme.
64 See for example, the provision for proportionate co-operation agreements in the Markets in Financial Instruments Directive (MiFID).
Where foreign deposits are to be covered under the deposit protection scheme, policy makers should decide whether such deposits are to be reimbursed in local or foreign currency. The FSF report notes that this decision would have implications for placing foreign exchange risk. If foreign currency deposits are converted into local currency before reimbursement, then the depositor may bear the risk. If the reimbursements are made in foreign currency, the deposit insurer may bear the risk. The report recommends that if reimbursements are to be made in local currency, a transparent rule should be set out in advance to determine the relevant date for the exchange rate to be used in the conversion. A system that offers to reimburse depositors in a foreign currency must have access to foreign assets and sufficient foreign currency funding to be able to meet its obligations.66

In the determination of insurance coverage limits, policy makers should strive to ensure that:

- Coverage is at a level sufficient to sustain the required degree of public confidence necessary to prevent destabilising bank runs, but not so extensive as to eliminate all effective market discipline in the bank’s risk taking;
- Coverage is at a level that bears some relationship to average measures of income or wealth, so as to provide a sufficient degree of protection to savers.67

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66 FSF Report (n1) 25.
67 Ketchu (1999) (n20); see also Mac Donald (1996) (n42). The IMF recommends the use of twice per capita income as a rule of thumb to calculate coverage limits but also recommends that countries should consider other factors, like the distribution of deposits according to their size. See G Garcia (1999) (n23) Table 5.
4.6. Membership

Considerations relating to membership include whether participation in the deposit protection scheme should be voluntary or mandatory and the type of institutions that should be eligible for membership.

4.6.1 Compulsory/Voluntary Membership

Participation in a deposit insurance scheme can either be voluntary or a compulsory legal requirement for all deposit-taking institutions. Most countries operate a compulsory deposit insurance scheme. Where voluntary systems exist, they tend to be either private systems or those that are funded by the insured financial institutions.

A compulsory scheme may be difficult to implement in countries where banks are owned by lower levels of government because it is likely to be ‘politically awkward’ for a national government to compel such banks to join the scheme. Such banks are also generally presumed to enjoy implicit government guarantee of their deposits. Furthermore, a conflict of interest may arise where the government owns the deposit insurer as it might give preferential treatment to government-owned banks in certain circumstances. It has however been argued that because state-owned banks enjoy an implicit guarantee of their deposits, compulsory deposit insurance membership of such banks removes a potential source of distortion between financial institutions, thus helping to level the playing field.

69 Talley and Myers (1990) (n55).
70 Ibid.
Arguments in favour of a voluntary deposit insurance system have been described as ‘essentially political and philosophical in nature’. Such arguments are often predicated on the theory that compulsory deposit insurance involves cross-subsidization of weak institutions by the financially stronger. While this is invariably true, cross-subsidy and its inherent potential to encourage risk-taking can be mitigated by the introduction of risk-based deposit insurance premium.

Compulsory deposit insurance is necessary to avoid the adverse selection problem associated with deposit insurance. Where deposit insurance premium is not tied to failure-risk, a voluntary deposit insurance system is more likely to attract risk-prone banks that would stand to benefit most from the inherent insurance subsidy. If depositors are less concerned about deposit insurance and are unaware that it is voluntary then the stronger banks may opt out.

A voluntary system may also lead to instability in membership if strong banks opt out when the cost of failure is high. This may affect the financial viability of the deposit insurance system leading to a loss of public confidence in its capability to protect depositors. Voluntary systems are often not financially viable and are undermined by adverse selection. A compulsory system widens the funding base of the deposit

72 Talley and Mas (1990) (n55) 31.
74 FSF Report (n1) 21.
75 Wheeless and Kumbhakar (1995) (n73) conclude that the voluntary nature of the pre-1930 deposit insurance system in Kansas greatly increased adverse selection and moral hazard, which ultimately led to its collapse.
insurance system and avoids the possibility that only the weakest institutions join the scheme.\textsuperscript{76}

A voluntary system of deposit insurance creates a dichotomy in the banking system between insured and uninsured banks; at normal times, depositors that are able to assess bank conditions would place their deposits in uninsured banks to take advantage of the high deposit rates these banks would offer in compensation for the risk. This situation is expected to shift during a crisis with a mass exodus of deposits from uninsured to insured banks. This could result in a liquidity crisis and exert considerable strain on the lender of last resort facility. The demands of these depositors could also lead to a fire sale of assets by the banks.

A voluntary system has thus been described as inherently unstable, producing large scale deposit shifts between protected and unprotected banks, depending on the state of public confidence in the banking system.\textsuperscript{77} Because of the potential nature of the membership of voluntary systems, such systems are likely to be less financially viable over time.

A voluntary system of deposit insurance is unlikely to meet one of the cardinal objectives for establishing deposit insurance schemes, which is the protection of small depositors. This is because depositors of banks that opt out of the system would not be protected by the scheme.\textsuperscript{78} A voluntary scheme also negates the desire for a safe and stable banking system. The failure of an uninsured bank, whether large or small,

\textsuperscript{76} Hoelscher (2006) (n15) 11.
\textsuperscript{77} Talley and Mies (1990) (n55) 32.
\textsuperscript{78} Ibid. For a contrary view, see J. Balten-sperger and J Dermine ‘The Role of Public Policy in Insuring Financial Stability: a Cross-country Comparative Perspective’ (1986) INSEAD Working Paper No.86/33.
would create panic and loss of confidence in the banking system.\textsuperscript{79} Thus, in practice, compulsory deposit insurance is generally preferred to voluntary deposit insurance.\textsuperscript{80}

A compulsory system ensures a high number of participating banks thus ensuring an even spread of risk. However, it may be possible to attain a high level of participation in a deposit insurance scheme without legal obligation. This can be achieved if the authorities provide extra incentives to make participation in the scheme attractive to large banks. The authorities can also sensitize the depositing public and raise awareness on the existence and need for deposit insurance.\textsuperscript{81}

While compulsory membership of the deposit insurance scheme necessarily involves a degree of cross-subsidization in the banking sector, compulsory schemes generally promote financial stability and enhance the level of public confidence; these are benefits that are enjoyed by all banks in the system. It is important that all institutions that are members of the deposit insurance system should be subject to the same standards of strict regulatory oversight in order to minimize the risk to the system.

### 4.6.2 Eligibility

In most cases, deposit insurance membership is automatically granted to any institution that has received a licence from the relevant supervisory authority.\textsuperscript{82} The FSF report points out two circumstances in which membership considerations arise.

\textsuperscript{79} JU Ehhodaghe ‘Bank Deposit Insurance Scheme in Nigeria’ (1991) 1 \textit{NDIC Quarterly} (1).

\textsuperscript{80} A recent survey of deposit insurer practice conducted by the International Association of Deposit Insurers (IADI) showed that compulsory membership existed in all the countries represented in the survey. See \url{http://www.iadi.org/finalC20Reports/Design_Paper_Final.c20FebG20004.pdf}, accessed 2 May 2007.


\textsuperscript{82} Membership of the scheme is also terminated upon withdrawal of such a licence. Deposit insurers with risk-minimizing powers usually have the power to suspend or to terminate membership of institutions where they constitute risk to the deposit insurance fund.
First, when a deposit insurance system is established; and second, when membership is granted to new banks in an existing system. After establishing the scheme, policymakers seek to minimize the risks to the insurer while granting extensive membership. The two options are automatic membership or requiring banks to apply for membership.\textsuperscript{83}

Where membership of the scheme is compulsory for all banks or a certain category of banks, it is inevitable that such banks that are mandated to be insured must be admissible into the scheme.\textsuperscript{84} The deposit insurer may however adopt certain criteria and minimum standards that must be complied with by all participating institutions. The deposit insurer should co-operate with other safety net authorities, particularly the licensing and chartering authorities, in the adoption and enforcement of such standards.

Policy makers should also consider whether the scheme should be enlarged to include non-deposit taking financial institutions. Although, in terms of depositor runs, such institutions do not pose the same peculiar risk that banks pose,\textsuperscript{85} systemic considerations may necessitate that some form of protection is extended to these institutions. As noted earlier, the traditional distinctions that existed between financial markets are now appearing increasingly artificial; where these institutions are part of a group or conglomerate structure, the ripple effects of any failure or shock in the non-deposit taking business of the group may be transmitted to the deposit-taking business.

\textsuperscript{83} I&F Report (n1) 21.

\textsuperscript{84} Garcia (1999) (n23) opines that all institutions that take value deposits from the general public should be considered for inclusion.

4.7. Funding

Deposit insurance schemes must be adequately funded to function effectively and to achieve the objectives for which they have been established. The funding mechanism should be adequate to ensure the prompt reimbursement of depositors’ claims after a bank failure. An under-funded deposit insurance system would lead to agency problems and could create costly regulatory forbearance. It is the financial capacity of the insuring entity that gives credibility and public confidence to the deposit insurance scheme and thereby removes much of the incentive for bank runs. Indeed the ability of the insurance scheme to support financial stability is intricately linked with its ability to carry out a prompt payout of depositor claims when an institution fails.

In designing a deposit insurance scheme, policymakers need to consider two basic issues, which are the source and the mode of funding.

4.7.1. Source of Funding

Issues that arise in relation to the source of funding revolve around the issue of who should pay for deposit insurance. Funding can be sourced in many ways, such as government grants, levies or premiums assessed against participating banks, market borrowings or a combination of these sources. Policymakers have to choose between alternative solutions available to ensure that the deposit insurance scheme is adequately funded.

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86 See FSF Report (n1) 26.
87 The deposit insurer is likely to keep extending the time for distressed banks to comply with regulatory requirements because it wants to avoid resolution costs.
89 See HM Treasury (2005) (n59).
90 FSF Report (n1) 26.
Policymakers should hinge their considerations on two factors, which are:

(a) Those who will enjoy the benefits of deposit insurance should pay for it; and

(b) The source of funding should be able to maintain public confidence in the scheme.

The first consideration is based on equitable grounds. The FSF report recommends that member banks should pay the cost of deposit insurance since they and their clients benefit from having an effective insurance system. It has also been opined that the owners of banks, firms, their borrowers, and all the economic agents of a nation benefit from deposit insurance as far as it ensures economic stability and as such should contribute to the funding of the scheme. In as much as a government also benefits from a stable economy and makes political gains when the public feel that their wealth is secure, it should also provide funding for the scheme.

Morrison and White argue that deposit insurance should be funded not by bankers or depositors but through general taxation. They note that the existence of deposit insurance makes bank investments attractive to depositors. In the absence of deposit insurance, most depositors would prefer to place their funds in less productive self-managed projects which would not be of any benefit to the general economy. Thus, deposit insurance schemes increase social welfare. This benefit would however be lost if bank stockholders are forced to make payments into the deposit insurance fund because it decreases the capital they have at stake in the bank and increases their incentives to undertake moral hazard. They also posit that payment by depositors into
the deposit insurance scheme takes away with one hand what they give with the other.92

Regardless of the appropriateness or otherwise of the source of funding, it is crucial that the funding mechanism should be adequate for the deposit insurer to meet its liabilities. It should be able to maintain a high degree of public confidence in the deposit insurance scheme and the public should be assured that the system is capable of paying compensation and would keep its promises.93 The funding source should also be able to provide the funds necessary for a prompt reimbursement of all the insured liabilities of a failed bank. This is of particular importance to privately funded systems. Such systems should strive to achieve a target level of funding that would ensure it would meet all demands that will be placed upon it in normal times and moderately adverse circumstances.94

The source of funding should reflect country-specific factors. It is not unusual to find deposit insurance schemes with multiple or mixed sources of funding. In developing countries, the banking system may not be sufficiently strong to finance all the compensation that would be required if a banking crisis occurs without experiencing an erosion of capital. In such countries, it may be appropriate for the government to provide part of the funds required as a back-up to the scheme’s own resources.95 The

93 Ibid.
94 Garcia (1999) (n23) Table 6, which shows that 17 of the countries surveyed maintain a target level for the DI fund, which is often expressed as a desirable percentage of insured deposits.
95 MacDonald (1996) (n42). MacDonald notes that the extent to which deposit insurance schemes should rely on government assistance can, however, only be determined in the light of the strength of the commercial banking system and the government’s ability to find resources for this purpose.
government may also provide funds to augment the take-off capital of the scheme. The existence or the promise of government support would serve to boost the level of public confidence in the scheme and the banking system because the public expects the government to be solvent at all times.

4.7.2. Mode of Funding

There are two main issues to be considered in determining the mode of funding a deposit insurance scheme: first, whether funding should be on an ex ante or ex post basis; and second the appropriate method for assessing banks for the cost of deposit insurance.

1. Ex ante/Ex post Funding

Ex ante funding

This mode of funding involves the accumulation of a reserve or fund to cover deposit insurance claims in the event of the failure of a member bank. Ex ante funding allows the deposit insurance scheme to spread the premiums paid by banks over the course of a business cycle. It is an equitable method of funding deposit insurance schemes because failed banks would have previously contributed to the insurance reserve or fund.

\[96\] \textit{Garcia} (1999) (n23) finds that many countries have provision for government to assist a depleted fund with loans. 53 of the 66 privately funded systems that were surveyed had some form of access to public funding. \textit{Frelo\'r} (2004) (n91) opines that many privately funded systems can also be seen as mixed because the government promises to help if such fund schemes become short of liquidity.

\[97\] \textit{FSI} report (n1) 26. Assessment of premiums may be on a flat rate or risk-adjusted basis. See the discussion on risk-adjusted premium in the preceding chapter.
In an ex ante system, the mere existence of an earmarked fund or reserve helps to boost public confidence in the ability of the scheme to meet its obligations. Ex ante systems are generally more rule-based and provide greater certainty in depositor protection. In the absence of a dedicated fund, there may be political, legal or other obstacles to obtaining funds when they are required for deposit insurance purposes. With an ex ante system of funding, these funds would be available when needed provided the assessments have reflected ‘realistic assumptions regarding potential losses and other deposit insurance costs.’

It has been suggested that where banking failures are infrequent, a fund can augment its resources by investing its assets. However, such investments should be in low-risk, liquid assets and the fund should avoid getting involved in the allocation of credit among competing interests in the private sector. Ex ante funding sources can also be supplemented by ex post levies as well as government credit or guarantees for funds borrowed by the scheme from the central bank or financial market, where the fund is insufficient to meet its obligations.

The FSF report notes that ex ante funding has the potential to remove capital from the banking system because premiums paid to the deposit insurer cannot be used for other purposes. These assets are likely to yield a lower rate of return than they would if held by the banks. The deposit protection scheme may have to employ administrators and investment experts to manage these assets and this will result in additional costs. Another disadvantage of ex ante funding is that institutions may find it

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98 Lee and Kwok (2000) (n30) argue that an ex-ante fund would give more ‘psychological comfort’ to depositors.
100 MacDonald (1996) (n42); Talley and Mas (1990) (n55).
difficult to join or leave a scheme due to the imposition of exit or entry payment requirements.\(^{103}\)

Where a dedicated deposit insurance fund has been created, it is important to decide whether there should be an appropriate target ratio of the fund balance to total insured deposits. This usually involves making a judgement on an ideal adequacy level of the fund based on predictions of potential losses. However, the process of estimating the probability of loss where information is imperfect could be very complicated in practice.

**Ex post Funding**

Where this mode of funding operates, assessments are levied after the failure of a member bank in order to raise the funds required to satisfy deposit insurance claims.

The earliest known deposit insurance scheme was funded through this mode.\(^{104}\) In an ex post funded system, the deposit insurance scheme operates as a loss-sharing or mutual guarantee arrangement among participating institutions.\(^{105}\)

The main advantage of ex post funding is that it provides an incentive for inter-bank monitoring because each bank seeks to avoid the costs associated with the failure of another member. This incentive may be particularly strong in a banking system made up of a small number of large banks.\(^{106}\) In countries with weak accountability and transparency regimes, ex post funding reduces the opportunities for misappropriation.

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\(^{103}\) *Ibid.* This point relates only to voluntary schemes.

\(^{104}\) This was the scheme created in the state of New York in 1929, in which merchants who traded with foreigners agreed to be liable for each other’s debts. See Ch. 3.


\(^{106}\) *FSF Report* (n1) 27.
of accumulated deposit insurance funds by public authorities. An ex post funded system also helps to foster unity in the banking system because banks contribute to fund the compensation of the depositors of a member bank that has failed.

Ex post systems do not offer the certainty present under ex ante systems. Since assessments and collections occur after a failure, prompt reimbursement of insured depositors may be more problematic. They are also inequitable inasmuch as a failed bank would not have to contribute to the funds required to compensate its depositors.

In relation to incentivive compatibility of deposit insurance design and moral hazard, ex post funding is incompatible with the rationale for risk-based premium assessment systems. Theoreticaly, risk-based premiums influence the risk-behaviour of banks and discourage excessive risk-taking as risky activity would attract the payment of higher deposit insurance premiums. Because banks are levied after the occurrence of a bank failure, ex post funded systems are limited in their ability to influence bank risk-behaviour through deposit insurance assessment. To this extent, ex post systems are less effective in counteracting moral hazard incentives.

Ex post funding concentrates the cost of compensation as it is not spread out over time, thereby placing an additional burden on healthy banks at a time when they may also be under pressure. Where a failure occurs during an economic downturn, the regulators may be pressurized to provide forbearance because the ability of the

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108 FSF Report (n1) 27.
109 Most national laws provide for the deposit insurer to have a claim on the failed bank’s residual assets.
110 This is because bank failures usually occur at periods of general economic recession. See MacDonald (1996) (n42).
The main drawbacks of ex post funded systems have been summarized by Garcia as 'often privately run by their member institutions: do not have clearly specified responsibilities regarding sharing the costs of compensating depositors; lack back-up funding from the government; offer coinsurance; are limited to their roles and responsibilities; and, because they are privately run, have difficulty in obtaining information from the supervisor and the central bank.'

Although ex ante funding is generally preferable, it is possible to combine features of both funding models. It is important that the funding model adopted takes account of country-specific factors and reflects the public policy objectives for which the scheme was established. Policy makers should ensure that:

- The scheme has legal authority to levy contributions from banks;
- The nature and source of the scheme’s funding should be clearly understood by the authorities, participating institutions and the general public;
- The power to levy contributions is exercised in a fair and equitable manner so that unreasonable and damaging burdens are not placed on member banks;
- Assessments take account of risk-related factors. However, because of the complexity in calculating risk-adjusted levies ex ante, it is advisable that new schemes, especially in developing countries, start off with flat rate premiums and this can be changed gradually, over time;
- Where ex ante funding is established, the fund is well managed and readily available to cover losses as they arise.

111 FSF Report (n1) 27.
113 MacDonald (1996) (n42).
114 See Chapter 3, para.3.5.2.3.
• There are provisions for back-up funding.

II. Assessment System

There are two main options available for building and maintaining a deposit insurance fund. These are the flat-rate premium system and the risk-based or differential premium system.

Under the flat-rate assessment system, all insured banks are assessed at the same rate for the purpose of deposit insurance premium. A flat-rate system is aimed at ensuring that the deposit insurer maintains an adequate financial capacity. The disadvantage of this method of assessment is that except where deposit insurance is made compulsory, adverse selection will be encouraged with only risky banks left to participate in deposit insurance. It also creates incentives for moral hazard as the price paid for deposit insurance does not reflect risk. The significant advantage is its simplicity, which makes it easy, cost-effective and practicable, especially for new systems in developing countries.

A risk-based system involves the assessment of premium based on the risk a particular bank poses to the deposit insurer. Apart from being an equitable assessment method, under ideal circumstances, risk-based assessments should mitigate the risks of moral hazard associated with deposit insurance. In a market with perfect information, relating deposit insurance premium to risk is preferable.

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117 The limitation of this assessment method was examined in the previous chapter. See para.3.5.2.3.
118 FSI Report (n1) 28.
Although a risk-related premium system is not the perfect solution to the deposit insurance problem, its objective is to provide an incentive for banks to reduce excessive risk-taking and to create a fair assessment process. Where it is adopted, the approach used should be effective at differentiating banks into appropriate risk categories and have access to, and utilize a variety of relevant information. It should also be forward looking and acceptable to the banking industry and other safety-net participants.119

Because of the complexities involved in calculating risk ex ante, a regular review process should be put in place to ensure that any changes in the sources of risk over time are put into consideration and insurance premiums are subsequently adjusted.

Risk-related premium systems are necessarily information intensive. As such, attention should be paid to the accuracy of the information being relied upon to calculate risk, particularly where the deposit insurer has to rely on another safety-net participant as the source of such information. A balance also needs to be struck between the information requirements of the deposit insurer and the need not to create a burdensome regulatory regime for banks.

Risk-adjusted premiums are susceptible to subjective judgement and political manipulation, thus it is expected that banks might want to contest the decision of the deposit insurer to place them in a certain premium or risk category.120 Although judicial review is an available option in most jurisdictions, the establishment of a


120 See for example the U.S. case of Doolin Security Sav. Bank v FDIC, 53 F.3d 1395, where the FDIC’s decision to terminate the insured status of a healthy bank in a dispute over its assessment risk classification was challenged.
formal and independent review and dispute settlement mechanism would serve to settle any disputes that may arise and also to review decisions of the deposit insurer in an expeditious manner.\textsuperscript{121} This would ensure fairness and consistency in the assessment system and also limit the scope for arbitrariness.\textsuperscript{122}

4.8. Intervention and Failure Resolution

The FSF Report notes that the objectives of an effective bank failure resolution process are to ‘meet the deposit insurer’s obligations; ensure depositors are reimbursed promptly and accurately; minimise resolution costs and disruption of markets; maximise recoveries on assets; settle bona fide claims on a timely and equitable basis; and reinforce discipline through legal action in cases of negligence and other wrong doing.’\textsuperscript{123}

A properly designed deposit insurance system should provide an effective exit mechanism for winding down a failed bank and provide the public with ready access to insured funds. From a public policy perspective, the main objective of bank regulation is not to prevent individual bank failure but to protect the stability of the banking system as a whole. As such, the failure of an individual bank should not, in all circumstances, raise serious systemic concerns. In a competitive market, the survival of the fittest institutions promotes the health, viability and efficiency of the

\textsuperscript{121} An example of a similar body that has been established in the UK is the Financial Services and Markets Tribunal, although the UK has not adopted a differential assessment system. The tribunal is an independent body set up to review the FSA’s regulatory and supervisory decisions in individual cases. See s.132, FSMA 2000.

\textsuperscript{122} In Doolin Security Sav. Bank v FDIC (n120) Doolin alleged institutional bias and non-adherence to due process on the part of the FDIC in withdrawing its deposit insurance cover.

\textsuperscript{123} FSF Report (n1) 31. Professor Roy Goode has also described the overriding objectives of an insolvency law, which are equally important in bank resolutions. These are: the restoration of the company to profitable trading where practicable; maximization of returns to creditors where the company cannot be saved; establishment of a fair and equitable system for the ranking of claims and the distribution of assets among creditors; and identification of the cause of failure and imposition of sanctions on culpable management. See RM Goode \textit{Principles of Corporate Insolvency Law} (Sweet & Maxwell, London, 2005) 39.
sector. However, the process of resolving such failure has important systemic implications and can affect the confidence and viability of the regulatory authorities.

It is important to note that intervention and failure resolution powers are not always the exclusive right of the deposit insurer. These powers may be allocated to, or exercised in concert with other safety net participants. In countries that operate the pay-box model of deposit insurance, the failure resolution powers are usually conferred on another agency within the financial safety net. The failure resolution powers are often conferred on the deposit insurer where it has a risk minimizing mandate. It is important that specific legislative provisions support arrangements for close co-operation and exchange of information among safety net participants.\textsuperscript{124}

4.8.1. Legal Framework for Bank Resolution

The special nature of banks and their vital role in an economy is the main justification for regulation and supervision of banks. As noted above, banks that are no longer financially viable must be allowed to fail. However, because the manner of resolving such banks could have systemic consequences and affect the rights of depositors, there could also be an extension of the argument for regulation to justify a special regime to deal with failing banks.

Generally, the declaration of insolvency is based on two tests: the balance sheet test and the cash flow or equity test. With the first test, an institution becomes technically insolvent where its liabilities exceed its assets. With the second test, insolvency is determined where the institution is unable to pay its debts as they become legally

due. Where banks are concerned, there is an additional test, which is generally referred to as regulatory insolvency. Regulatory insolvency connotes non-compliance with capital adequacy requirements. For banks, the two tests mentioned above are not relevant trigger points for regulatory intervention. The triggers for regulatory action precede the state of insolvency and the conditions for commencement of proceedings under general insolvency law. Regulators may need to intervene before the state of over-indebtedness is reached or some degree of regulatory forbearance may be permitted to give the bank the opportunity to return to a position of compliance.

Policymakers must decide whether to introduce a special insolvency regime for banks or whether general insolvency laws would govern bank insolvencies. There is a contrasting approach across jurisdictions. Whereas in some jurisdictions banks are subject to court-administered insolvency proceedings governed by general insolvency law, others have introduced a special insolvency regime for banks, which is implemented by the bank supervisor or the deposit insurer. While it has been argued that there may be no need for a special insolvency regime in countries where

[128] Hupkes (2000) (n 126). Banks differ from other financial firms because of information asymmetry and the nature of their contracts; hence supervisors, depositors and other creditors would be unable to access the exact nature of their balance sheet until it is too late. See K Simons and S Cross 'Do Capital Markets Predict Problems in Large Commercial Banks' (May 1991) New England Economic Review 51.
[130] For a comparative analysis, see Hupkes (2000) (n126) 49.
[131] This is the approach in most European countries.
[132] For example, USA, Canada and Switzerland.
bank failure are rare, bank failure, if not effectively resolved could have far-reaching systemic consequences.

Arguments in favour of a special regime for bank insolvency are based on the grounds that the goals of a bank insolvency resolution are different from those of general corporate insolvency, hence the general insolvency framework would be insufficient to treat certain features of bank resolution. In many countries, the general insolvency law is required to balance the interests of only three competing interests, namely, creditors, employees and owners; however in banking insolvency, the public interest in a sound banking system must be considered as an additional interest.

Given that bank failures affect the public, entailing costs to the taxpayer and the deposit insurer, regulators, as representatives of the public interest, should endeavour to intervene early in order to minimize or avoid losses to creditors and the deposit insurer. Essentially, good timing is critical for an efficient resolution and exit policy. General insolvency laws may not provide the necessary intervention powers to deal with failing banks prior to insolvency. The need for preventive and corrective action at the pre-insolvency stage is crucial to minimizing the costs and disruptions

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134 These goals include: prompt resolution to minimize credit and liquidity losses, as well as costs to taxpayers and the deposit insurer; market discipline; and the promotion of public confidence by avoiding interruptions to financial services. See GG Kaufman ‘Using Efficient Bank Insolvency Resolution to Solve the Deposit Insurance Problem’ in A Campbell and others (eds.), Deposit Insurance (Palgrave Macmillan, New York, 2007) 198.
associated with bank failure. A special bank insolvency regime also provides consistency and certainty to stakeholders as to how banks would be treated in insolvency. This would help to prevent loss of confidence resulting from uncertainty in a bank failure. Hence, policymakers must consider whether general insolvency laws are adequate to support an efficient intervention policy or whether a special insolvency regime for banks should replace or complement them.

Policy makers must ensure that the approach adopted is fast and efficient and allows for early intervention by the supervisor. In countries with a slow judicial process, it may be advisable to adopt an administrative procedure, which would be implemented by the supervisor. However, in the absence of a uniform international framework for bank insolvency, a court based system might be more acceptable where there is an international dimension to a bank failure. Factors such as political independence of regulators, accountability and transparency, and the availability of remedies for infringement of rights should also be considered. Where the institutional framework for these factors is weak, a court based system is preferable.

An effective resolution framework should include early warning and prompt corrective action (PCA) mechanism. This would serve to reduce the cost of resolution and to prevent sudden banking crises. The appearance of the early warning signs should trigger intervention and failure resolution powers of the deposit insurer or the relevant supervisor. It has been suggested that a 'non-viability' test should be the trigger for determination. This should include the bank’s ability to meet capital

requirements; signs of deterioration in the quality or value of assets; liquidity problems or severe decline in earnings. These mechanisms must be clearly defined in law, transparent and credible. The powers should not be too discretionary in order to avoid arbitrary action and the scope for harmful forbearance; this must however be balanced against the need to avoid over-prescriptive regulation and the need to allow a sufficient degree of flexibility based on regulatory judgement. These considerations must be consistent with the objectives of the deposit insurance scheme and other macroeconomic policy objectives.

There are numerous steps that are required to liquidate the business of a failing bank. Such steps include the resolution or disposition of the failing bank, reimbursement of insured depositors, liquidation of the bank’s assets, settlement of claims and disposition of pending or outstanding litigation. The deposit insurance system should be designed, with the support of the relevant legislative provisions, to effectively and promptly carry out these functions so as to minimise the disruption associated with bank failure.

4.8.1.1. Resolution Options

The legal framework should help to determine the type of resolution option that is most effective in achieving the goals of the resolution process. The priority of claims on the receivership, the rights of claimants, and the authority of the receiver to take control and dispose of assets should all be provided for in legislation. There are generally three resolution options that are available. These are: liquidation and reimbursement of depositors’ claims; purchase and assumption transactions, use of

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140 Sabourin (n124).
142 FSF Report, 31.
bridge banks and open bank financial assistance. The main features of these resolution options will be considered in turn.

I. Liquidation and Reimbursement of Depositors’ Claims

This involves the closure of a failed bank while its assets and uninsured claims are transferred to a receiver/liquidator for liquidation and settlement.\(^{145}\) Insured depositors are also reimbursed up to the specified coverage limit,\(^{146}\) or the insured balances may be transferred to another open bank, thereby making the balances available to the depositors.

Adoption of this option effectively terminates the existence of the insured bank, and it can be used where it has proved impossible to secure a merger or acquisition deal mainly because the failing bank has no franchise value. It may also be adopted where it is considered to be the fastest way of ensuring that depositors are reimbursed in order to prevent contagious runs, which may trigger a systemic crisis; or when the costs involved are considered to be less than that of other resolution options.\(^{147}\)

This method can be disruptive because depositors would be forced to find new banks and there would be a reduction in the availability of credit due to the closure of the institution.\(^{148}\) It may also be costly for the deposit insurer to effect a deposit payout, especially where a large bank is involved.

\(^{143}\) Ketcha (1999) (n20); Campbell (2006) (n129).

\(^{144}\) This is also known as deposit pay-off.

\(^{145}\) FSF Report, 32.

\(^{146}\) The insurer takes the place of the insured depositors in the receivership.

\(^{147}\) For various reasons adduced by different countries that have adopted this option, see W Su ‘General Guidance for the Resolution of Bank Failures’ in A Campbell and others (eds) Deposit Insurance (Palgrave Macmillan, New York, 2007), ch 10.

Where reimbursement is to be used, the law should provide a realistic time limit from
the date of the bank closure to actual reimbursement. This would avoid unnecessary
delay, which could result in loss of confidence and contagious runs on other healthy
banks. The deposit insurer should also be given access to the relevant information and
deposit records for the purpose of the payout.

II. Purchase and Assumption Transactions

A purchase and assumption (P & A) is a transaction in which a healthy bank or group
of investors assumes some or all of the obligations, and purchases some or all of the
assets of a troubled bank.\textsuperscript{149} It has been noted that many banks and other firms
provide products and services that are similar to those offered by a failed bank and
that because of this similarity, operations and most of the assets and liabilities of
insolvent banks tend to be acquired by other institutions.\textsuperscript{150} The assets that are not
acquired under the P & A transaction are disposed of by the receiver/liquidator.

P & A transactions minimise market disruptions by avoiding interruptions in banking
operations and allowing credit relationships to be maintained.\textsuperscript{151} P & A may also be
considered to be less costly than depositor reimbursement. In a P & A, the assets that
are taken over by the assuming bank will not end up in the receivership, where they

\textsuperscript{149} ING's acquisition of Barings in 1995, and the recent acquisition of Bear Stearns by JP Morgan
Chase are examples of similar transactions. See FSF Report 32. Instead of a P & A transaction, the
failure resolution authority may also arrange a financially assisted merger of the failing bank with
another healthy bank. On the use of the P&A by the FDIC, see generally FDIC Resolution Handbook,
2003.

\textsuperscript{150} GJ Benston and GG Kaufman 'The Appropriate Role of Bank Regulation' (1996) 106 The

\textsuperscript{151} Ketcha (1999) (n20).
would have had to be liquidated at unfavourable prices.\textsuperscript{152} Another advantage of the P&A transaction is that it is usually a private sector funded transaction, not needing the injection of public funds. A key hindrance to the use of P & A transactions is that it may be difficult, in a financial crisis, to find a bank with sufficient liquidity and willing to take over a failing bank. This is particularly true in developing countries.\textsuperscript{153}

\section*{III. Bridge Bank}

A modification of the P & A transaction, which is often used in the resolution of large and complex banks, involves the use of a ‘bridge bank’. The relevant supervisory agency takes over ownership or control of the failed bank, through a temporary structure, until a final resolution can be achieved.\textsuperscript{154} A bridge bank maintains banking services for the customers, gives supervisory authorities sufficient time to evaluate and market the failed bank, and prevents a bank from failing while prospective acquirers take time to evaluate the quality of its assets.

The major disadvantage of using the bridging bank structure is the time, expertise and financial resources that would be expended in running the institution. It is important that the bank does not remain under official control for a long time as it may lose value and draw deposits away from other banks.\textsuperscript{155} This may also lead to increased costs in the final resolution of the bank. The relevant law should provide a maximum time limit for a bridge bank to remain in operation.

\section*{IV. Open-Bank Financial Assistance}

\textsuperscript{152} Jallely and Mas (1990) (n 55).

\textsuperscript{153} In developing countries, it is often the case that the acquiring bank will be a foreign bank; such an acquisition will give the opportunity to move into a new market.

\textsuperscript{154} The Competitive Equality Banking Act of 1987 gives the FDIC authority to charter a temporary bank, which can be used to manage a failed bank for up to 3 years until the bank is acquired or merged.
In open-bank assistance, the resolution authority provides financial assistance in the form of cash, loans, or assets purchases to a troubled institution to prevent its failure.\textsuperscript{156} Open bank assistance is usually provided to banks that are deemed 'too big to fail.'\textsuperscript{157} In certain cases, open bank assistance may also be adopted where the cost of doing so is considered less than that of a depositor payout.

One significant disadvantage relating to the use of open bank assistance is that public funds are required to keep the troubled bank afloat. The use of open-bank assistance raises issues relating to fairness, cost and moral hazard. This failure resolution method is also susceptible to intense political lobbying and may lead to shareholders and other uninsured creditors and depositors receiving compensation that they would not otherwise have done.\textsuperscript{158} To avoid adverse effects on market discipline, private sector solutions should always be explored in resolving failing banks, with public funds being utilized only in exceptional circumstances, such as where there is a grave danger of systemic risk.\textsuperscript{159}

\textsuperscript{156} This authority has been used by the FDIC between 1987 and 1994 to solve 114 failed banks with $89.9 billion in total assets through 32 bridge banks.
\textsuperscript{158} This refers to the fear that the potential failure of a large bank poses significant disruptive threats to other financial institutions, the financial system as a whole, and possibly to the economic and social order. See generally GH Stern and RJ Feldman \textit{Too Big To Fail: The Hazards of Bank Bailouts} (Brookings Institution Press, Washington DC, 2004).
\textsuperscript{159} FSF Report. 33.
\textsuperscript{160} A Campbell 'Bank insolvency and the Problem of Nonperforming Loans' (2007) 9 Journal of Banking Regulation 1. 25.
4.8.2 Policy Considerations in Failure Resolution

In designing the failure resolution framework and in adopting the appropriate resolution option for a particular institution, the regulator should be guided by the following policy considerations:

- The need to enhance public confidence and maintain the stability of the financial system;
- The need to minimize moral hazard by promoting market discipline;
- The need to minimize losses and costs, essentially by controlling the timing of the intervention and applying a least-cost resolution test;
- The need for an equitable, consistent and transparent process: the deposit insurer should put in place well-defined policy guidelines and standard operational procedures for all bank resolution processes;
- The need to minimize disruption of banking services in the communities where the insolvent banks are located;
- The need to limit government involvement in the ownership and management of financial institutions. This makes it imperative for market-based resolution options to be explored as far as possible.

An efficient failure resolution framework puts the extent of the losses suffered during a bank failure under the control of the regulator or deposit insurer. Kaufman articulates four principles for an efficient failure resolution regime, all of which are

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160 Due to information imperfections, any perception of inequitable treatment in the distribution of dividends and losses from the liquidation process could undermine public confidence and consequently the entire process.
161 Su (2007) (n147).
162 JF Bovenzi and MIF Muldoon ‘Failure Resolution Methods and Policy Considerations’ (1990) 3 FDIC Banking Review 1, 1.
hinged on the concept of timely and prompt action by regulators. These principles are:

- Prompt legal closure where the bank’s capital declines to a pre-specified and well-publicized minimum value greater than zero;
- Prompt estimates of the recovery value and assignment of any credit losses (haircuts) to de jure uninsured bank claimants;
- Prompt re-opening, particularly of large banks, with full depositor access to their accounts on their due dates at par value for insured deposits and recovery value for uninsured deposits, and full borrower access to existing credit lines;
- Prompt re-privatization and re-capitalization of the bank in whole or in part at adequate capital levels.

The above-mentioned principles presuppose the existence of the necessary legal and institutional framework that permits early intervention and prompt corrective action. For timely intervention to be possible, it is important to put in place a rule-based or statutory trigger mechanism for early intervention when the warning signs for a bank failure appear.

It is also important that the relevant bank insolvency laws provide for the various resolution options discussed above. The absence of alternatives may lead to unnecessary liquidation of banks which may be economically inefficient in most cases. It is also possible that in the absence of alternative resolution options other than liquidation, the banking supervisor may delay closing the bank and engage in harmful regulatory forbearance.

Generally, the resolution process for failed banks should involve a balancing act on the part of the regulator. Where the least-cost resolution test is required by law, the question arises as to whose interests should be considered. It is submitted that in applying the test, the relevant authority should not only choose the resolution option that is least-costly to the deposit insurance fund, but should also consider the interests of other stakeholders such as depositors.

While a least-cost test is important, it is pertinent to note that the least-cost option may not necessarily be the most effective option in all cases. 'Effectiveness' should be determined by reference to the deposit insurer’s mandates and objectives. Hence, such factors such as the interests of depositors and overall financial stability should be balanced against the need to minimize cost. The deposit insurer should therefore adopt the most cost-effective resolution option.

4.9. Public Awareness

Public information and awareness about the existence, purpose, functions and limitations of deposit insurance is a factor that is often overlooked in the design and implementation of deposit insurance schemes.165 The characteristics of a deposit insurance scheme need to be publicized regularly so that its credibility can be maintained and strengthened.166 More than anything else, it is the knowledge of the existence and purpose of deposit insurance that provides confidence and reduces the possibility of a shock occurring in a crisis. It is impossible for deposit insurance to foster public confidence in the banking system if the public is not aware of its

164 Kaufman (2007) (n1 34), 199.
166 FSF Report, 29.
existence. If depositors are uncertain whether or not their funds are safe, there is a strong likelihood that they will withdraw their funds at the slightest hint of a problem at their banks. This situation could lead to a bank run with possible systemic implications.

In many countries, the level of deposit insurance awareness is low.\textsuperscript{167} Most people assume that the deposit insurer is just another supervisor and that the government protects all of their deposits.\textsuperscript{168} This has necessitated the establishment of public awareness programs in most countries that have deposit insurance schemes. It is crucial that a public awareness program is introduced as soon as possible after the decision has been made to establish a deposit insurance scheme. This would ensure that when financial crises occur, the public would be aware about the protection that the scheme offers, thus maintaining confidence in the financial system.\textsuperscript{169}

A properly designed public awareness program would promote the dissemination of information that facilitates an understanding of the deposit insurance scheme, its main features and limitations. Public awareness programs should be designed to achieve the following objectives:

\begin{itemize}
\item The dissemination of information to facilitate the understanding of the concept of, and the rationale for deposit insurance;
\item The promotion and sustenance of confidence in the financial sector;
\end{itemize}

\textsuperscript{167} R Markova ‘Case Study on Public Awareness – Bulgaria’ (2003) \textit{Presentation at the IADI/EBRD Seminar on Deposit Insurance for the Western Balkans, BIS, 8-9 December 2003}.

\textsuperscript{168} CDIC, ‘Public Awareness and Education Programme Overview’. \url{http://www.cdic.ca/?id=142} , accessed 20 August 2006.

\textsuperscript{169} IFI Report, 29.
• The dissemination of vital information to insured depositors when bank failure occurs.\textsuperscript{170}

It is important to determine the target audience for a public awareness program. The target audience should include:

• The general public;
• Media;
• Banks and Banking Associations, including their employees;\textsuperscript{171}
• Law makers and public officials;\textsuperscript{172}
• Uninsured depositors and other creditors of failed banks.\textsuperscript{173}

Special communication strategies need to be developed to ensure that the goals of the program are achieved and that the target audience is reached. Some of the communication techniques that can be used include:

• Press releases and conferences;
• Printed material (annual reports, periodic journals, Q & A brochures);
• Regularly updated websites and telephone help lines;
• Discussions and seminars\textsuperscript{174}; and
• Research.\textsuperscript{175}

\textsuperscript{170} FSF Working Group on Deposit Insurance, \textit{Discussion Paper on Public Awareness}.
\textsuperscript{171} FSF Report 29 notes that bank employees, especially those in operations and those on the front-line, are important conduits for providing information about deposit insurance.
\textsuperscript{172} Lawmakers and public officials need to be sensitized where there is need for deposit insurance reform and on the direction of such reform.
\textsuperscript{173} Markovitz (2003) (n167).
\textsuperscript{174} Ibid.
\textsuperscript{175} National qualitative and quantitative studies can be carried out to evaluate the success of the public awareness program.
4.10. Interrelationship with Safety Net Participants

Efficient interrelationship between financial safety net participants is essential to the success of a deposit insurance scheme. The FSF Report states that: 'when a single organisation performs all the safety net functions the smooth resolution of potential tensions is dependent on clarity of mandates and an adequate accountability regime among the relevant departments. However, when the functions are assigned to different organisations, issues related to information sharing, allocation of powers and responsibilities, and coordination of actions among different functions are more complex and need to be addressed clearly and explicitly.'\(^{176}\) Thus interrelationship considerations will vary according to a country's specific institutional arrangements.

The basic features of a financial safety net are:

- The Lender of Last Resort (LoLR): this is usually a function of the central bank;\(^{177}\)
- Supervision: this is also a function of the central bank or other specialized agencies;\(^{178}\)
- Deposit insurance: usually managed by a public agency or privately or a joint private/public venture.\(^{179}\)

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\(^{176}\) FSF Report, 19; while most countries have the financial safety net functions separated, some countries have adopted consolidated regulatory and supervisory regimes, for example, the UK and Taiwan.

\(^{177}\) In Germany, the LoLR is managed by the Liko bank, a private company owned by banks and the Central Bank.

\(^{178}\) In the UK and Australia, supervision is done by separate agencies. In the US, Canada and Nigeria, the deposit insurer carries out some supervisory functions.

\(^{179}\) JAC Santos ‘Is the Institutional Allocation of Deposit Insurance Important?’ *Presentation at the International Association of Deposit Insurers’ Meeting, Manila, 16-17 February 2006.* Apart from these safety net participants, most countries have a government department (the Ministry of Finance or Treasury) that is usually responsible for financial sector policy; also a third safety-net component, namely, an exit mechanism for weak financial institutions, may exist on its own or may be merged into the deposit insurance or supervision function. See S Ingves and M Quintyn ‘Financial Stability Assessments: Implications for Governance Arrangements’ *Presentation at the International*
Differences in mandates, interests, opinion and policy of financial safety net participants create a potential for conflict. This makes co-ordination and co-operation essential if the effectiveness of these bodies is not to be undermined. The major considerations for policy makers in the development of an effective interrelationship strategy will now be considered in turn.

4.10.1 Information Sharing

The different safety net functions contribute to the stability of the financial system but they create a potential conflict of interest because their functions necessarily overlap and are also interdependent. The deposit insurer requires information to function and the primary source of information is usually the supervisory authority. The deposit insurer can also obtain information directly from banks.

A deposit insurer’s information requirements vary according to its mandate and this is illustrated in Table 4.1 below. Where deposit insurance is operated through a simple pay-box model, the deposit insurer only requires basic information for the calculation of premiums and the prompt settlement of depositors’ claims when banks fail.180 A risk-minimizing deposit insurer requires more information because of its broader mandate. It should have access to financial statements and other reports of banks in order to be able to monitor their financial conditions and anticipate any problem.

The information requirements of the deposit insurer in normal times also differ from the requirements in a crisis. While information in normal times is required for the
purpose of calculating premiums and risk evaluation, during a bank failure or crisis, the deposit insurer requires more information for the purposes of depositor reimbursement and bank resolution or liquidation.\textsuperscript{181}

The supervisory authority is the safety net participant that is best placed to assess accurately and ensure the quality of information provided by financial institutions. This makes it important for policymakers to ensure close and effective co-ordination between the supervisory authority and the deposit insurer. It is often necessary for the deposit insurer to supplement information obtained from the supervisory authority with information obtained directly from banks. The need to obtain relevant and sufficient information should however be balanced against the need not to place an excessive burden on the banking industry; an effective information sharing arrangement would prevent unnecessary duplication thus reducing the regulatory and reporting burden on banks. Safety net participants should also ensure that the confidentiality of certain information is respected and maintained in the process of information sharing.\textsuperscript{182}

\textsuperscript{180} The information required relates to a bank's deposit base including the amount of deposits held by individual depositors. This will enable the deposit insurer to apply coverage limits.


Table 4.1 Deposit Insurance Mandate and Interrelationship Issues

<table>
<thead>
<tr>
<th>Mandate</th>
<th>Powers</th>
<th>Interaction During Life Cycle Of Institutions (Beginning, Middle, End)</th>
<th>Effectiveness and Cost Minimization</th>
<th>Interrelationship Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Pure pay-box</td>
<td>Reactive (e.g. clean up, liquidation)</td>
<td>Failure</td>
<td>Low</td>
<td>Mainly information sharing</td>
</tr>
<tr>
<td>(2) Cost-reducing objective</td>
<td>Mainly reactive, some proactive features (e.g. clean-up but some interaction upon failure)</td>
<td>Approaching failure (but some interaction upon failure)</td>
<td>Low – Medium</td>
<td>Requires well defined roles, responsibilities, information sharing and coordination</td>
</tr>
<tr>
<td>(3) Full risk-minimizer</td>
<td>Proactive (e.g. risk identification, risk assessment and management)</td>
<td>Beginning, Midlife, Troubled</td>
<td>High</td>
<td>Requires well defined roles, responsibilities, information sharing and coordination</td>
</tr>
</tbody>
</table>


4.10.2 Allocation of Regulatory Powers

In order to fulfil its mandate effectively, each member of the financial safety net would prefer to monitor and supervise financial institutions in its own right. This would be impracticable and would result in a conflict of interests and mandates as well as increased regulatory costs. Thus, it becomes important to determine the institutional allocation of regulatory powers and functions. A clear designation of powers and responsibilities of safety net participants is a critical step toward achieving effective interrelationship. Institutional allocation is affected by various factors, which include the development level of a country’s financial sector, political interference and the supervisory infrastructure.184

The FSF Report recommends that regulatory allocation arrangements can be formalised through legislation, memoranda of understanding, legal agreements, or a combination of these methods.185 Legislation is the primary means for allocating institutional arrangements among regulators. However, it is impossible for lawmakers to envisage all the practical possibilities of regulatory conflict at the time the law is being promulgated. It thus becomes important that a combination of all the methods mentioned above is utilized in regulatory allocation. Furthermore, the allocation of regulatory mandates and co-ordination arrangements should be made clear ex ante before any crisis occurs. Prior discussions and a high degree of transparency are essential requirements when establishing the co-ordination framework to facilitate information sharing and effective communication.186

184 I Dong 1 ‘Role of Deposit Insurance Agences in an Integrating Financial Supervisory Environment’ Presentation at the International Association of Deposit Insurers’ Meeting, Manila, February 16-17, 2006.
185 FSF Report 20.
Examples of practical problems that may arise between regulatory institutions and the deposit insurer will be considered below:

I. Deposit Insurer and the Termination/Closure Authority

Where the function of the termination or closure of failed banks is assigned to a different regulatory body, it is possible that the terminating authority may adopt a looser closure policy than the deposit insurer would have adopted. This can lead to a potential conflict of interest because deposit insurance losses are closely related to the timing of the closure of a failing bank. Thus, the interest of the deposit insurer in ensuring the timely closure of a bank when a failure is imminent might be different from the interest of the closure authority. The closure authority will not necessarily bear the full costs of delaying a bank closure as such costs is usually the deposit insurer's responsibility.

Policymakers can mitigate this problem by introducing regulation that protects the deposit insurer from other regulatory policies or regulation that targets institutions whose policies may give rise to conflict. Such regulation includes:

- Giving the deposit insurer the right to withdraw insurance;
- Giving legal priority to insured depositors;
- Introduction of PCA mechanisms.

Introduction of risk-adjusted capital standards can also help to protect the deposit insurer against the policies of a different closure/termination authority. A high capital
standard would reduce the probability of the deposit insurer incurring losses when a bank fails because losses are first absorbed by capital.189

II. Deposit Insurer and Lender of Last Resort (LoLR)

The LoLR helps to prevent contagious bank runs by providing liquidity support to banks that are illiquid but solvent and have good collateral, in order to allow them to meet depositor demands and avoid closure.190 Where the LoLR function is allocated to an institution other than the deposit insurer,191 the institution may also adopt a loose liquidity support policy. By giving liquidity support to banks through short-term collateralized loans, the LoLR gives itself priority over depositors and avoids costs that may result from failure.192 Where the LoLR function and the terminating function are allocated to a single institution, there is the high probability for regulatory forbearance, which may be damaging to the deposit insurer’s interest.

It is also important to note that some deposit insurers can also provide liquidity support to insured banks. This creates a potential conflict as provision of such support is the traditional function of the LoLR. While the deposit insurer is usually given this power for the purpose of preventing individual bank problems from resulting in systemic crisis, it could also create an internal crisis where the deposit insurer is also responsible for failure resolution. A deposit insurer with such ‘conflicting mandates’

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190 The theory on the need for LoLR was developed by W. Bagehot, in his book Lombard Street: A Description of the Money Market (H.S King, London, 1873); see also H Thornton An Enquiry Into the Nature and Effects of the paper Credit of Great Britain (J. Hatchard, London, 1802). See Chapter 2 for a discussion on the LoLR.
191 The LoLR is the principal function of most Central Banks around the world.
should be given access to appropriate and sufficient information to make its judgement.\textsuperscript{193}

This problem can be solved by enacting laws and regulation to give priority to deposit insurance claims. This should also stipulate penalties to be imposed on the LoLR when its loans lead to losses for the deposit insurer. Such regulation will create the incentive for the LoLR, in the exercise of its discretionary powers, to provide liquidity support only to solvent banks.\textsuperscript{194} It is however important that the discretionary nature of the LoLR function is maintained. This will allow the LoLR to assess the severity of individual cases and subsequently determine whether or not to grant liquidity support.\textsuperscript{195}

In order to solve potential interrelationship problems, policymakers should consider whether or not other safety net participants should be allowed to sit on the deposit insurer’s governing board or have some input in the deposit insurer’s decision-making process. In this regard, it would also be useful to establish a body to ensure cooperation, co-ordination and harmonization of policies and activities of financial safety net participants.\textsuperscript{196} Government-owned deposit insurance systems and other financial safety net participants should also have a degree of accountability to another supervisory or government authority.\textsuperscript{197} Although statutory and formal arrangements are necessary for the effective co-ordination of the activities of the safety net

\textsuperscript{193} Carr (2007) (n181).

\textsuperscript{194} Following the finding of a US House of Representatives Study in 1991 that Federal loans to troubled banks in the 1980s resulted in increased losses to the FDIC, Congress, through the FDICIA, introduced restrictions and stipulated a penalty for lending to banks that subsequently fail.


\textsuperscript{196} In Canada, committees of officials of the Deposit insurance scheme and the supervisory authority have been established to facilitate the consideration of all matters of mutual interest. In the US, the banking agencies are members of a council established to promote consistency, uniformity and progress in banking supervision.
functions, goodwill and commitment is required on the part of each safety net participant for such arrangements to succeed.

4.11 Provisional Conclusion

While the concept of deposit insurance is a relatively simple one, its design and implementation is undoubtedly complex. Its intricacies involve setting realistic objectives against the background of institutional factors, and matching the objectives with the appropriate structure and design features. An attempt has been made in this chapter to develop a set of sound practices in order to create a model of deposit insurance that creates the right incentives to mitigate the perverse effects of deposit insurance.

The application of the design and structural principles enunciated in this chapter should be considered against the backdrop of two important considerations. The first consideration is the role which certain factors, which are exogenous to the deposit insurance scheme, play in its successful implementation. These factors include political stability, macroeconomic stability and overall soundness of the banking system, and the adequacy of the supporting regulatory and legal framework.\(^{198}\)

The second consideration is the fact that there is no ‘one size fits all’ approach to the design and implementation of deposit insurance schemes. As will be seen in the next chapter, design features vary according to country-specific peculiarities. With regard to these differences, the various design options have been considered with the trade-offs necessary to strike a proper balance. As noted in the FSF Report, a continuous

\(^{197}\) In Korea, the safety net is coordinated by the Ministry of Finance and the Economy and the Financial Supervisory Committee (FSC).

\(^{198}\) These can be referred to as foundational issues.
evaluation and improvement process can be useful in achieving the balance required.\textsuperscript{199}
CHAPTER 5

COUNTRY EXPERIENCE AND INTERNATIONAL PERSPECTIVE OF DEPOSIT INSURANCE SCHEMES

5.0 Introduction

In the preceding chapter, the basic design and structural issues to be considered by policy makers in the implementation of a deposit insurance scheme were considered. This was done in an attempt to develop a set of sound principles. However, abstract arguments do not achieve much without the context of historical factors; financial, political and legal systems; contracting environments; and regulatory objectives which vary across jurisdictions. These have a significant bearing on the design and implementation of deposit insurance schemes in different jurisdictions. This notwithstanding, the continuous elimination of sectoral and geographic limitations in financial markets has raised certain international dimensions to the introduction of deposit insurance schemes and a consequent need for co-operation or harmonization among national schemes.

This chapter starts with an analysis of the deposit insurance laws and arrangements in two key jurisdictions, the United Kingdom and the United States. The deposit insurance schemes in both countries serve as key models of the pay-box and risk-minimizer deposit insurance systems respectively. The latter part of the chapter considers the cross-border issues and means of achieving efficient and effective coordination among national schemes.
5.1 Country Experience: The UK

5.1.1 An Overview of UK Banking Regulation

The UK financial sector is made up of a wide range of deposit-taking and non-deposit-taking institutions. For the purpose of this thesis, more attention will be focussed on the regulation of deposit-taking financial institutions. Prior to 1979, there was little or no formal regulatory law applying to banking business in the UK. Historically, the supervision of the banking sector was a function of the Bank of England, which was established in 1694 by an Act of Parliament. It is remarkable to note that until 1979, the Bank of England operated its supervisory functions on a largely non-statutory basis. In this regard, it has been observed that:

'Self regulation operated by the Bank of England relied upon personal knowledge of the banks which operated in the UK. Moral persuasion, a form of coercive persuasion, was very much the order of the day. Whenever the bank wished to exercise its considerable authority, in the event of a suspected deviation from acceptable practice, the Governor of the bank would simply send a polite letter to the appropriate institution indicating the way in which the bank expected the institution to conduct its business. When it wished to enforce a policy of general application, it would send out formal letters of request requiring each bank to conform to new practice and new procedures which the bank deemed appropriate.'

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Although such letters had no force of law, the Bank expected its views to be observed in the spirit as well as the letter, and it was often remarked that no banker in his right mind would buck the Bank of England. 4

A number of factors necessitated a change in the supervisory regime that existed at the time as the volume and complexity of banking activities increased significantly. The first UK Banking Act of 1979 was motivated in particular by two factors. First, after the secondary banking crisis of 1973-74, 5 which was characterised by over-lending followed by a fall in property values, it became clear that a large number of banks operated outside the ambit of the Bank of England’s supervisory regime. Second, as a member of the European Economic Community (EEC), legislation was necessary to implement the first EEC Banking Directive of 1977 which was partly aimed at harmonising the authorisation of credit institutions throughout the member states of the EEC. 6

However, the Bank of England did not admit the ineffectiveness of the existing regulatory framework, insisting that the main policy lesson from the period of the secondary crisis was that ‘self-regulation can be put to too great a test if competition from the less-regulated and less-disciplined is too easily permitted.’ 7 The Bank also recognised the dangers that the failure of individual banks posed to the system and noted that it had to mount a rescue operation ‘for the benefit of the depositors of a

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group of institutions which were not fully recognised banks, but whose otherwise inevitable collapse would have threatened the well-being of some recognised banks.8 This led the bank to press for a reform of its regulatory arrangements and the tightening of the legal regime governing use of banking names and descriptions.

The key feature of the 1979 Act was the introduction of new authorisation procedures requiring any company desiring to operate as a deposit-taker in the UK to secure authorisation from the bank unless it was specifically exempted under the Act. A deposit-taking institution was recognised as a bank based on the range of banking services it provided. Such services included sterling or foreign currency current or deposit account facilities; the acceptance of funds in the wholesale money markets; provision of overdraft or loan facilities; and foreign exchange services.9

As a result of the historically informal evolution of banking supervision in the UK, there is still no formal list of permitted or prohibited lists of activities that banks may engage in, as is found in the banking laws of many countries.10 The term ‘bank’ has been interpreted to connote different things at different times and for different purposes.11 Due to historical differences, there is no international uniformity in the definition of ‘banking business’ and most countries tend to define it in a fairly general way or by reference to a list of permissible activities.12 However, for EC member countries, the Credit Institutions Directive can be regarded as a point of reference. Under the directive, a ‘credit institution’ is defined as an undertaking whose business is to receive deposits and other repayable funds from the public and to grant credits

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9 Banking Act 1979, Sch. 2.
for its own accounts. Article 18 of the Directive provides that a credit institution can freely carry out throughout the EC any activity listed in Annex 1 provided it is permitted to carry out the activity in its home member state. The activities enumerated in the annex can serve as a general guide as to what will be classified as constituting ‘banking business’.

Apart from the authorisation requirement of the 1979 Act, banks were also subject to the supervisory procedures adopted by the Bank of England which included the requirement of prudential returns; meetings with management; and the measurement and assessment of capital and liquidity adequacy, and foreign currency exposure. The bank also scrutinised large loan exposures, the operations of banking groups and bank ownership. The bank was also responsible for the administration of the Deposit Protection Scheme.

While the Banking Act of 1979 was motivated by the inadequacies of the Bank in dealing with the secondary banking crisis of the 1970s, the failure of Johnson Matthey Bankers Ltd. (JMB) in 1984 was the catalyst for the promulgation of the Banking Act 1987. JMB went into liquidation mainly because of a high concentration of excessive loans granted to select customers. It was discovered that if JMB had been subject to the strict supervisory regime that applied to deposit-taking institutions, its financial difficulties would have been uncovered earlier. The 1987 Act gave the Bank

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16 JMB was licensed under the 1979 Act as a ‘recognised bank’. The collapse highlighted the problems in making a distinction between recognised banks and licensed deposit-takers.
significant new powers to cover the supervisory lapses that were exposed following the failure of JMB, but the general approach to regulation under the 1979 Banking Act was not altered.

After the failure of JMB, a committee set up by the Chancellor of the Exchequer reviewed the issue of bank supervision. The Committee proposed that the new Banking Act should create a Board of Banking Supervision to assist the Governor of the Bank of England in his supervisory responsibilities. For the purpose of this thesis, it is critical to note that the committee observed that the role and aim of the banking supervisor was 'to ensure that the bank is managed in such a way as not to put at undue risk the interest of depositors, with that institution or more generally.' The Bank of England Act 1998 was also passed into law and it transferred the regulatory powers previously exercised by the Bank of England under the 1987 Act to the Financial Services Authority (FSA).

The closure of the Bank of Credit and Commerce International (BCCI) in 1991 and the problems at Barings in 1995 precipitated further change in the UK approach to banking supervision. There was also a growing trend toward the formation of

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17 *Perr* (1989) (n4).
18 The two-tiered authorisation system was abolished. The Bank’s powers to investigate and to seek information were enhanced substantially, as well as the notification requirements applicable to authorised institutions.
19 The Committee to Consider the System of Banking Supervision. The committee’s recommendations were set out in Cmd. 9550, 1985.
20 The purpose of this was to bring outside expertise to bear on the Bank’s supervisory functions as the Board was to consist of a majority of independent members.
21 This underscores the point that traditionally, depositor protection has been one of the cardinal objectives of UK banking supervision.
23 BCCI was liquidated while Barings was purchased by the Dutch Bank ING. For a description of the BCCI affair, see P Truell and I Gurwin *BCCI* (Bloomsbury, London, 1992). The Barings affair is described in J Gapper and N Denton *All that Glitters* (Hamish Hamilton, London, 1996). See also RJ Herring ‘BCCI & Barings: Bank Resolutions Complicated by Fraud and Global Corporate Structure’ in
financial conglomerates as UK banks strived to have an international presence to compete with their global counterparts.24 Following the election of the Labour Government in 1997, the Chancellor of the Exchequer made an announcement to parliament on 20 May, 1997 that the government intended to reform the UK’s regime for the regulation of financial institutions. The principal feature of this proposal was to create a single, statutory regulator for the full range of financial institutions,25 with ‘clearly defined regulatory objectives and a single set of coherent functions and powers.’26

The Financial Services and Markets Act 2000 (FSMA) came into force on 1 December, 2001.27 The Act confers extensive broad regulatory powers over the whole financial services sector on the Financial Services Authority (FSA). The FSA has been described as ‘the broadest financial regulator in the world, combining prudential, conduct of business and market conduct regulation across the full range of financial services, including banking, securities, investment management and insurance.’28 The FSA has a broad regulatory scope in three respects. First, it is cross-sectoral, as it


25 This entailed the bringing together of nine regulatory bodies: the Securities and Investments Board, the Personal Investment Authority, the Investment Management Regulatory Organisation, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of trade and industries, the Friendly Societies Commission and the Registrar of Friendly Societies.


covers the whole financial sector; second, it regulates both the prudential and conduct of business aspects of regulated businesses and third, it has enormous powers; authorization, rule-making (such as the Handbook), monitoring, investigating, enforcement and the administration of the compensation scheme.29

In performing its quasi-legislative and policy-making functions, the FSA has four statutory regulatory objectives. These are (a) market confidence, (b) public awareness, (c) consumer protection, and (d) the reduction of financial crime.30 The treasury retains regulatory responsibility for the overall regulatory regime and the Bank of England retains responsibility for the stability of the financial sector. The division of responsibilities between the Treasury, the Bank of England and the FSA is contained in a Memorandum of Understanding which sets out their obligation to co-operate closely.31 It is believed that an integrated national financial services regulator in the UK is best suited to achieve the intended regulatory objectives based on four primary considerations:

- Market developments, such as the increase in the number of financial conglomerates and the blurring of the boundaries between financial products, make sector-based regulation increasingly less viable;

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30 S. 2 (2), FSMA 2000. These objectives are defined in s.s 3, 4, 5 & 6 respectively.

• There are economies of scale and scope available to an integrated regulator, and there is value in being able to allocate scarce regulatory resources efficiently and effectively;

• There are benefits in setting a single regulator clear and consistent objectives and responsibilities, and in resolving any regulatory conflicts within a single agency; and

• There are advantages in making a single regulator accountable for its performance against its statutory objectives, for the regulatory regime, for the costs of regulation and for regulatory failure.32

The set-up of the legal provisions that underlie the present regulatory regime can be understood in the form of a hierarchy. At the top of the structure is the FSMA 2000, which provides for the establishment of the FSA, its powers and duties, and other regulatory matters. This is followed by a layer of regulation in the form of statutory instruments;33 and after this comes the provisions that are made by the FSA itself, which are contained in the FSA Handbook.34 The FSMA 2000 also retains the requirement for institutions to be authorized in order to engage in banking in the UK in the sense of ‘deposit taking’. It imposes a general prohibition on anyone carrying on regulated activity in the UK.35 Only ‘authorized persons’, or ‘exempt persons’ may undertake such activity.


33 For example the FSMA 2000 (Regulated Activities) Order 2001 (SI 2001/544).

34 These consists of rules made under the general rule-making power in FSMA 2000, s.138, or under specific rule-making powers; guidance made pursuant to s.157 and ‘evidential provisions’ tending to establish a contravention of, or compliance with another rule made under s.149. See Blair and others (2002) (to) 17.

5.1.2 Deposit Protection in the UK

A deposit guarantee scheme, to compensate depositors in the event that their bank is unable to repay their deposits, has existed in the UK since the establishment of the Deposit Protection Scheme under the Banking Act 1979. There were also similar schemes for investment and insurance. Under the Deposit Guarantee Schemes Directive, EU member states are now required to have deposit guarantee schemes.

As part of its regime of consolidated financial services regulation, the FSMA 2000 provides for the creation of a single Financial Services Compensation Scheme (FSCS) under Part XV of the Act, covering all regulated activities undertaken by authorised persons. Although the scheme operates as one consolidated scheme, there are differences between the different financial sectors covered with regard to the main features of the scheme. The main features of the scheme will now be examined in turn.

I. Organizational Structure

The FSMA 2000 provides for the FSA to establish a body corporate (the scheme manager) to exercise the functions of the deposit protection scheme. The constitution of the scheme manager must provide for a Chairman and a Board.

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36 See Chapter 2 for a discussion of the historical evolution of the UK Deposit Protection Scheme.
37 The Investors Compensation Scheme (ICS) under the Financial Services Act 1986, s. 54 and the Policyholders Protection Scheme under the Policyholders Protection Act 1975.
38 Directive 94/19/EEC. The UK Scheme is substantially designed in compliance with the provisions of the directive.
39 For a review of the relevant provisions on the compensation scheme, see Blair and Walker (2006) (n27), ch.5.
40 The protection of consumers of financial services is one of the statutory objectives that were set for the FSA under the FSMA 2000; an effective compensation arrangement for consumers has a key role to play in achieving this objective. The Act requires the FSA to make rules establishing a scheme for compensating consumers when authorised firms are unable, or likely to be unable to satisfy claims against them. The relevant rules are contained in Block 4 of the Handbook (COMP Module).
41 This is envisaged by FSMA 2000, s. 214 (1) (b). The main focus of this discussion on the FSCS is on the deposit protection sub-scheme although reference will be made to the scheme as a whole where appropriate. See FSCS I Outlook (November 2001).
Although the Chairman and the Board are to be appointed and liable to removal from office by the FSA, the terms of their appointment must be such as to ensure their independence from the FSA and the operation of the compensation scheme. The FSCS is thus independent of the FSA although accountable to it and ultimately to the Treasury. Membership of the main board of the FSCS is confined to ‘public interest representatives’; this is a clear departure from the practice where commercial bankers sat on the old Deposit Protection Board without being required to operate in a public interest capacity.

The FSA and the FSCS have entered into a Memorandum of Understanding (MoU) to provide a framework for the relationship between the FSA and the FSCS. The MoU recognises the operational independence of each body but also acknowledges the importance of close co-operation, assistance and effective interrelationship.

II. Funding

The FSMA 2000 allows the compensation scheme to make provision ‘for the establishment of different funds for meeting different kinds of claim’; and for ‘the imposition of different levies in different cases.’ What the Act envisages is an industry funded scheme where the FSA makes the rules to share the costs of compensation across the industry. It has been argued that this option ‘encourages bankers to keep their institutions sound and lays the cost on those [i.e. the banks] who

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1. FSMA 2000, s. 212 (1). This body is the Financial Services Compensation Scheme Ltd. (FSCS), a company limited by guarantee which was established in March 2000.
2. The scheme manager is required to submit a report on the progress made at least once a year to the FSA, including a statement identifying the value of each of the funds established under the scheme. See FSMA 2000, s. 218; COMP. 2.2.5G.
6. FSMA 2000, s. 214 (1) (b) & (c).
benefit most from the scheme. The provisions in relation to the funding of the FSCS are set out in the FEES Module of the Handbook. The principle is that the firms that are still trading fund the compensation costs for those firms that have failed (ex post funding). The levies that are charged are proportional to the size of the protected deposits held by the firm.

Under a new funding system introduced in April 2008, the FSCS is split into five broad classes for levying purposes: Deposits, General Insurance, Life and Pensions, Investment, and Home Finance. With the exception of the deposits class, each class is further divided into sub-classes. Firms are allocated to these sub-classes based on the activities they are permitted to undertake, and it is possible that a firm could be allocated to one or more sub-classes. The FSCS cost structure also includes ‘management expenses’ and ‘compensation costs’. Management expenses are the costs of establishing, maintaining and operating the FSCS. Compensation costs are the amounts paid to claimants (or for their benefit).

The FSCS operates a funding model with a mixture of advance and retrospective calls possible to provide flexibility. Each firm contributes proportionally to the tariff base applicable to its relevant class or sub-class. A threshold for each sub-class is set by the

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49 See FEES 6.3.5R.
51 FEES 6 ANNEX 3. The rationale for this differentiation is that there are considerable differences between the various sectors in terms of the products involved, the behaviour of consumers, the risks involved, the ability of each sector to fund compensation and in terms of the scope and practice of business. Firms are not expected to meet the cost of claims arising from areas of business in which they do not participate. See FSA ‘Consumer Compensation: A Further Consultation’ (June 1999) FSA Consultation Paper CP24.
53 FEES 6.1.5G
54 Management expenses are further divided into ‘base costs’ and ‘specific costs’.

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FSA, which represents the maximum that the FSCS can levy for compensation in any one year. Under the funding model, compensation costs are initially met by the relevant industry class up to the threshold. Where compensation costs exceed the threshold, there is a possibility of cross subsidy among the classes, so that the FSCS can use money held to the credit of one class to pay compensation costs in respect of another class. All funds received by way of levy or otherwise are to be managed as the FSCS considers appropriate. In doing so the FSCS must act prudently, and is expected to use its resources 'in the most efficient and economic way'.

III. Powers and Mandate

The UK depositor protection scheme has been described as having 'the essentially social purpose of shielding retail customers who may be ill-placed to assess the financial soundness of particular intermediaries. The functions of the FSCS are to assess and pay compensation to claimants in relation to claims made in connection with regulated activities carried on by regulated persons (whether or not with permission) in accordance with the rules. The FSCS is an example of a relatively narrow scheme, responsible mainly for the management of the fund and the payment of compensation. According to the MoU between the FSA and the FSCS, the FSCS has the following responsibilities:

i. The effective operation of the scheme;

55 The FSCS makes calls for funds from institutions for the amount of compensation that analysis has predicted would be payable in the year. See FEES 6.3.1R; 6.3.3G.
56 FEES 6.5.7R; FEES 6 ANNEX 3R.
57 FEES 6.3.15R; FEES 6.3.17R.
58 COMP 2.2.6R.
59 COMP 2.2.6R.
61 FSMA 2000 s.213 (3) (a).
63 These are also outlined in COMP 2.2.
ii. Making and implementing procedures to enable the FSCS to operate its functions;

iii. Making levies for management expenses, compensation costs and establishment costs as are required under the rules to enable it to carry out its role;

iv. Using its resources in an efficient and economic way;

v. Reporting to the FSA on the discharge of its functions; and

vi. Publishing information on its operation.

The general powers of the scheme are set out in Section 214 of FSMA 2000. The compensation scheme may make provisions in regard to the following:

i. the circumstances in which a relevant person may be considered to be unable or likely to be unable to satisfy claims made against him;

ii. setting up different plans for meeting different kinds of claim;

iii. imposition of levies in each case;

iv. limiting the levy payable by a person for a specified period;

v. repayment of the levy whether in full or in part in specified circumstances;

vi. entertainment of claims made only by a specified kind of claimant;

vii. consideration of a claim only if it comes under a specified category;

viii. the procedure to be followed in making a claim;

ix. whether to make interim payments before a claim is finally determined;

x. amount payable on a claim to a specified maximum amount, or a maximum amount calculated in a specified manner; and

xi. where payment is to be made to a specified person other than the claimant.
Section 215 of the Act makes provision for the rights of the compensation scheme in a relevant person’s insolvency. The Act gives the scheme a right to recover money paid as compensation from an authorized person. Where a person other than a Compensation Scheme manager presents a petition under Section 9 of the Insolvency Act 1986 or Article 22 of the 1989 Order concerning a company or partnership that is a relevant person, the Compensation Scheme manager will have the same rights as are conferred on the FSA by Section 362 of the Act. On the capacity to present a winding-up petition against a body that is a relevant person, the Scheme manager has the same rights that are conferred on the FSA by Section 371 and Section 374 with respect to an individual bankruptcy.64

In order to allow the FSCS to perform its functions effectively without any legal hindrance, the FSCS and its staff are entitled to immunity, except where they act in bad faith or where damages may be sought under section 6(1) of the Human Rights Act 1998.65

IV. Coverage

To avoid moral hazard deposit protection schemes should exclude from their coverage the deposits of those who are deemed capable of exerting market discipline and those who bear some responsibility for a bank’s failure. Under the FSCS regime, certain deposits are excluded from coverage. These include: deposits of banks and large companies; overseas financial services institutions; governments and central administrative authorities; directors and managers of banks (and their close relatives); bodies corporate in the same group with a defaulting bank; auditors of the defaulting

64 FSMA 2000 s. 215.
bank; and persons holding five per cent or more of the capital of the defaulting bank. or any body corporate in the same group. In accordance with the EC Directive, deposits of those connected with a criminal conviction for money laundering are also excluded.

The level of compensation payable under the FSCS is dependent on the type of business involved. For the purposes of deposit-taking business, a claim is a ‘protected claim’ if it is a claim for a protected deposit. Further, a deposit is a ‘protected deposit’ only if the deposit was made with an establishment of a UK deposit-taking institution, or a branch of a UK firm which is a credit institution established in another EEA state under an EEA right. Until recently, the maximum level of compensation available to an individual depositor was £31,700. However, following the run on Northern Rock, the compensation limit was raised, initially to £35,000, and currently, depositors have full coverage of £50,000. This limit applies to the aggregate amount of claims in respect of the protected deposits that an eligible claimant has against the relevant person.

V. Compensation

Section 214 (1) (a) of the FSMA 2000 gives the FSCS the power to make provisions as to the circumstances in which a relevant person is to be taken (for the purposes of the scheme) to be unable, or likely to be unable, to satisfy claims made against him.

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66 Comp 4.2.2R.
67 Directive 94/19/EC Art. 2.
68 Comp 5.3.1R
69 One hundred per cent of the first £2000 and ninety per cent of the next £33,000.
70 Comp 10.2.3R.
71 Comp 10.2.2G.
72 A relevant person is a participating firm or an appointed representative of a participating firm. Comp 6.2.2G.
The FSCS may make a claim to an eligible claimant if it is satisfied that the claim is in respect of a protected claim against a relevant person who is in default.\(^\text{73}\)

A relevant person is in default if in the opinion of the FSCS or FSA, it is unable or likely to be unable to satisfy protected claims against it.\(^\text{74}\) The FSCS may determine a relevant person to be in default if it is satisfied that a protected claim exists and that the relevant person is the subject of one or more of the following proceedings:

1) The passing of a resolution for a creditors’ voluntary winding up;

2) A determination by the relevant person’s home state regulator that the relevant person is unlikely to be able to meet claims against it;

3) The appointment of a liquidator or administrator, or provisional liquidator or interim manager;

4) The making of an order by a court of competent jurisdiction for the winding up of a company, the dissolution of a partnership, the administration of a company or partnership or the bankruptcy of an individual;

5) The approval of a company voluntary arrangement, a partnership voluntary arrangement or an individual voluntary arrangement.\(^\text{75}\)

From the date the compensation scheme has been triggered by any of these events, the FSCS must be in a position to pay compensation within three months.\(^\text{76}\) This is in

\(^{73}\) Comp. 3.2.1R; Comp. 3.2.2R also makes provision for payment to a person who makes a claim on behalf of another person. Examples of such circumstances include personal representatives claiming on behalf of the deceased; trustees claiming on behalf of beneficiaries; or a donee of an enduring power of attorney making a claim on behalf of the donor of the power. See Comp 3.2.3G. Compensation is payable only to the claimant or as directed by the claimant. Comp 11 however sets out circumstances under which compensation may be payable to persons other than the claimant.

\(^{74}\) Comp. 6.3.2R.

\(^{75}\) Comp 6.3.3R.

\(^{76}\) Comp 9.2.1R; the FSA may grant the FSCS an extension but payment must be made within six months of that time. Comp 9.2.2R sets out the conditions under which the FSCS may postpone compensation.
adherence to the Deposit Guarantees Scheme Directive requirement that compensation should be paid within three months of the non-availability of deposits.\textsuperscript{77}

\section*{5.1.3 Deposit Protection in the UK: An Assessment}

An assessment of the UK deposit protection scheme done on the basis of the number of bank insolvencies that have occurred since its inception would present a high success rate, since relatively few deposit-taking institutions have failed. The only systemic crisis experienced in the UK since the introduction of deposit protection was minor,\textsuperscript{78} and was one about which deposit protection could do little.\textsuperscript{79} However, the recent Northern Rock crisis has highlighted certain deficiencies, not only in the deposit protection scheme, but in the overall regulatory system.

\subsection*{5.1.3.1 The Northern Rock Debacle}

Northern Rock presented a classic case of a bank run. The bank, which was the UK’s fifth largest mortgage lender, was bailed out by the Bank of England with an emergency loan facility following problems in the credit markets originating from the U.S sub-prime mortgage financial crisis.\textsuperscript{80} This triggered anxiety and loss of confidence by savers and shareholders leading to scenes of thousands of savers

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\textsuperscript{77} Art.10 of the Directive. It is also compliant with IMF recommendation of 30 days. See Garcia (1999) (n 44). This is also a marked departure from the requirement under s.58 of the Banking Act 1987 where the Deposit Protection Board was required to ‘be in a position’ to make payments within 3 months. See D Turing ‘Deposit Protection’ in F Oditah (ed) Insolvency of Banks: Managing the Risks (Sweet & Maxwell, London, 1996).

\textsuperscript{78} After the collapse of BCCI there was a mass movement of deposits from smaller banks to banks that were perceived to be bigger and safer (flight to quality).


queuing up to withdraw their funds and close accounts at the bank’s branches. Despite
assurances from the Government and the Bank of England, the savers were not
assuaged and a sum exceeding £2 billion was withdrawn within days, with the bank’s
share value also falling sharply. Fears of a contagion also led to a fall in share prices
of other UK banks.81

The run on Northern Rock has raised questions as to the nature and adequacy of the
regulatory tools available to the authorities to resolve such problems. In particular, the
ability of the FSCS to sustain consumer confidence in the financial system must be
considered. The FSA has admitted that there were key failings in the supervision of
Northern Rock.82 In January 2008, HM Treasury, the Bank of England, and the FSA
(the authorities) published a consultation paper containing proposals for strengthening
the framework for financial stability and depositor protection.83 In July 2008, a further
consultation paper was published by the authorities, which contained additional
details of the proposals for reform.84

Following the consultation process, the government intends to enact new legislation
to address five key objectives, which are: strengthening the financial system; reducing
the likelihood of banks failing; reducing the impact of failing banks; effective
compensation arrangements; and strengthening the Bank of England and improving

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81 Alliance & Leicester shares lost nearly one-third of their value while shares in Bradford & Bingley
dropped by more than 15%. See The Independent, ‘Alliance & Leicester Shares Take a Beating’ Tuesday,
18 September 2007. Available at [http://www.independent.co.uk/news/business/news/alliance-
Consultation’ Cm 7436, 2008, Available at
coordination between authorities. The five objectives are geared towards reforming the pre-crisis and post-crisis aspects of UK banking supervision. While the main focus of this thesis is deposit protection, which falls under the post-crisis category of regulatory intervention, there is a strong link between pre-crisis and post-crisis regulatory mechanisms. A strong pre-crisis regulatory regime will, most importantly, reduce costs that would accrue to the compensation scheme in the aftermath of a crisis.

It is pertinent to note that the immediate cause of the crisis in Northern Rock was the refusal of other banks to lend to it. Northern Rock’s business model, which relied heavily on wholesale funding, was dependent on an uninterrupted flow of funds through the inter-bank and wholesale markets. This meant that the bank became vulnerable as soon as liquidity dried up in the banking sector. However, a better structured pre-crisis regulatory regime could have prevented the escalation of the problem.

The UK regulatory regime has been described as being ‘worryingly flat-footed in a crisis’ as the crisis has underscored the need for a wider range of regulatory options in dealing with bank failures. The main limitation of the UK regulatory regime in the management of a potential crisis is the absence of a statutory prompt corrective action (PCA) mechanism and the potential for regulatory forbearance. The consensus of

87 Hall (2002) (n45). For an analysis of supervisory forbearance and PCA, see K Narayana and I Shim, ‘Forbearance and Prompt Corrective Action’ (2007) 39 Journal of Money, Credit and Banking 5, 1107. PCA mechanisms are generally absent in most EU supervisory regimes. See MJ Nieto and LD Wall
opinion among critics of the regulatory reaction to the Northern Rock crisis is that the regulators should have acted promptly to avert the crisis escalating. It has been observed that ‘comparisons between the US and the UK have been made, to the detriment of the UK, following the speedy rescue package the Federal Reserve Bank of New York arranged for Bear Stearns in March 2008, which contrasts with the lengthy, slow and rather inefficient resolution procedure for Northern Rock.’

Regulatory authorities faced with financially troubled institutions must decide to either resolve the institution or delay action for a period of time in the hope that the institution’s position will improve. In most cases, a decision is delayed until it is too late, resulting in significantly higher resolution costs which fall on the taxpayer. In the case of Northern Rock, it appears that no member of the tripartite regulatory structure would have been willing to close the institution either before it obtained the LoLR facility or after billions of taxpayers’ money had been expended on rescuing the institution. The desire to maintain the reputation of a capable monitor and the fear of lawsuits from the bank’s shareholders would have prevented any regulator from making this decision. A solution to the problem of regulatory forbearance is the introduction of a statutory PCA mechanism into the regulatory regime. PCA would create specific statutory trigger-points to serve as the basis for regulatory intervention.

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88 Preconditions for a Successful Implementation of Supervisors’ Prompt Corrective Action: Is There a Case for A Banking Standard in the EU? (2006) 7 Journal of Banking Regulation (March/April), 191. The European Shadow Financial Regulatory Committee (ESFRC) also recommends the introduction of ‘pre specified trigger capital ratios’ which should initiate a progressive series of restrictions on a failing bank’s activities. See ESFRC ‘Dealing with Problem Banks in Europe’ Statement No.1, 22 June 1998; the ESFRC also argues that implementation of PCA in each individual member state would contribute to host country supervisors’ trust in home country supervisors. See ESFRC ‘Reforming Banking Supervision in Europe,’ Statement No.23, 21 November 2005.
The existence of a statutory basis for early regulatory intervention would enable the regulatory authorities to detect bank problems and take appropriate corrective action without the fear of litigation.

While the introduction of PCA based on solvency ratios in the United States has generally been considered successful, it has been suggested that any introduction of PCA in the UK should go one stage further by incorporating both solvency and liquidity ratios in the various threshold categories. This would enable the primary causes of bank failure to be covered by the regulatory regime. While this would not prevent banks from encountering problems, it would enable the regulators to detect bank problems earlier, thus affording them time to act efficiently. PCA mechanisms have been described as ‘speed bumps to slow a bank’s deterioration and to force regulators to become more involved with troubled banks well before insolvency, so that they may be ready to close them legally when the minimum capital ratio is breached and not be caught by surprise and delayed.’

Though the introduction of PCA mechanisms would ensure that the likelihood of bailing out banks with severe liquidity or solvency problems is greatly reduced, it is important to emphasize that the introduction of PCA would necessitate several changes in the overall legal and regulatory framework. The regulatory authorities must possess the appropriate regulatory tools to act once a PCA trip wire has been

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breached. A number of factors must also be considered when defining the ratios that would trigger mandatory supervisory action. These issues are beyond the scope of this thesis, however, it is important to state that the introduction of a PCA mechanism would significantly increase the information requirements of the supervisory authorities and also increase the need for effective co-ordination between the various authorities. Particularly the roles of each member of the tripartite regulatory structure in a crisis should be clearly defined. The successful implementation of PCA would also depend on the political will to close insolvent banks as soon as the legal conditions are triggered.

5.1.3.2. Reform of UK Deposit Protection

The main legislative changes that have been proposed following the Northern Rock crisis include the introduction of a Special Resolution Regime (SRR), the granting of additional powers to the FSA and Bank of England for heightened supervision and financial stability respectively, and the introduction of a more efficient compensation scheme. Much of the emphasis here would be on the reform of the deposit protection arrangements.

As observed earlier, deposit protection in the UK was conceived primarily as a means of achieving the ‘consumer protection’ objective of the FSMA 2000. In addition to

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95 The FSA consultation paper has highlighted the need for new rules to require banks to provide more information to the FSA to prove that they are meeting threshold conditions. See Cm7308 (2008) (n83), ch.3.
96 See Cm7308 (2008) (n83); Cm7436 (2008) (n84).
this, the scheme also assists in achieving the ‘market confidence’ objective of the Act. Previously, debate on reforming the compensation scheme has centred on the adequacy or otherwise of the cover provided under the scheme. However, following the Northern Rock crisis, the extent to which the scheme contributes to market confidence has also come under consideration.

One of the prime concerns of policy makers in the design and implementation of deposit protection schemes is to provide sufficient cover for depositors while at the same time limiting the propensity for moral hazard. One of the ways in which moral hazard can be checked is through the introduction of co-insurance.98 Before the advent of the FSMA, the deposit protection scheme in the UK included an element of co-insurance. Initially protection was limited to seventy five per cent of the first £10,000 of protected deposits. Following the implementation of the Directive, this was raised to ninety per cent of the first £20,000 with no protection thereafter.99 All depositors were thus subject to co-insurance at a very low level, a position which elicited a lot of criticism.100 Under the current regime, co-insurance was removed in part, with one hundred per cent coverage for the first £2,000 and ninety per cent for the next £33,000. From the point of view of protecting the consumer, this limit was still described as being too low, as the poorest and least sophisticated bank depositors should not be expected to provide a degree of co-insurance for small deposits.101 Following the run on Northern Rock, the element of co-insurance has now been

97 For a detailed discussion of the reform proposals, see Lastre (2008) (n88).
98 See chapter 3 for an analysis of the effectiveness and desirability of co-insurance as a means of countering moral hazard.
99 See SI 1995/1442.
removed from the UK scheme and depositors are now fully covered up to a maximum of £50,000.

With the removal of the co-insurance element, the debate over its inclusion may have been laid to rest; however, due to consumer protection and moral hazard considerations, it remains debatable whether or not the current limit is sufficient and if it should be raised. The UK deposit protection scheme was hitherto less generous than arrangements in other countries. The justification for this was that higher cover would adversely affect market discipline incentives for depositors and bank managers. While market discipline remains an important element in banking stability, it is important that the level of deposit insurance cover is adequate enough to create and maintain the required level of confidence, which is also central to banking stability.

Deciding the appropriate and adequate level of compensation is a difficult process. While it can be argued that the current limit of £50,000 is adequate to protect the unsophisticated depositor, the same can be said of the previous limit of £35,000. It remains to be seen whether a suggested increase to £100,000 would have a significant effect in distorting market incentives. Even then, the need not to distort incentives must be balanced against the importance of maintaining a sufficient degree of confidence in the system. The consultation paper lists factors that should be

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102 Cm 7308 (2008) (n83) Chart 5.1.
103 See P Jackson ‘Deposit Protection and Bank Failures in the United Kingdom’ (1996) Bank of
considered in setting the compensation limits, which include the appropriate level of consumer protection, and simplicity and consumer understanding. 104

The majority of retail deposit accounts in UK banks hold less than £35,000 and it has been shown that increasing the limit would not have a significant impact on the number of depositors covered. 105 However, the Government’s response to the run on Northern Rock and subsequent bank failures by guaranteeing all bank deposits is an indication that the present coverage level is not sufficient to maintain consumer confidence in a crisis. The guarantee, which was necessitated by the need to prevent a full-scale financial crisis, created an implicit guarantee of deposits in all other banks which in itself creates distorted incentives for moral hazard.

With the removal of coinsurance, there is currently no other mechanism, apart from compensation limits, to counteract moral hazard in the UK Compensation Scheme. Coinsurance is founded on the principle that the person who pays the coinsurance is responsible for creating the risk. It is worthy of note that while coinsurance was introduced to make depositors exert market discipline, 106 risk-related assessments (primarily targeted at the behaviour of regulated firms) are absent. This appears to be based on the rationale that consumers of financial services, and not regulated firms, should bear the costs of counteracting moral hazard. While there is no evidence to suggest that coinsurance is inimical to banking system stability, there is evidence that risk-based premiums work better in mitigating moral hazard and risk-taking by banks. 107

104 Cm 7308 (2008) (n83), 70.
105 Ibid, 68.
106 Coinsurance was removed only because recent events have shown that it creates an incentive for depositors to run on their banks. See Cm 7308 (2008) (n83), 68.
A major limitation to the UK compensation scheme is public awareness. Public consciousness of the existence of the scheme and its features seems to be very low, and consumers who are unaware of the existence of the scheme might assume that there is no protection. This also raises concern on the possibility of systemic risk. Even if the compensation limit is raised, depositors who are ignorant of the protection that is available are still likely to run on their banks. The long queues that were witnessed during the Northern Rock crisis can partly be attributed to the ignorance of the depositors of the existence of a compensation scheme.

In order to avoid banking runs, insured depositors also need to be assured of immediate access to their funds. The consultation paper notes that it may take several months for depositors’ funds to be reimbursed in a complex failure involving a high volume of claims. This fact partly contributed to the run on Northern Rock. Thus, it has been proposed that the FSCS should aim to make compensation payments within one week of a bank closing. This target might however be impracticable unless certain other aspects of the Scheme are considered, particularly the need to revise the mode of funding the scheme.

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108 A recent survey by the FSCS showed that less than a quarter of researchers were correctly told the name of the compensation scheme when they asked about compensation arrangements if a firm is unable to meet claims made against it. 41% of researchers were either told that there was no protection at all, or were not provided with any information about the protection available. See FSCS Outlook, Issue 4 (August 2003). Note also that there are restrictions on the use in advertising of information on the FSCS.  
109 One of the statutory objectives of the FSA is to promote public awareness and understanding of the financial system. Under COMP. 2.2.3R, the FSCS is mandated to publish information for claimants and potential claimants on the operation of the compensation scheme. The means by which effective public awareness can be achieved are discussed in Chapter 4.  
110 Hamalainen Memo (n90).  
111 Cm 7508 (2008) (n83), 71.
The FSCS funding method has been described as being reactive rather than proactive.\(^{112}\) The fact that the FSCS adopts a mainly ex post funding model, where banks have to be levied to meet compensation payments after a failure that has not been forecast, means that without government support, it would be difficult to raise the funds for a deposit pay-out within a week, especially where there has been a failure of a large bank.\(^{113}\) The adoption of a risk-based deposit insurance system is also not compatible with an ex post funding model. The purpose of risk-based assessments is to ensure that risky banks pay for the cost of insurance, this would be defeated if assessments are made only after banks become insolvent.

As noted earlier, in comparison with other parts of the world, bank failures are relatively rare occurrences in the UK.\(^{114}\) The run on Northern Rock did not lead to the collapse of the bank, thus the Compensation Scheme was not actively involved in managing the crisis. This notwithstanding, the run could have been prevented if a Compensation Scheme had been in place that gave depositors the awareness that their funds were substantially covered and also the confidence that the funds would be made promptly available in the event of their bank experiencing difficulties.

The reform of the UK Scheme should be guided by the need to tailor the scheme to suit its statutory objectives. Recent events have shown that the scheme, as currently structured, is neither appropriately designed nor appropriately publicized to meet

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\(^{112}\) Hamalainen Memo (n90).

\(^{113}\) Only £4.4 m left to protect UK’s bank deposits’ The Independent 25 September 2007. Available at http://www.independent.co.uk/news/business/news/only-pound44m-left-to-protect-uks-bank-deposits-403350.html, accessed 17 December 2007. The House of Commons Select Committee on Treasury also notes in its report that an examination of FSCS funding indicates that ‘it would not be able to cope with the failure of a medium-sized, let alone a major financial institution.’ Proposals for pre-funding and FSCS access to public sector funding are contained in Cm7308 (2008) (n83), ch.5.

\(^{114}\) Compensation payouts from the UK Scheme have been small in comparison with other countries that operate deposit protection schemes. While this reflects the less generous nature of the Scheme, it is mainly due to the relatively small number and size of banks that have failed. See Jackson (1996) (n92).
these objectives (particularly market confidence and consumer protection). Most importantly, a Compensation Scheme that engenders confidence would also reduce the incentive for runs, thus creating more time for regulators to react appropriately and avoid taking panicky decisions aimed only at placating running depositors.

There are various options open to supervisory authorities in resolving a failed bank, and these were considered in the previous chapter. These options include deposit payoff, open bank financial assistance and the use of bridge banks. These options should be available to the appropriate regulatory authority, to be applied in individual cases guided, among other things, by the need to minimize losses and disruptions to the banking system.

The intended reform includes proposals for the introduction of an SRR.\textsuperscript{115} This is a welcome development given that it has been posited in this thesis that the special nature of banks justifies the adoption of a bank specific insolvency regime. However, it has been argued elsewhere that the existing regulatory tools open to the UK authorities in dealing with bank failure have not been fully utilized. Particularly, that it would have been worth retaining the administrative order procedure in the Insolvency Act 1986, more so as this procedure has been used with a relative degree of success in the past, an example being the administration of Barings Bank in 1995.\textsuperscript{116}

\textsuperscript{115} Cu7308 (2008) (n83), ch 4.

\textsuperscript{116} A Campbell and others (2008), 'Response to Financial Stability and Depositor Protection: Strengthening the Framework' Available at \url{http://www.hm-treasury.gov.uk/media/F/1/Andrew_Campbell.pdf}, accessed 15 June 2008. the British Bankers' Association also argue that sufficient weight has not been placed on improving the FSA's execution of its existing regulatory powers and that emphasis should be placed on effective utilization of the tools in the hands of the regulatory authorities. See BBA 'Financial Stability and Depositor Protection: Strengthening the Framework – BBA Response to the Tripartite Consultation Document' (2008) Available at \url{http://www.bba.org.uk/content/1/4/6/01/34/56/Financial_Stability_Submission.pdf}, accessed 15 June 2008.
The foregoing reservation notwithstanding, it is apparent that the UK authorities will go ahead with the introduction of a Special Resolution Regime. Under the proposals,\textsuperscript{117} the SRR will provide the authorities with a wider range of tools to deal with banks in difficulty. The SRR consists mainly of the 3 stabilization options, the bank insolvency procedure and the bank administration procedure. The stabilization options involve the use of bridge banks, private sector purchasers and temporary public ownership.\textsuperscript{118}

Under the proposals, the FSA, as regulator, will be responsible for determining whether a bank has breached the regulatory threshold conditions that would trigger the SRR. The Bank of England will be responsible for the implementation of the SRR, including taking the decision on which of the SRR tools to use. The Treasury will generally be responsible for decisions involving the use of public funds. The objectives of the SRR include the protection and enhancement of the stability of the financial system, protection and enhancement of public confidence and depositor protection.\textsuperscript{119}

Under the proposed Bank Insolvency Procedure, where threshold conditions have been breached, the Authorities can make an application to the Court for a bank insolvency order appointing a person to act as bank liquidator. The first responsibility of the bank liquidator is to arrange for all of the bank’s eligible claimants to receive compensation from the FSCS or have their accounts transferred, after which the bank is wound up.

\textsuperscript{117} See Cm 7446 (2008) (n84), para 4.18.
\textsuperscript{118} See http://www.publications.parliament.uk/pa/cm200708/cm bills/-/147/08147.1-5.html
The FSCS will be given an enhanced role in relation to depositors protected under the compensation scheme. In the context of the Bank Insolvency Procedure, the FSCS would be entitled to participate in proceedings for or in respect of a Bank Insolvency Order. The FSCS would nominate a member of a Bank Liquidation Committee, which will have the responsibility for overseeing the work of a bank liquidator appointed pursuant to a bank insolvency order. The liquidator would work with the FSCS to ensure rapid payout of depositors under the scheme and provide relevant support and information to the FSCS. The FSCS can also be called to contribute to costs arising out of the use of any of the resolution tools.

The main advantage of introducing a special regime is that there would be a clear and consistent policy and mechanism for resolving troubled banks. This would further promote confidence in the banking system by removing uncertainty as to how creditors will be treated in the event of insolvency. Uncertainty increases the probability of bank runs, by creating incentives for early withdrawal of funds while the bank’s assets still have sufficient value. In such a situation the initial runners enjoy the benefit of receiving full payment, while those unable or unwilling to run receive less.\textsuperscript{120} The need for a clear and consistent policy should however be balanced against the need to avoid a rigid and overly prescriptive regime. As such a reasonable degree of regulatory judgement should be retained for flexibility.\textsuperscript{121}

It is important to note that despite the enhanced role which the FSCS has been given under the SRR, the Scheme still remains primarily a pay-box scheme, with its responsibilities confined to effective depositor payout following a bank failure. In

\textsuperscript{120}Kaufman (2007) (n93), 201.
contrast to the extensive powers to be granted to the Tripartite Authorities, the proposals do not give the FSCS any definite powers in relation to the activation and implementation of the SRR. It is suggested that the Compensation Scheme should be given a wider role to play during bank insolvencies. This becomes imperative given that when the SRR is triggered, the FSCS would invariably incur costs. Issues of fairness and the need to minimize costs dictate that the FSCS should be given wider risk-minimizing powers. The House of Commons Treasury Committee published a report in January 2008, in which it recommended the creation of a single authority, similar to the US FDIC, with the power to resolve failing banks and the responsibility to administer the deposit insurance scheme.\textsuperscript{122}

Despite the proposed introduction of the SRR, the scope for harmful regulatory forbearance still remains. The proposed SRR still remains a discretionary power of the tripartite authorities. It is recommended that the adoption of a US-style PCA mechanism would be more appropriate. This would grant extensive risk-minimizing powers to the deposit insurer, with pre-specified mandatory regulatory action where corresponding pre-specified tripwires are breached.\textsuperscript{123}

5.2 Country Experience: The United States

5.2.1 An Overview of U.S. Banking Regulation

In comparison with other countries, banking regulation and supervision in the US is highly fragmented. The panoply of laws, regulatory agencies and financial institutions

\textsuperscript{121} Select Committee 5\textsuperscript{th} Report (2007/8) (n86), para.190.
\textsuperscript{122} Ibid.
\textsuperscript{123} See Table 5.1.
has been described as ‘quirky’ with ‘many oddities explainable only on historical grounds’.\textsuperscript{124} The history of banking in the United States is punctuated with accounts of financial crises and wide-spread banking failures.\textsuperscript{125} A unique feature of the American regime is the dual banking system under which banks may be chartered and regulated by either the Federal or a State Government.\textsuperscript{126} This can be attributed to the federalist nature of the American political system and the unwillingness to concentrate too much power in the central government.\textsuperscript{127} The Federal Reserve System, which performs both monetary and regulatory functions, was also created by the Federal Reserve Act of 1913, which created the twelve regional Federal Reserve banks which are supervised by the Federal Reserve Board.\textsuperscript{128}

Perhaps the most important historical factor that has shaped the form of banking regulation in the United States was the great depression of the 1930s. There was a significant decline of confidence in banks which resulted in a total collapse of the banking system in 1933. The number of banks in the United States fell by half during this period.\textsuperscript{129} This led regulators and legislators to conclude that the existing regulatory framework was insufficient to deal with the troubles that occurred at the time, particularly the loss of public confidence. Radical changes were introduced in

\begin{footnotesize}
\begin{enumerate}
\item JR Macey and others Banking Law and Regulation (3rd ed.) (Aspen Law & Business, New York 2001) 2. The chronology of the U.S. bank regulatory system and is complicated and an entire field of study on its own, which does not fall within the scope of this research. For a full historical review see K Spong (2000), Bank Regulation: Its Purposes, Implementation and Effects (5th edn, Federal Reserve Bank of Kansas City, Kansas City, 2000) ch2.
\end{enumerate}
\end{footnotesize}
the Banking Acts of 1933 and 1935. Although the Acts introduced many changes, the most significant of these was the creation of the Federal Deposit Insurance Corporation (FDIC).

There are four main categories of financial depository institutions in the United States: commercial banks; savings and loans associations; savings banks and credit unions. The major regulatory agencies that have control over depository institutions are the Office of the Comptroller of the Currency (O.C.C)\textsuperscript{130} for national banks; the Board of Governors of the Federal Reserve System for state member banks\textsuperscript{131} and bank holding companies; the Federal Deposit Insurance Corporation (FDIC) for state non member banks; the Office of Thrift Supervision\textsuperscript{132} for savings associations; and the National Credit Union Administration Board\textsuperscript{133} for credit unions. The antitrust division of the Department of Justice is also responsible for the review of bank merger applications under the federal antitrust laws, and the prosecution of criminal violations of federal law by bank officials. These agencies carry out bank safety and soundness examinations, compliance, data processing, and other numerous supervisory functions.

5.2.2 The Federal Deposit Insurance Corporation

Federal deposit insurance was introduced by the Banking Act of 1933 with the establishment of the FDIC to help restore public confidence in the banking system through the provision of insurance coverage for bank deposits and the promotion of

\textsuperscript{130} The OCC was established by the National Bank Act of 1863 as an autonomous bureau of the Treasury Department. The OCC supervises the operation of national banks and is responsible for the establishment and chartering of such institutions. See 12 CFR § 4.2; 12 USC § 27.
\textsuperscript{131} 12 USC § 248; Member banks are those which own stock in their local Federal Reserve Bank.
\textsuperscript{132} Established by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 as an autonomous unit of the Treasury Department.
\textsuperscript{133} 12 USC §1754, 1756, 1771.
safe and sound banking practices. By providing deposit insurance, the FDIC serves as a stabilizing influence in the economy by fostering public confidence through its role in protecting funds in deposit accounts. National banks and state banks that are members of the Federal Reserve System must be insured by the FDIC, while other institutions may apply for FDIC coverage. The main features of the deposit insurance scheme will now be considered in turn.

I. Organizational Structure

The FDIC is organized as an independent agency of government, which is administered by a five-man Board of Directors. The Board members are appointed by the President, with the advice and consent of the Senate, and with no more than three members being from the same political party. One member must be the Comptroller of the Currency and one member must be the Director of the Office of Thrift Supervision. The members of the Board are barred from holding any office, position, employment or interest in insured depository institutions. The Board is required to carry out the affairs of the FDIC fairly and without discrimination.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) made changes to the structure of the FDIC. It placed the responsibility for administering insurance for thrift institutions on the FDIC. The FDIC administered two insurance funds: the Bank Insurance Fund (BIF) and the Savings Association

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135 Although established as an independent agency, the requirement the requirement of OCC and OTS representation on the FDIC Board is capable of undermining the independence of the corporation as the Treasury can influence the direction of Board resolutions. See WM Isaac ‘A Look at Deposit Insurance Funds: Financial Reform’s Unfinished Agenda’ (2000) The Region, Special Issue, Federal Reserve Bank of Minneapolis.
136 12 USC § 1812; § 1819.
137 The Act was passed following the crisis in the Federal Savings and Loan Insurance Corporation (FSLIC). All assets and liabilities of the FSLIC were transferred to the FSLIC Resolution Fund, which is managed by the FDIC. See 12 USC § 1821a. For analysis of the FIRREA reforms, see JR Barth and
Insurance Fund (SAIF). These funds were not to be commingled and were to be used solely for their respective insurance purposes. Following the promulgation of the Federal Deposit Insurance Reform Act of 2005 (FDIRA), with effect from March 2006, the BIF and the SAIF have been merged into a new fund known as the Deposit Insurance Fund (DIF), with all assets and liabilities of the BIF and the SAIF transferred to the new DIF.

The Corporation is required to submit an annual report of its operations, activities, budget, receipts and expenditures to Congress. The report is expected to include inter alia: the current financial condition of the Deposit Insurance Fund; the purpose, effect and estimated cost of each resolution action taken for an insured depository institution; and the exposure of the insurance fund to changes in economic factors likely to affect the condition of the fund. The Corporation is also required to submit financial and operational reports to the Treasury on a quarterly basis.

II. Funding

Initially, the FDIC obtained capital of $150 million from the U.S. Treasury and $139 million from the Federal Reserve. The FDIC’s insurance fund is maintained by assessments on insured banks and savings associations; earnings on investments in U.S. Treasury securities; and a line of credit of $30 billion from the U.S. Treasury.

The amount each insured institution is required to pay is based on statutory factors such as the balance of insured deposits and the degree of risk the institution poses to others. “The Need to Reform the Federal Deposit Insurance System” (1991) 9 Contemporary Policy Issues 1, 24.

138 12 USC § 1821 (a)(4), (5) & (6).
139 L 109-171, enacted February 8, 2006.
140 Ibid § 2102.
141 12 USC § 1827.
142 These funds were repaid in full by 1948 from the FDIC’s accumulated revenues. See WH Schlichting and others Banking Law (Vol. 2, Matthew Bender, New York, 1982 updated 2004).
the insurance fund. The method of calculating assessments is known as the ‘Risk-based assessment system’, which was introduced by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).\textsuperscript{144}

Under the rule adopted by the FDIC Board in November 2006,\textsuperscript{145} insured institutions will be placed in different assessment risk classifications based on two criteria: capital level (capital group assignment) and supervisory ratings (supervisory group assignment). Institutions are classified into three capital group descriptions: well capitalized, adequately capitalized and undercapitalized. Supervisory group assignments are classified into three subgroups: Subgroup A, which consists of financially sound institutions with little or no weaknesses; Subgroup B, which consists of institutions that reflect weaknesses which if not corrected, could result in significant deterioration of the institution and increased risk of loss to the DIF; and Subgroup C, which is made up of institutions that pose a substantial probability of loss to the DIF unless corrective action is taken. The subgroup evaluations are based on the institutions’ composite CAMELS rating.\textsuperscript{146}

\section*{III. Mandate and Powers}

The mandate of the FDIC is to preserve and promote public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions. The FDIC can be classified as a ‘risk-minimizer’ deposit insurer with a broad mandate and extensive powers. To achieve its mandate, the FDIC has been given both insurance and

\textsuperscript{144}12 USC 1824.
\textsuperscript{146}12 CFR Part 327; under the FDICIA, the FDIC Board of Directors was required to review premium rates semi-annually. This requirement has been removed by the Federal Deposit Insurance Reform Act of 2007.
regulatory functions. The FDICIA confers extensive powers on the FDIC. The
Corporation has the authority to examine FDIC-insured state chartered banks that are
not members of the Federal Reserve System. Further, it can conduct a special
examination of any other insured depository institution whenever the Board of
Directors determines that a special examination of such insured depository institution
is necessary to determine its condition for insurance purposes.

The FDIC also has the power to terminate the insurance of an insured depository
institution that is involved in unsafe and unsound banking practices. Other powers
of the FDIC include:

- Power to approve conversions, mergers, consolidations, or assumptions of
deposit liability transactions involving insured depository institutions;
- Power to act as receiver for all insured depository institutions placed in
receivership;
- Power to protect depositors by making loans to, or purchasing assets from and
assuming liabilities of insured depository institutions, and to facilitate mergers
or consolidations in order to reduce risks or avert threatened loss to the
FDIC;

CAMELS is an acronym for component ratings assigned in a bank examination: Capital adequacy,
Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The ratings are on a
scale of 1-5, with 1 being the highest rating and 5 being the lowest.
• Power to prohibit payment of interest on demand deposits;\footnote{154} 
• Power to review proposals to reduce or retire capital of insured banks;\footnote{155} and 
• Power to organize a new bank to assume the insured deposits and temporarily perform the functions of a closed insured bank, or to form a bridge bank.\footnote{156}

IV. Coverage

Each depositor in an insured depository institution is protected based on the aggregate of all deposits in that institution held by the depositor in the same right and capacity. for the benefit of the depositor, either in the name of the depositor or the name of any other person, other than any amount in a trust fund.\footnote{157} In 1934, deposit insurance coverage was pegged at $2,500 but this amount was increased over time.\footnote{158} Under the FDICIA, the maximum coverage limit is set at $100,000.\footnote{159} The Federal Deposit Insurance Reform Act requires the FDIC to consider, at five-year intervals, whether to raise this cap to account for inflation and the Act also raised the coverage limit for many retirement accounts to $250,000 per depositor per institution. Following the recent financial crisis, the US Congress has approved a temporary increase in deposit insurance coverage limit to $250,000.

Deposits held in separate branches of an insured bank are not separately covered but those held in one insured bank are covered separately from deposits in another bank. It is possible to have deposits of more than $250,000 at one institution and still be

\footnotesize{\footnote{154} 12 USC §1828(g). \footnote{155} 12 USC §1828(i). \footnote{156} 12 USC §1821(m),(n). \footnote{157} The FDIC's regulations relating to insurance coverage are contained in 12 CFR part 330. \footnote{158} The limit was raised to $5,000 in 1934, to $10,000 in 1950, to $15,000 in 1966, to $20,000 in 1969, to $40,000 in 1974, and to $100,000 in 1980. \footnote{159} 12 USC §1821(a)(1)(b). Under the FDIRA of 2005, the deposit coverage for retirement accounts has been raised to $250,000. For an overview of the changes introduced by the FDIRA, see J. Douglas and others, 'Deposit Insurance Reform Enacted' (2006) 123 Journal of Banking Law 5 (May), 447.}
fully insured if the deposits are kept in different categories of legal ownership. Where there has been a merger of insured banks, the separate insurance of assumed deposits continues for six months after the deposit assumption, or in the case of a time deposit, until the earliest maturity date after the six-month period.

FDIC insurance does not cover money invested in stock, bonds, mutual funds, life insurance policies, annuities or municipal securities even where these investments have been bought from an insured bank. However, the FDIC insures accounts held by government depositors.

Insurance for deposits denominated in foreign currency is determined and paid based on the equivalent value of the amount in U.S Dollars as of the close of business on the date of the insured institution’s default.

V. Payment of Insured Deposits

Prior to the introduction of federal deposit insurance, depositors would recover a certain percentage of their money from a failed bank’s receivership. Depositors were unable to receive their funds for several years because disbursements were made only after the failed bank’s assets had been liquidated; in the absence of a depositor preference rule, depositors and unsecured creditors shared equally in the available assets of a failed bank. This led to a decline in confidence in the banking system, and depositor-runs became more frequent, consequently triggering more bank closings.

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160 12 CFR § 330.3.
161 12 CFR § 330.4.
162 12 CFR § 330.15.
163 The exchange rates for such conversions are those as of 12 noon on the date of default, using the exchange rate of the particular deposit agreement if specified, otherwise the ‘noon buying rates for cable transfers’ of the Federal Reserve Bank of New York are used. See 12 CFR § 330.3(e).
Under the FDIC regime, the FDIC pays out insurance funds to insured depositors and then becomes subrogated to the claims of the insured depositors.

There are three different payment options open to the FDIC for depositors in the case of a liquidation of, or other closing or winding up of the affairs of an insured depository institution. First, the FDIC can pay each depositor up to the limit of insurance by means of cash or cheque; second, the FDIC can make available the insured portion of the failed bank’s deposit liabilities by transferring them to an open bank; third, the FDIC can create a Deposit Insurance National Bank (DINB) to which the insured portion of the failed bank’s deposit liabilities will be transferred. The FDIC is required to pay insured deposits ‘as soon as possible’.

In exercising any of the options open to it, the FDIC is required to adopt a least-cost determination. The Corporation must determine that the option is necessary to meet its obligations to provide deposit insurance. Further, the action must not, directly or indirectly, have the effect of increasing losses to the insurance fund by protecting depositors for more than the insured portion of their deposits, or by protecting creditors other than depositors.

5.2.3 An Assessment of Federal Deposit Insurance

The FDICIA was promulgated mainly in response to the Savings and Loan Crisis in the 1980’s. The legislation mandates the regulator with the main goal ‘to resolve the

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164 12 USC § 1821 (f), (m).
165 Ibid.; Historically, the FDIC has been paying insured deposits within a few days. For a detailed analysis of how the FDIC effected the payment of insured deposits during the banking crisis of the 1980s and early 1990s, see FDIC Managing the Crisis: The FDIC and RTC Experience, 1980-1994 Vol. 1, (FDIC, Washington DC, 1998) ch9.
166 12 USC § 1823 (c)(4); 12 CFR § 360.1(a).
problems of insured depository institutions at the least possible long-term loss to the
deposit insurance fund.167 The cost-minimizing mandate represents a significant
change in the approach to regulatory objectives, which previously emphasized on
reduction in the number of bank failures. Under the FDICIA, the extent of losses to
depositors and the FDIC are largely under the control of the bank supervisors, and the
range of intervention powers under the Act are expected to be used to fulfil the
mandate to minimize losses.168

The main regulatory tools that have been introduced for the attainment of this
mandate are capital-based PCA mechanisms169 and the risk-based deposit insurance
assessment system.170 This reflects the focus of discussions on moral hazard, which
have been less on creating the right incentives for consumers and more on how it
relates to banks and their officers. The adoption of this mechanism rather than co-
insurance recognises the fact that the consumer does not possess the knowledge and
sophistication to judge the risk profile of depository institutions; instead, the FDIC is
given the responsibility to assess risk and charge premiums accordingly.

The main aim of the FDICIA reform is to align the incentives of bank owners,
managers and regulators with the interests of the deposit insurance fund.171 The

167 See 12 USC § 1831o.
168 See R Eisenbeis and I. Wall ‘Reforming Deposit Insurance and FDICIA’ (2002) 76 Federal Reserve
Bank of Atlanta Economic Review 1, 1.
169 For a detailed analysis of the concept and operation of the U.S. PCA mechanism, see Kaufman (ed)
170 Prior to the FDICIA, it was thought that direct supervisory regulation was sufficient to control risk
and that pricing deposit insurance to reflect risk was neither necessary nor feasible. However,
following the Savings & Loans Industry debacle, which was attributed in part to regulatory
forbearance, PCA mechanisms and the risk-based assessment system was introduced. See GJ Bensston
and GG Kaufman ‘The FDICIA After Five Years’ (1997) 11 The Journal of Economic Perspectives 3,
139; LJ White ‘The Reform of Federal Deposit Insurance’ (1989) 3 Journal of Economic Perspectives
4, 11.
171 The FDICIA has been criticized for over-protection of the Deposit Insurance Fund to the detriment
of other regulatory objectives. See SJ Hughes ‘Banking and Deposit Insurance: An Unfinished
capital-based PCA ensures that institutions falling below minimum capital standards face increasingly stringent regulatory restrictions and requirements. The PCA mechanism classifies banks into different risk categories based on book-value capital ratios\(^{172}\) and prompt termination of a bank is prescribed once its capital turns negative.

Banks classified as well or adequately capitalized are generally not subject to regulatory intervention, while undercapitalized banks come under increasingly severe regulatory constraints as their capital position declines. PCA should prevent regulatory forbearance and help to detect problems in banks before they escalate and cause losses to the insurance fund.\(^{173}\)

A major criticism of the PCA regime is that it is too rigid. It is argued that had PCA been in effect during the 1980’s, supervisors would have been compelled to close banks that ultimately survived. However, in the theoretical situation where PCA had been in effect, the banks and supervisors would have had different incentives and risky strategies would not have been pursued or condoned.\(^{174}\)

The main limitation of the U.S. PCA model appears to be its reliance on book-value capital standards for classification of banks.\(^{175}\) The absence of market-value standards could potentially lead to a situation where apparent insolvencies might escape

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\(^{172}\) These categories are well capitalized, adequately capitalized, under capitalized, significantly under capitalized and critically under capitalized. See Table 5.1.

\(^{173}\) Under the FDICIA, if the failure of an insured depository institution results in material loss to the Deposit Insurance Fund, the inspector general of the appropriate federal banking agency is required to make a written report which reviews the supervisory process of the institution. The report should ascertain why the failure resulted in a material loss to the deposit insurance fund and make recommendations for preventing future losses. See 12 USC 12310 (k). This reporting requirement would check incentives for regulatory forbearance; as such reports would generally be made public, imprudent forbearance would tarnish the reputation of those responsible. See RS Carnell ‘A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991’ (1993) 12 Annual Review of Banking Law 317.


regulatory scrutiny until it becomes too late because such banks remain book-value solvent. During insolvencies, book-value tends to increasingly overstate market-value for assets and understate them for liabilities. Reliance on book-value capital may also encourage the regulators to circumvent the provisions of the FDICIA by engaging in harmful forbearance to prevent potentially embarrassing insolvencies.

Market-value based standards are however not without limitations. The inherent limitation in adopting market-value standards is the availability of reliable and accurate information on which the regulator is to base its judgement. Adoption of market-value standards will necessarily involve estimations by the regulator. Market conditions are also transient in nature, therefore to avoid reliance on misleading information, bank positions would have to be assessed at very short intervals, creating additional regulatory costs and burden.

The foregoing notwithstanding the contribution of PCA can not be understated. From a legal perspective, the main advantage lies in the existence of a clearly specified and well publicized insolvency rule. It goes a long way to limit the scope for discretionary action thereby reducing the scope for forbearance on the part of the regulator.\textsuperscript{176} The use of corrective action has contributed to successful remediation of problem banks before insolvency and in reducing the number of bank failures.\textsuperscript{177}

The practical difficulties involved in implementing a risk-based deposit insurance system have been considered in this thesis.\textsuperscript{178} However, actuarial fairness dictates that

\textsuperscript{176} On regulatory forbearance, see Narayana Shim (2007) (n87).
\textsuperscript{178} See Chapter 3.
the premiums that banks pay on insurance should reflect the expected costs that they impose on the insurance fund. Such costs should however be reduced by the PCA provisions, which mandate regulators to intervene in advance of insolvency to reduce costs to the deposit insurance fund. This has led to the conclusion that the existence of both measures in the U.S. deposit insurance system is superfluous.\textsuperscript{179}

It is true that in an ideal situation, PCA should prevent the FDIC from suffering loss, except in cases of fraud.\textsuperscript{180} It is however important to note that perfection is very rare in bank supervision and supervisory errors may occasionally cause the deposit insurance fund to suffer loss. It is also possible that occasional large, adverse macro economic shocks may have sudden impacts on the balance sheets of many banks, rendering them insolvent before prompt supervisory action can be taken. This justifies the retention of an equitable means of pricing deposit insurance because losses can occur even with PCA.

In the event of a sudden macro economic shock, banks with stronger capital positions are more likely to survive the shock than banks with a low capital base; thus such banks pose little risk of loss to the deposit insurance fund. Hence, deposit insurance premiums should not only reflect the risk of loss to the deposit insurance fund but also the magnitude of loss.

The level of public awareness of the existence and functions of the deposit insurance scheme in the U.S. appears to be more than that in the U.K. This is due to the

\textsuperscript{180} Fraud was a significant factor in the failure of Keystone Bank, WV, which resulted in a $780 million loss, which represented about 75 per cent of the institution’s assets.
historical antecedents\textsuperscript{181} of the FDIC and the wide ranging role that the corporation plays in the banking system. In terms of depositor protection, U.S. depositors are in an apparently better position than their U.K counterparts. Although the principal purpose of deposit insurance in the U.S has always been the reduction of systemic risk, the philosophy underlying this approach has been that systemic stability can be achieved by promoting public confidence in the financial system through a substantially adequate level of depositor protection.

Although the U.S deposit insurance scheme contains no element of co-insurance, in an apparent bid to retain an element of depositor discipline, deposit insurance coverage was pegged at $100,000. The wisdom behind this coverage cap is questionable when the complexities of the legal provisions for coverage allows most depositors to enjoy full insurance coverage by ensuring that deposit accounts are held in different rights and capacities.\textsuperscript{182} It has been noted that the limit of $100,000 was excessive when it was set in 1980 as it exceeded what was needed to cope with inflation at the time. However, the real value of this amount has now been roughly halved by inflation since 1980 and is now below the real value of coverage in 1974 when the nominal coverage limit was $40,000.\textsuperscript{183} The inadequacy of the coverage limit, particularly in providing the desired level of public confidence, has prompted the temporary increase in the coverage limit to $250,000.

The reform introduced by the FDIRA is a welcome development for allowing the FDIC to review the coverage limit at five-year intervals by indexing it to inflation. This would further aid financial stability as it engenders public confidence in the

\textsuperscript{181} Traditionally, there has been a high level of bank failure and depositor losses in the United States.
banking system through effective depositor protection. Since it is unreasonable to expect individual depositors to effectively monitor bank risk, the coverage limit should be substantially increased while the legal provisions relating to coverage should be simplified to apply to a single individual in an institution. The deposits of government entities, banks and other depositors that are better placed to assess and monitor bank conditions, which are presently covered, should be excluded from deposit insurance coverage to reinforce market discipline.

Table 5.1 Mandatory Actions under PCA

<table>
<thead>
<tr>
<th>Classification</th>
<th>Mandatory Action</th>
</tr>
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<tbody>
<tr>
<td>Well Capitalized and Adequately</td>
<td>None, but cannot pay dividends or management fees that would lead to undercapitalization</td>
</tr>
<tr>
<td>Capitalized</td>
<td></td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>Close monitoring; Capital restoration plan required within 45 days; Restriction on growth, and prior approval required for acquisitions, branching and new lines of business.</td>
</tr>
<tr>
<td>Significantly Undercapitalized</td>
<td>Subject to provisions applicable to undercapitalized; Recapitalization required; Restriction on interest rates, growth and activities; New Directors and officers required; Restrictions on holding company.</td>
</tr>
<tr>
<td>Critically Undercapitalized</td>
<td>Conservatorship, receivership or other action required; Appointed of receiver required if other action fails to restore capital within stipulated time.</td>
</tr>
</tbody>
</table>

182 It has been observed that a family of four, for example, can hold insured deposits of up to $2 million in a single institution. See FDIC ‘Options Paper’ (August 2000). Available at http://www.fdic.gov/deposit/insurance/optionpaper.html accessed 15 June 2007.
183 FDIC Options Paper (n182).
5.3 Deposit Insurance: Cross-border Issues

5.3.1 International Financial Stability

The erosion of traditional borders in financial markets has not been limited to sectoral lines but has also cut across geographic boundaries, raising systemic risk concerns. According to Alan Greenspan:

'The global financial system has been evolving rapidly in recent years. New technology has rapidly reduced the costs of borrowing and lending across national borders, facilitating the development of new instruments and drawing in new players... This burgeoning global system has been demonstrated to be a highly efficient structure that has significantly facilitated cross-border trade in goods and services and, accordingly, has made a substantial contribution to standards of living world-wide. Its efficiency exposes and punishes underlying economic weaknesses swiftly and decisively. Regrettably, it also appears to have facilitated the transmission of financial disturbances far more effectively than ever before.' 186

With the expansion of international financial markets, new aspects of risk have been created which have the potential to undermine international financial stability. The adverse effects of bank failure become even more damaging where it involves an internationally active bank exposing financial safety-net players to various insolvency and intervention regimes. While the failure of BCCI has highlighted the inherent

difficulties in supervising internationally active banks, recent financial crises in some parts of the world have raised the awareness of the role of contagion in international financial markets. Under panic conditions, markets do not effectively discriminate between countries with strong and weak economic systems, which may cause such panics to spread to countries with sound economic structures and policies.

The emergence of multinational banking and international financial conglomerates has also increased concerns about the efficacy of bank regulation and supervision at an international level. Financial conglomerates have been at the forefront of globalization as they operate in different countries through different legal entities. Although these firms offer the advantages of diversified assets, risks and sources of earnings, their structure poses several problems for regulators. Apart from systemic concerns bordering on the potential spill over effect of the failure of an international conglomerate, national supervisors also have to deal with the allocation of supervisory responsibilities. Conflicting approaches to the legal regime governing

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190 This refers to the conduct of banking activities through a branch or subsidiary located in a foreign country. See RM Pecchioli The Internationalisation of Banking: The Policy Issues (OECD, Paris, 1983) ch.2.


192 The interrelationship of various entities within a multinational conglomerate increases the risk that problems within an affiliate in one jurisdiction will spread to other affiliates in other jurisdictions. See K Alexander and others Global Governance of Financial Systems: The International Regulation of Systemic Risk (Oxford University Press, Oxford, 2006) ch.1.
bank insolvencies across jurisdictions could also pose considerable challenges in the event of a failure of a large international conglomerate.\textsuperscript{193}

The development in the international financial market has highlighted a fundamental problem: the enormous mismatch that exists between an increasingly sophisticated and dynamic international financial world with rapid globalization of financial portfolios, and the lack of an adequate institutional framework to regulate it.\textsuperscript{194} The response to this has been the establishment of international financial bodies and efforts to develop international standards (soft law)\textsuperscript{195} and harmonize basic features of national regulatory regimes.\textsuperscript{196} Most of these bodies have no legal status as international organisations and hence have no legal capacity to promulgate 'hard law'. however, they serve as a forum where peer pressure can act as a powerful incentive to improve policy and implement soft law.


Examples of such bodies include the Financial Stability Forum (FSF)\textsuperscript{197} and the Basel Committee on Banking Supervision.\textsuperscript{198} Most proposals for the reform of the international financial architecture are centred on improving the roles and functions of the few international financial institutions. Improved regional co-operation has also played a significant role in international financial stability.\textsuperscript{199} The EU has taken the initiative\textsuperscript{200} in developing an international legal framework with high profile efforts at financial integration, but there have been other regional efforts such as the North American Free Trade Agreement (NAFTA) and the West Africa Economic and Monetary Union (WAEMU).\textsuperscript{201} At a more general level, the International Organisations with responsibility for international monetary and financial relations are the International Monetary Fund (IMF), the International Bank for Reconstruction and Settlement (World Bank), and the World Trade Organization (WTO).\textsuperscript{202}

5.3.2 Cross-border Banking and Deposit Insurance

As noted earlier the failure of a multinational bank could raise significant concerns for regulators because of differences in national insolvency rules. Such a failure could also be further complicated by different approaches to deposit insurance across

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\textsuperscript{197} The FSF was established to 'promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.' The FSF’s Compendium of Standards lists the standards that are internationally accepted as important for international financial stability. See generally T Bennett \textit{Tolley’s International Initiatives Affecting Financial Havens} (Tolley, London, 2001) ch 7.

\textsuperscript{198} The Committee was created by the Central Bank Governors of the G10 nations in 1974, with a mandate to improve the soundness of banking systems, and to establish a level playing field for international operators. It is also a forum for international co-operation within G10 countries and between G10 and non-G10 countries. The Committee formulates supervisory guidelines and standards, and recommends best practice. The Committee is best known for its International Standards on Capital Adequacy, the Core Principles for Effective Banking Supervision, and the Concordat on Cross-border Banking Supervision. See generally \textit{Walker} (2001) (n191), part I.


\textsuperscript{200} This has been through the EC treaty regime and legislative framework implementing the Single Market Programme.


\textsuperscript{202} For a discussion on the legal framework for international financial regulation, see \textit{Alexander} (2006) (n192), ch.3.
different national jurisdictions. Thus it is pertinent to examine the feasibility of establishing an agency to act as an international deposit insurer or at least harmonize basic features of national schemes. It is also important to consider the current provisions of national deposit insurance laws on cross-border banking.

5.3.2.1. Internationalization/Harmonization of Deposit Insurance

The rising trend in globalization of banking activities has prompted calls for internationalization of financial safety net measures to protect international financial markets from the effects of contagion. In the same vein, Grubel has also proposed the establishment of an International Deposit Insurance Corporation (IDIC). He argues that such a scheme would lead to the elimination of negative international externalities, which each country alone has inadequate incentives to combat. The proposed scheme would function like existing national schemes but would serve the multinational banking community.

International co-operation in the area of deposit insurance is essential to ensure a "level playing-field" on which banks can compete internationally. It has been shown that domestic deposit insurance policies affect the international location of deposits. Hence, in the absence of international harmonization, countries have an incentive to

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use deposit insurance as a competitive tool to attract international bank deposits rather than the traditional goals of depositor protection and financial stability.206

The proposal for an international deposit insurer would encounter some practical problems, which would make it complicated, perhaps impossible to implement. The main barrier to such a scheme is the cross-country differences in regulatory culture and the disparity between levels of financial development in different jurisdictions.207

It has been argued that a convergence of British and American policy makes it easier to harmonize international banking regulation.208 From the analysis of the deposit insurance schemes in the UK and the US, it is apparent that differences in regulatory culture and objectives have greatly shaped the evolution and design of deposit insurance in both countries. Hence it is difficult to see how both jurisdictions would agree on the features of an international scheme; for example, on the issue of co-insurance where both countries previously adopted diametrically opposite policies in their domestic schemes.209

Another potential difficulty with the proposal for an international deposit insurance agency is that of ensuring participation in the scheme by all countries and the potential for free-riding. Where a few countries refuse to join the scheme,
multinational banks within their jurisdiction would not have to pay for insurance. This has the potential to give such countries a competitive edge, as banks would have an incentive to transfer their business to such countries. Grubel however argues that market forces would counteract such an incentive as uninsured banks would be required to pay higher interest rates on their deposits to compensate depositors for the higher risk of loss. He also posits that domestic legislation could be adopted to penalize branch banking in 'non-IDIC-member countries'.

It is doubtful whether market forces can play the role described above especially where the country concerned is, for example, the United States (or another important financial power, such as the UK), where there is a strong institutional framework for prudential supervision of foreign banks already in place. In such a case, refusal to participate in an international deposit insurance scheme would not ipso facto denote higher risk to depositors. It would also be self-detrimental for domestic law to prohibit branch banking where such a country has opted out of the scheme.

An international scheme would also fail to have a desired effect of boosting confidence in the international financial system if none of the major financial powers decides to take on a hegemonic role within the deposit protection arrangement. The assumption of such a role might be understood as that of a guarantor, and in the absence of this, any international arrangement would lack credibility.

Efforts to ensure financial stability at the international level can be grouped into crisis prevention and crisis management measures. The provision of deposit insurance at the
international level falls under the latter category while the development of rules for risk assessment and capital standards at the international level falls into the former. National interests will often override international considerations when it comes to protecting a country’s safety net resources. Therefore, national agencies that otherwise co-operate to forestall financial crisis often compete with each other to avoid or minimize the use of their funds when failure eventually occurs.\footnote{Hupkes ‘Who Killed Burden Sharing?’ Proceedings of the IADI Cross-border Symposium, Basel, 3 May 2007.} In the event of a failure with an international dimension, host countries will also be reluctant to expend taxpayers’ money to prevent instability in another jurisdiction. Thus in the absence of an international regime for bank insolvency and deposit insurance, the main challenge after the failure of an internationally active bank is that of burden sharing.\footnote{Burdensharing issues typically involve: emergency liquidity assistance (ELA), primary supervisory responsibility, deposit protection responsibility, and failure resolution responsibility. On the need for an international failure resolution regime, see RM Lastra ‘Cross-border Resolution of Banking Crisis’ in DD Evanoff and others (eds) International Financial Instability: Global Banking and National Regulation (World Scientific Publishing, Singapore, 2007) 311.}

It has been aptly observed that ‘crisis prevention strategies present an attractive alternative to regulators who are unprepared to shoulder the world’s banking problems but who are nonetheless concerned about the financial system’s safety and soundness.’\footnote{Hupkes ‘Who Killed Burden Sharing?’ Proceedings of the IADI Cross-border Symposium, Basel, 3 May 2007.} A crisis management regime may allow free-riding on the guarantor by institutions from small states while crisis prevention measures are primarily aimed at monitoring financial institutions and ensuring that they have sufficient capital to withstand financial difficulties.

Whereas it is practically impossible to implement an international deposit insurance scheme effectively, it is still desirable to implement international harmonization of
basic features of national schemes. The need for harmonization should be balanced against the equally important requirement for countries to design national schemes that reflect country-specific circumstances. The International Association of Deposit Insurers (IADI) was established in May 2002 with the objective to 'contribute to the stability of financial systems by promoting international cooperation in the field of deposit insurance.'\textsuperscript{214}

Harmonization is perhaps more realistically feasible on a regional rather than on an international basis, as there is likely to be more convergence of regulatory objectives at the regional level.\textsuperscript{215} At the international level, the Financial Stability Forum (FSF) set up a study group to review experiences with deposit insurance schemes and to develop international best practices.\textsuperscript{216} The fact that the report of the study group is characterized by an open-ended approach with few conclusive recommendations further highlights the inherent difficulties in developing an international framework for deposit insurance.

A relatively successful attempt to harmonize deposit insurance at the regional level is the EU Deposit Guarantee Directive (the Directive).\textsuperscript{217} Unlike other efforts to

\textsuperscript{213} EB Kapstein 'Resolving the Regulator's Dilemma: International Coordination of Banking Regulations' (1989) 43 \textit{International Organization} 2 (Spring) 323.

\textsuperscript{214} See http://www.iadi.org. The IADI has recently formed a research and guidance Sub-committee on deposit insurance cross-border issues to develop guidance for national schemes faced with cross-border banking risks.

\textsuperscript{215} In recent years, regional cooperation and institutions have developed faster and more easily than multilateral systems. On Regionalism generally, see ED Mansfield and HV Milner 'The New Wave of Regionalism' (1999) 53 \textit{International Organization} 3 (July) 589.

\textsuperscript{216} The terms of reference of the study group were, among others, to: (a) study recent experiences with deposit insurance schemes by examining systems that worked with and those that did not work with a view to synthesizing the key lessons learned; (b) assess the desirability of setting out international guidance on deposit insurance recognizing that different country circumstances may imply distinct policy prescriptions; and (c) evaluate what form such guidance could take (including formulation of general principles for deposit insurance schemes and setting out pitfalls to be avoided in their design and operation). See FSF, 'FSF Study Group on Deposit Insurance- Terms of Reference'. November 1999. Available at http://www.fsforum.org/publications/publication_19_60.html, accessed 2 February 2005.

harmonize regulatory and supervisory regimes, harmonization has been possible at the European level because of the EC legislative framework. Harmonization under the Directive will be considered briefly below.

5.3.3. EU Harmonization

The Directive mandates all member states to adopt an explicit system of deposit insurance, and adopts the principles of ‘mutual recognition’ and ‘home-country control’ in assigning deposit insurance responsibility for internationally active banks. Foreign branches are insured by the home-country deposit insurance scheme while foreign subsidiaries are covered by the host-country scheme.

The Directive requires national schemes to provide a minimum coverage of €20,000. Member states are allowed to introduce co-insurance up to a share of ten per cent for depositors. The directive expressly excludes inter-bank deposits from deposit insurance coverage but states are allowed to choose whether or not to insure the deposits of authorities, insurance companies, pension funds and deposits not denominated in EU currency.

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219 See Article 3 of the Directive. In principle, the Directive also requires every credit institution to join a deposit guarantee scheme.

Economic reforms in Europe are geared towards the development of a single market in financial services and the presence of a 'level playing field' is germane to the attainment of this objective.\textsuperscript{221} To this extent, the Directive contains three principal provisions that serve to limit the use of deposit insurance as a tool for regulatory competition.\textsuperscript{222}

The first of these provisions is the restriction on advertising. Article 9 requires member-states to establish rules limiting the use in advertising of deposit insurance information. This provision restricts banks from using differences in deposit insurance schemes for competition purposes.\textsuperscript{223}

Second, the ‘topping up’ provision contained in Article 4 allows foreign branches to supplement their insurance cover up to the level of the host-country by joining the host-country scheme. The essence of this provision has been considered by the European Commission and it was noted that though the ‘topping up’ provision has rarely been used in practice, it should still be retained as it allows branches from accession countries to compete favourably in other parts of the EU.\textsuperscript{224}

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\textsuperscript{222} On regulatory competition in the EU, see G Hertig ‘Regulatory Competition for EU Financial Services’ (2000) 3 Journal of International Economic Law 2, 349.

\textsuperscript{223} This is a by-product of the application of this provision as the Directive states that the provision is to ‘prevent such use from affecting the stability of the banking system or depositor confidence’. See Article 9 (3).

The third of these provisions is Article 4, which initially limited the level and scope of coverage of deposit insurance provided by home-country schemes to the level and scope of coverage available under the host-country scheme.\textsuperscript{225}

The possibility for deposit insurance policies to be used as a tool for international regulatory competition has not been completely eliminated by the Directive. In particular, it has been shown that countries that charge a low deposit insurance premium have a competitive edge over others.\textsuperscript{226} To this extent, it is surprising that EU policy makers do not appear to have given adequate consideration to the prescription of a minimum deposit insurance premium or a means by which premium may be ascertained. In the absence of such prescription, countries are left to determine deposit insurance premiums and in practice these are low, as most member states charge on an ex post or demand basis, which means that effectively the insurance premium is zero.\textsuperscript{227}

The recital to the Directive notes that ‘harmonization must be confined to the main elements of deposit guarantee schemes’; undoubtedly, this underscores the importance of tailoring deposit insurance schemes to country-specific circumstances and the inherent difficulties in trying to achieve harmonization.\textsuperscript{228} Indeed, the directive is open-ended on several key elements of deposit insurance design with the most notable mandatory provision of the directive being the requirement of a minimum coverage limit of €20,000. This requirement is designed to ensure a fair level of depositor

\textsuperscript{225} See Article 4 (1); this provision expired on 31 December 1999. The provision was only necessary as a transitory measure as some countries were granted a transitional derogation from the requirements of the Directive; see Article 7(1); see generally European Commission ‘Commission Report on the Application of the Export Prohibition Clause, Article 4(1) of the Directive on Deposit Guarantee Schemes’ COM (99) 722, 1999.

\textsuperscript{226} See Huizinga and Noodene (2002) (n205).

\textsuperscript{227} For a detailed discussion, see Huizinga (2005) (n205).
protection across member-states; however, because of the uneven state of economic development and wealth, it has also been criticized as leading to over-insurance and exacerbation of the moral hazard problem in accession countries. As the directive only stipulates a minimum coverage limit, it is also possible that coverage limits may be used as a means of competition for international bank deposits, as banks whose home-country schemes provide a generous level of coverage would be more attractive to depositors.230

The extent to which the EU harmonization efforts can help to contain systemic risk remains questionable. The recent events following the run on Northern Rock assumed an international dimension when the queues in the bank’s UK branches were replicated in Ireland. The queuing depositors were only assuaged following an Irish government announcement that the full guarantee of Northern Rock deposits by the UK government also applied to Irish depositors.231 Because the Directive only harmonizes general aspects of deposit insurance, member states have the discretion to determine the level of coverage to be applied, including coinsurance, as well as the funding mechanism to be adopted.232 As a result, the design and functioning of deposit insurance schemes differs from one state to the other and there is little clarity as to the fate of foreign depositors in the event of a bank failure.233

232 For a detailed discussion, see J Cariboni and others ‘Deposit Protection in the EU: State of Play and Future Prospects’ (2008) 9 Journal of Banking Regulation 2, 82.
233 ‘When the Safety Net Fails’ The Economist (U.K), 3rd. 9th May 2008, 94.
The foregoing notwithstanding, the Directive, by requiring member-states to adopt a system of deposit protection within their territories, has ensured that the twin traditional objectives of deposit insurance, which are financial stability and depositor protection, are enshrined in the financial safety-net regimes of member-states. The directive has also eliminated, to a relatively successful degree, the use of deposit insurance as a tool for regulatory competition between member-states. Finally, the directive has harmonized the legal position of national deposit insurance laws on the allocation of deposit insurance responsibility between home and host countries for multinational banks.

5.3.4. Cross-border Provisions of National Deposit Insurance Laws

Deposit insurance is a relatively simple concept but its design and implementation is complex. Due to the complications involved, which mostly arise from country-specific factors, cross-border issues are easier to deal with by national law provisions. More importantly, policy makers should ensure that troubled international banks do not negatively impact the resources of the host-country deposit insurance scheme. The cross-border provisions in the deposit insurance laws of the two jurisdictions examined earlier in this chapter will now be considered.

I. UK Cross-border Provisions

In relation to an incoming EEA firm’s passported activities, its home-state deposit protection scheme must provide cover in respect of business within the Deposit Guarantee Directive, whether that business is carried on from a UK branch or on a
cross-border services basis.234 Section 214(5) of the FSMA 2000 allows the compensation scheme to provide for a person who qualifies for compensation under Schedule 3 of the Act,235 and falls within a prescribed category, to elect to participate in the scheme.

Where there is no cover provided by the EEA firm’s home state, or the scope or level of cover is less than that provided under the UK scheme, the firm may elect to obtain ‘top up’ cover from the UK scheme for its passported activities carried on from a UK branch.236 Where an incoming EEA firm obtains ‘top up’ cover, the FSCS is required to establish a co-operative link with the firm’s home-state compensation scheme in order to establish its procedure for the payment of compensation to claimants.237

A firm granted ‘top up’ cover under the UK scheme must comply with the rules in the Sourcebook which apply to participant firms; where a firm fails to comply, the FSCS must notify the FSA and the firm’s home-state regulator, and where the firm fails to meet its obligations for a period of twelve months, the FSCS may terminate the firm’s ‘top up’ cover.238


Foreign bank operations are generally governed by the International Banking Act of 1978.239 A foreign bank is defined as any company organized under the laws of a
foreign country, a territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands which is carrying on the business of banking, or any subsidiary or affiliate of any company organized under these laws.\footnote{12 USC § 1813(r); 12 USC § 3101(7).} A foreign branch is any office or place located outside the domestic branch areas at which banking operations are conducted.

Foreign banks in the US are required to conduct all domestic retail deposit activity through an insured bank subsidiary.\footnote{12 USC § 3104(d); the foreign bank must also allow the FDIC to examine any of its branches, offices, agencies or affiliates located in the US.} The FDIC would only insure deposits in a branch of a foreign bank if the bank agrees that every branch established or operated by that bank in the same state would also be insured.\footnote{12 CFR § 347.203.} The objective of this provision is to afford equal competitive opportunity to foreign and US banking organizations in their US banking operations.\footnote{12 USC § 1815(c)(1); 12 CFR § 347.210.} It is also easier for a deposit insurer or relevant supervisor to deal with a subsidiary as a separate legal entity than with a foreign branch. This explains the rationale for the home-country principle enshrined in the EU Deposit Guarantee Directive.

As a precondition for FDIC insurance, foreign banks are required to deliver to the Corporation a surety bond, a pledge of assets, or both, in such amount and of such type as the Corporation may require.\footnote{12 USC § 3104(a).} This is to serve as protection to the deposit insurance fund against the inherent risks of insuring foreign banks whose activities, assets and personnel are for the significant part outside US jurisdiction.\footnote{12 CFR § 347.210.} Before approving an application for a foreign bank to be insured, the FDIC Board must consider among other things the financial history and condition of the bank.
The FDIC may also co-operate with foreign supervisory agencies; the Corporation may disclose information obtained in the course of exercising its supervision or examination powers to a foreign bank regulatory or supervisory authority, if it determines that such disclosure is appropriate for supervisory and regulatory purposes and that the interests of the United States will not be prejudiced.  

5.3.5. Cross-Border Co-operation Agreements

Dealing with cross-border banking problems involves co-ordinating information and decision making, and dealing with potential conflict between jurisdictions, for example, relating to cost and burden sharing. These problems pose a peculiar challenge in the absence of an agreement or protocol to be used in a crisis. Cross-border agreements can be used to ensure adequate supervision of internationally active banks. Such agreements ensure mutual recognition of supervisory efforts by home and host country supervisors, thus avoiding duplication or the existence of regulatory loopholes.

\[\ldots\]

245 12 USC § 1815(c)(4).
246 12 USC § 1815(b); a foreign bank must give a written commitment to provide the FDIC with information about the bank's affairs and those of its affiliates which are located outside the US. This would enable the FDIC to determine relations between a foreign bank and its insured branch, and to determine the financial condition of the foreign bank as it relates to the insured branch. See 12 CFR § 347.203.
247 12 CFR § 347.207.
249 Examples of these agreements include the European Central Bank’s Memorandum of Understanding (MoU) on cooperation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis Situations; the EU Directive on Re-organization and Winding up of
Cross border co-operation agreements are particularly useful for deposit insurers in terms of information sharing. As noted in Chapter 4, a well designed deposit insurance system should have in place an effective information sharing arrangement. Information sharing arrangements could be formal or informal but the nature of information that is shared has led to such agreements being formalised in legislation, memoranda of understanding or other agreements.

Information sharing agreements at the domestic level are adapted to suit the information requirements of the financial safety-net participants involved. This is determined by their respective roles, mandates and responsibilities. These agreements become more complex at the cross-border level as there are many more safety-net participants with varying roles, objectives and powers, thereby making it difficult to coordinate information and activities. For example, it will be particularly difficult to establish an information sharing agreement where there is a pay-box system operating in one country and a risk-minimizer in the other.

Information sharing agreements should take account of the roles, responsibilities, mandates and powers of the parties in their respective jurisdictions. The agreements should specify what information is to be shared and by whom. The nature, level of detail and frequency of information to be exchanged between deposit insurers should be specified.251

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250 See Table 4.1.
Apart from the challenge of aligning the differing mandates, powers and objectives from various jurisdictions, any agreement at a cross-border level also has to take account of differences in intervention and legal insolvency regimes.

The success of an information-sharing arrangement is dependent on the freedom of national authorities to release certain information. In many countries, there are legal constraints on the publication or release of prudential information by supervisory authorities. For supervisory authorities from this countries, it is pertinent to ensure the confidentiality of any information shared under any agreement. In the absence of a confidentiality clause in an information sharing agreement, most deposit insurers would be loath to provide information.252

Information sharing agreements must make provision for the timely release of data, so that prompt action can be taken. The fact that different jurisdictions will have different views on prompt corrective action must be taken into consideration.253 Some areas in which there may be conflicting approaches in different countries include the point at which a failing bank requires intervention and which entity initiates the resolution process. Supervisory authorities may also have divergent views on whether a particular failure should be treated as having systemic effects and if so, whether in the host or home country. Most importantly, the success of an information sharing agreement would depend on the political will of individual countries.

252 See Basel Committee on Banking Supervision Information Flows between Banking Supervisory Authorities (Supplement to the Concordat) 1990.
253 Davies (2007) (n251).
5.4 Provisional Conclusion

The differences in the deposit insurance systems of the two countries studied in this chapter underscore the importance of policy objectives and individual country characteristics in the design features and modalities of deposit insurance schemes. Historical antecedents have also been a major factor in the development of the deposit insurance scheme. The high number of bank failures in U.S. banking history has contributed to the development of a robust scheme for protecting bank depositors. In contrast to this, a hitherto relatively stable banking system in the U.K., with the Compensation Scheme remaining relatively dormant, had relegated the issue of deposit protection to the background of banking regulation policies. The Northern Rock debacle however, has marked a watershed for the UK Compensation Scheme following proposals for wholesale changes to be implemented in new legislation. The continuous evolution and reform process in these countries underscores the complex nature of deposit insurance adoption and design.

Globalization has highlighted the risks associated with cross-border banking services. Thus, initiatives to introduce or reform deposit insurance systems must take these risk factors into account. While policymakers should design their deposit insurance schemes to suit country-specific factors, it is equally important to consider the impact that international banks have on the resources and effectiveness of home-country deposit insurance schemes.

While cross-country differences make the establishment of an international scheme a near impossible task, well designed deposit insurance systems should ensure effective co-operation between host and home-country safety net participants. Particular attention should be paid to the allocation of supervisory responsibility, information
sharing arrangements and burden sharing arrangements in the event of cross-border insolvency.
6.0 Introduction

The adoption of explicit deposit insurance in Nigeria was a significant development, representing one of the key features of government economic policy in the 1980’s. The Nigerian scheme, established in 1988, was only the second in Africa after Kenya had established its own scheme in 1985. This chapter reviews the deposit insurance experience in Nigeria, beginning with an overview of the history and structure of the regulatory and supervisory framework for the financial sector in Nigeria. Major developments leading to the adoption of explicit deposit insurance are reviewed. Subsequently, the design and operation of the deposit insurance scheme is analyzed, with recommendations for reform.

The main objective of this chapter is to highlight aspects of the deposit insurance problem in the Nigerian context. In reviewing the experience of this country, the main challenges and lessons that can be learnt are identified; comparisons are made with the schemes examined in the previous chapter where relevant, and the sound practice principles developed earlier are used as a guide.
6.1 Bank Regulation and Supervision in Nigeria: Historical Background

The development of banking regulation in Nigeria can be classified into three phases, namely:

I. 1892 – 1952

II. 1952 – 1985

III. 1986 to date

I. 1892 – 1952

This was the first period in the evolution of banking in Nigeria. It can be described as the ‘Free Banking Era’, as any firm that wanted to carry on banking activity only needed to register under the Companies Ordinance if it consisted of more than ten members. Apart from this requirement, which only came into operation in the 1920’s, there were no other laws or regulations to control the business of banking in Nigeria.

The history of banking business in Nigeria can be traced back to the 19th century when the Elder Dempster Company was involved in specie movement of money from one part of the country to another. The African Banking Corporation was later established in 1892 and it took over specie movement from Elder Dempster. The

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1 See S 2(1) Banking Ordinance Cap. 38 1922
3 On the evolution of banks in Nigeria, see generally F Olalusi ‘Introduction to Banking’ (Evans Brothers, Ibadan, 1983) Ch 5; GO Nwankwo Golden Thoughts on Money and Banking (CIBN Press, Lagos, 2001) 1134.
4 This was long before Nigeria attained political independence in 1960.

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Bank of British West Africa (BBWA)\(^7\) was established in 1894 after which it merged with the African Banking Corporation. For many years after its establishment, the BBWA was the sole banker to the British Government in Nigeria and all the major firms that existed at the time. The BBWA remained the main player in the banking industry until the establishment of Barclays Bank D.C.O.\(^8\) in 1925. The British and French Bank\(^9\) was also established in 1948, and these three banks formed the core of the banking industry in Nigeria at the time.

Like most developing countries, the banks that dominated the early period of banking evolution in Nigeria were foreign owned. This can be attributed to the fact that banking was introduced in the 19\(^{th}\) century mainly for the benefit of European merchants that traded in Nigeria.\(^10\) As the Nigerian economy developed, indigenous banks evolved to challenge the foreign monopoly.\(^11\) The early indigenous banks\(^12\) included the Industrial and Commercial Bank, established in 1914;\(^13\) the Nigerian Mercantile Bank, established in 1931;\(^14\) and the National Bank of Nigeria, founded in 1933. The Abgonmagbe Bank was also established in 1945.\(^15\)

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\(^6\) A bank with its headquarters in South Africa.

\(^7\) Subsequently renamed Standard Bank of Nigeria Ltd., and now First Bank of Nigeria PLC.

\(^8\) Now Union Bank PLC.

\(^9\) Now U.B.A. PLC.

\(^10\) A large percentage of the indigenous population at the time was illiterate and the level of economic activity that required banking was low. The indigenous people also held a very cynical view of banks and banking business and would rather dig secret places to bury their money than keep it in the banks. See E.O. Oloyede "The Bank Customer and Banking Law in Nigeria" (1975) 19 Journal of African Law 1/2, 66.


\(^12\) For a full list of banks that operated in Nigeria at the time the country attained independence in 1960, see Central Bank of Nigeria. Annual Report of Statement of Account for Period Ended 31/12/61.

\(^13\) The bank failed in 1930 as a result of poor capitalization and mismanagement.

\(^14\) The bank failed in 1936, also due to poor capitalization and mismanagement.

\(^15\) The bank's assets were taken over in 1969 by then Western State Government to whom the bank was heavily indebted, it is now known as Wema Bank PLC.
One dominant feature of this early period was that most of the banks collapsed almost as soon as they were established. Apart from inadequate capitalization and mismanagement, most of the failed banks embarked on a policy of rapid branch expansion within a short period of commencing operations. In sharp contrast to the foreign banks that existed at the time, the indigenous banks lacked adequate qualified and experienced personnel. The collapse of the Nigerian Penny Bank, another indigenous bank, in 1946 generated so much controversy that it led to the setting up of the Paton Commission of Enquiry in September 1948 to investigate banking practices in Nigeria. The report of the commission noted a number of factors that were responsible for the high rate of bank failures. These include:

- Poor management;
- Inadequate capital base;
- Fraud;
- Reckless and imprudent lending;
- Illiquidity.

The commission’s recommendations formulated the basis of the first banking legislation in Nigeria, the Banking Ordinance 1952. Presently, the Nigerian Banking system is made up of a mixture of foreign and indigenous banks as well as banks financed by both foreign and local capital.

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16 See Table 6.1. The only banks that survived the early period were the National Bank and the African Continental Bank.
18 Each of the Banks had a paid up capital of less than ₦12,000.
19 For a classification of Nigerian laws and legal system, see AO Obilade The Nigerian Legal System (Sweet & Maxwell, London, 1979).
Table 6.1 - Failed Banks in Nigeria (1892-1960)\textsuperscript{20}

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Date Established</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Industrial &amp; Commercial Bank</td>
<td>1929</td>
<td>Failed in 1930</td>
</tr>
<tr>
<td>The Nigerian Mercantile Bank</td>
<td>1931</td>
<td>Failed in 1936</td>
</tr>
<tr>
<td>The Nigerian Farmers &amp; Commercial Bank</td>
<td>1947</td>
<td>Failed in 1953</td>
</tr>
<tr>
<td>Merchants Bank</td>
<td>1952</td>
<td>Failed in 1960</td>
</tr>
<tr>
<td>Pan Nigerian Bank</td>
<td>1951</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Standard Bank of Nigeria</td>
<td>1951</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Premier Bank</td>
<td>1951</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Nigerian Trust Bank</td>
<td>1951</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Afroseas Credit Bank</td>
<td>1951</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Onward Bank of Nigeria</td>
<td>1951</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Central Bank of Nigeria\textsuperscript{21}</td>
<td>1951</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Provincial Bank of Nigeria</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Metropolitan Bank of Nigeria</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Union Bank of British Africa</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>United Commercial (Credit) Bank</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Cosmopolitan Credit Bank</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Mainland Bank</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Group Credit &amp; Agricultural Bank</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>Industrial Bank</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
<tr>
<td>West African Bank</td>
<td>1952</td>
<td>Failed in 1954</td>
</tr>
</tbody>
</table>

II. 1952 – 1985

The failure of many of the early indigenous banks led to cynicism and loss of confidence in the banking system. Local depositors suffered considerable loss and this also affected some foreign investors who had engaged the services of the failed financial institutions. The Paton Report, which emanated from the 1948 enquiry, resulted in the Banking Ordinance of 1952. In addressing the problems that characterised the growth of the banking industry, the legislation made provisions for: 22

- Minimum paid-up capital requirement;
- Maintenance of adequate liquidity ratio;
- Imposition of ceiling on unsecured loans;
- Examination and supervision of banks;
- Licensing.

The Ordinance prohibited the carrying on of banking business in Nigeria except by a limited company registered in Nigeria and holding a licence granted by the Financial Secretary to the Government. A distinct feature of the 1952 Ordinance was the two-tiered capital adequacy regime. Banks were classified into indigenous and expatriate banks, with different capital adequacy requirements applying to both groups. 23 The logic behind the differential treatment is still not clear as the expatriate banks were generally speaking, better managed than the indigenous banks that were beset by liquidity problems at the time.

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22 This bank is not connected with the Government of Nigeria or the Central Bank of Nigeria (CBN).
23 See GO Nwankwo Prudential Regulation of Nigerian Banking (University of Lagos Press, Lagos, 1990) 18.
24 £12,500 for indigenous banks, and £100,000 for expatriate banks.
In order to check the incessant illiquidity problem in most of the banks, each institution was required to maintain a reserve fund into which twenty per cent of its annual profit was paid until the total reserve fund equalled its paid-up capital. Enforcement powers were vested in the Financial Secretary, who undertook periodic examinations to ascertain the level of compliance with the provisions of the Ordinance. The Financial Secretary was empowered to withdraw the licence of a bank if, after an examination, it was discovered to be in violation of the Ordinance’s provisions.

The 1952 Ordinance was the first attempt to supervise banking business in Nigeria formally and it had its shortcomings. These include:

- Absence of a liquidity assistance mechanism;
- Absence of an institutional mechanism for supervisory purposes; and
- Absence of an explicit deposit protection scheme.

As a result of these shortcomings of the 1952 Ordinance, two main legislations were enacted in 1958, the Central Bank of Nigeria Ordinance of 1958 and the Banking Ordinance of 1958. The major changes introduced include:

- The establishment of the Central Bank of Nigeria (CBN); 24
- Increase in the authorized paid-up capital of expatriate banks to N400, 000; 25
- Increase in the percentage of annual profit to be allocated to the reserve fund to twenty five per cent;

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21 The CBN is responsible for the issue of legal tender currency in Nigeria, the maintenance of external reserves in order to safeguard the international value of the currency, the promotion of monetary and financial stability, acting as banker and financial adviser to the Federal Government and acting as lender of last resort. Prior to the establishment of the CBN, the West African Currency Board was charged with the responsibility for the operation of a common monetary system in all the former British Colonies of West Africa. See generally BC Onyido ‘The Role of the Central Bank in the Nigerian Financial System’ (2004) 28 Bullion 1, 13; Nwankwo (2001) (n.3) 380.

25 The capital requirement for indigenous banks under the old law was retained.
• A new credit ceiling at twenty five per cent of the paid-up capital of the bank per customer; and

• Further restrictions on banks, including prohibition from investment in real property; ownership of subsidiary companies not carrying on banking business; engaging in wholesale or retail trade.

The Central Bank Ordinance was amended in 1961 mainly to give the CBN power to liquidate troubled banks; and in 1962 to provide for an increase in the capitalization requirements for indigenous banks, and to remove the prohibition on the ownership of real estate. The 1958 legislation was repealed by the Banking Act of 1969, with the aim of strengthening the banking system and increasing the powers vested in the CBN. It has been aptly observed that the 1969 Act marked an improvement on the earlier law through the 'range of additions to the Central Bank's armoury of control techniques, and in broadening the sphere of monetary control to embrace most banking institutions other than commercial banks.' Significant provisions of the 1969 Enactment include:

• Increase in the capitalization requirement for indigenous and foreign banks;

• Mandatory incorporation of all banks operating in Nigeria as Nigerian companies;

• All advertisements by banks were made subject to scrutiny and approval of the CBN;

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26 The requirement was raised to N500, 000.
27 Cap 28, LFN 1990.
30 Banking Act 1969, s.6(1).
31 Banking Act 1969, s.1(1). Prior to this, foreign banks operating in Nigeria were only required to register their presence but since they were technically not Nigerian companies, they were largely unaffected by legal regulation of Nigerian companies. The legal requirement currently in force is contained in the Companies and Allied Matters Act, CAP 59, LFN 1990, ss.54-60.
32 Banking Act 1969, s.28(2).
Establishment and closing of branch offices by banks was subject to the approval of the CBN.33

In the 1970’s, there were other significant developments in the banking sector in Nigeria. First, the period saw the emergence of merchant banking business in the country. Second, the country evolved from a poor agricultural economy into a rich oil-based economy, the boom in the oil sector and increased earnings in foreign exchange from oil sales created increased liquidity in the banking system.34 Thirdly, the Indigenization Act35 changed the ownership structure of most Nigerian banks by introducing minimum equity participation of Nigerians in banking companies.36 After the promulgation of the Indigenization Act, the Federal Government began investing in banking business, and acquired majority shareholding in the three biggest banks - First Bank, Union Bank and the United Bank for Africa. Hence, the Nigerian banking industry changed from the hitherto foreign-investor dominated market to a government dominated market.37

The implementation of the indigenization law, and the resultant government domination of the industry, created some problems for the Nigerian banking industry. First, because the management of most banks were government appointees, such management invariably changed as often as government changed. Thus the political instability that existed at this time also resulted in management instability. The nature of the appointments also meant that individuals with little or no experience in bank

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33 Banking Act 1969, s.4.
35 See the Nigerian Enterprises Promotion Decrees of 1972 and 1977; Banking was classified under Schedule 2 of the Decree, which required that at least 60% of the equity of banks must be Nigerian-owned.
36 The Act required 60 per cent indigenous and 40 per cent foreign equity participation. This law was repealed in 1989 by the Nigerian Enterprises Promotion Act, Cap. 303, LFN 1990, foreigners are now allowed to hold a 100% shareholding in Nigerian banks.
37 This was in accordance with government policy at the time to take control of certain critical sectors of the economy, which included the financial and oil sectors. See Sanusi (1992) (n2) 10.
management were appointed to manage banks. This led to a high incidence of fraud and mismanagement. Second, government ownership of banks created a high incentive for moral hazard with most bank management and depositors operating under the assumption of an implied government bail-out in the event of a bank failure.

The resulting deterioration of the financial condition of banks and concern for the safety of depositors' funds led to the reforms that were introduced in the next phase discussed below.

III. 1986 to date

In 1986, developments in the domestic and world economy compelled the Federal Government of Nigeria to introduce a new economic policy. This was referred to as the Structural Adjustment Programme (SAP). In implementing the policy, the government deregulated the financial services sector and introduced a more liberal

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41 See National Economic Emergency Powers Decree, No. 22 of 1988. The SAP was intended to restructure the macroeconomic framework through the alteration and realignment of the aggregate domestic expenditure and production patterns by reducing the dependence on imported goods and petroleum exports; and diversification of the revenue and production base of the economy to ensure stable growth. This involved an initiative to use the private sector as a catalyst for economic growth through privatisation and commercialisation of government owned enterprises. Various laws were enacted in furtherance of the policy and these include: Nigerian Enterprises Promotion (issue of Non-Voting Equity Shares) Decree 1987; Privatization and Commercialization Decree 1987; Securities and Exchange Commission decree 1988; Nigeria Deposit Insurance Corporation Decree 1988; Mortgage Institutions Decree 1989; Companies and Allied Matters Decree 1990; Central Bank of Nigeria Decree 1999; Banks and Other Financial Institutions Decree 1991; Insurance Decree 1991; and People’s Bank of Nigeria Decree 1990. For a discussion of the provisions of these laws, see TC Osanakpo 'A Critical Review of Banking-Related Legislation in the Structural Adjustment Era' in Banking and Other Financial Malpractices in Nigeria, Federal Ministry of Justice Law Review Series (Malthouse Press, Lagos, 1990) 28; O Yerokun Legal Aspects of Structural Adjustment Programme in Nigeria (Department of Law University of Ilorin, Oyo, 1989).
bank-licensing scheme.\textsuperscript{42} It also divested itself of its interests in most of the commercial banks. Naturally, this led to an upsurge in the number of banks in the country.\textsuperscript{43} While this period has been described as the ‘time to practice the new found ability and confidence of Nigerians to manage their own banks’,\textsuperscript{44} the proliferation of banks in the sector also introduced new problems which necessitated new legislation to minimize the incidence of bank failure and control the effects of such failure where it occurred.\textsuperscript{45}

Three principal legislations were enacted, which now constitute the mainframe of the regulatory and supervisory structure in Nigeria. These are: the Nigeria Deposit Insurance Corporation (NDIC) Act 1998;\textsuperscript{46} the Central Bank of Nigeria (CBN) Act of 1991;\textsuperscript{47} and the Banks and Other Financial Institutions Act (BOFIA) 1991.\textsuperscript{48} While the NDIC Act established an explicit deposit insurance scheme for Nigeria, the CBN Act and the BOFIA were introduced to strengthen the existing regulatory powers and supervisory functions of the CBN and NDIC.\textsuperscript{49} The laws also brought non-bank financial institutions under the control of the CBN.\textsuperscript{50}

Presently, the supervisory functions of the CBN are performed through two main departments. The Banking Supervision Department is responsible for the supervision

\textsuperscript{42} In deregulating the sector, the government’s objective was to improve economic efficiency and effective resource allocation through increased competition and enhancement in quality and spread of financial services delivery.

\textsuperscript{43} Between 1986 – 1993, the number of banks in Nigeria increased from 41 to 120, representing a 192\% increase.

\textsuperscript{44} Samwol (1992) (n2) 14.


\textsuperscript{46} This Act has been repealed by the Nigeria Deposit Insurance Corporation (NDIC) Act 2006.

\textsuperscript{47} This act has been repealed by the CBN Act 2007.

\textsuperscript{48} Decree No.25 of 1991, now Banks and Other Financial Institutions Act.

of Deposit Money Banks and Discount Houses while the Other Financial Institutions Department supervises other financial institutions such as Community Banks, Micro-Finance Banks, Primary Mortgage Institutions, and Development Finance Institutions.\footnote{See generally AA Adeogun ‘A Review of the Genesis and Implications of Recent Promulgations’ in EO Akanki (ed) Unilag Readings in Law (University of Lagos, Lagos, 1999)}

The main areas of regulatory focus in the current regime can be broadly grouped into three, namely: entry, risk evaluation and containment, and failure resolution.\footnote{See CBN, ‘Supervision Framework’ Available at http://www.cnb.org.ng/supervision/framework.asp, accessed 3 July 2007.} The entry process involves licensing, which is the sole prerogative of the CBN under the Banks and Other Financial Institutions Act (BOFIA).\footnote{See GA Ogulaye (2007) ‘The Role of Deposit Insurance in Promoting Financial System Stability in Nigeria’ in A Campbell and others (eds) Deposit Insurance (Palgrave Macmillan, New York, 2007) ch. 14.} Risk evaluation and containment is carried out through banking supervision, which is the joint responsibility of the CBN and the NDIC. Failure resolution functions are also shared between the NDIC and the CBN.

Other agencies responsible for the regulation of the Nigerian financial system include the Securities and Exchange Commission (SEC);\footnote{The CBN has the power to grant and revoke banking licences. Previously, the approval of the President was required before a banking licence can be revoked, and this resulted in delays in granting approval for the revocation of licences for terminally distressed banks. This requirement was removed through an amendment to the Act in 1998. See ss 3 & 5 BOFIA} the National Insurance Commission (NAICOM);\footnote{The SEC was established by the Investments and Securities Act (ISA) of 1999 to regulates the capital market and to approve mergers and acquisitions} and the Economic and Financial Crimes Commission (EFCC).\footnote{NAICOM is vested with the responsibility for regulating the insurance industry under the National Insurance Commission Decree No. 1 of 1997 and the Insurance Act 2003} Due to the plethora of regulatory agencies in the Nigerian financial system, the Financial Services Regulatory Coordinating Committee (FSRCC) was established

\begin{footnotesize}
\footnotetext[1]{See generally AA Adeogun ‘A Review of the Genesis and Implications of Recent Promulgations’ in EO Akanki (ed) Unilag Readings in Law (University of Lagos, Lagos, 1999)}
\footnotetext[4]{The CBN has the power to grant and revoke banking licences. Previously, the approval of the President was required before a banking licence can be revoked, and this resulted in delays in granting approval for the revocation of licences for terminally distressed banks. This requirement was removed through an amendment to the Act in 1998. See ss 3 & 5 BOFIA}
\footnotetext[5]{The SEC was established by the Investments and Securities Act (ISA) of 1999 to regulates the capital market and to approve mergers and acquisitions}
\footnotetext[6]{NAICOM is vested with the responsibility for regulating the insurance industry under the National Insurance Commission Decree No. 1 of 1997 and the Insurance Act 2003}
\footnotetext[7]{The EFCC was established by the EFCC Act 2003, and is responsible for the prevention, investigation and prosecution of financial crime}
\end{footnotesize}
in 1994, to promote co-operation and co-ordination in the activities and policies of the various regulatory bodies.

The Nigerian financial system has undergone remarkable changes over the years and it has been shaped by economic as well as political factors. Regulatory initiatives have mainly been in response to crisis in the sector or as a tool for attaining certain policy objectives. While there was another crisis at the onset of the Structural Adjustment Programme, during which a significant number of banks failed, the sector enjoyed relative tranquillity thereafter.57

On 6 July 2004, the Governor of the CBN announced a major policy initiative that affected the banking sector as the minimum capital base for banks was increased to ₦25 billion. This development triggered a ‘regulatory-induced restructuring’58 as banks had to pool resources together through mergers and acquisitions. This has resulted in the so-called ‘consolidated’ Nigerian banking sector, which is currently made up of twenty five universal banks. This is perhaps the most significant event in the history of Nigerian banking and its regulation as it is believed that this would solve the various problems that have plagued the sector.59

Table 6.2 - Regulation and Supervision of Financial Institutions in Nigeria

57 There were 89 banks in operation at the end of 2004.
<table>
<thead>
<tr>
<th>Financial Institution</th>
<th>Applicable Law</th>
<th>Supervisory Agency</th>
<th>Insurance/Compensation Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Market Operators</td>
<td>ISA 1999, CAMA 1990.</td>
<td>SEC</td>
<td>None</td>
</tr>
</tbody>
</table>

**6.2. Deposit Insurance in Nigeria**

Deposit protection in Nigeria is the main responsibility of the Nigeria Deposit Insurance Corporation (NDIC). However, prior to the establishment of the NDIC (and even after its establishment), the CBN has, through its functions, directly or indirectly introduced policies for the protection of bank depositors. The financial safety net for the Nigerian banking sector consisted mainly of the Lender of Last Resort (LoLR) facility provided by the CBN and bank supervision. The government provided an

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implicit blanket guarantee of depositors’ funds with no formal arrangements for funding.

The establishment of the CBN followed a period of mass bank failure and loss of depositors’ funds. Although the laws establishing the CBN and governing its activities have been reviewed over time, they have contained basic provisions that serve the purpose of protecting bank depositors, albeit as an incidental purpose to the main object of the bank, which is to ‘promote monetary stability and a sound financial system in Nigeria’. These provisions include:

- Banking supervision;
- Capital requirements, Reserve Fund requirements and restriction of dividends;
- Emergency liquidity assistance;
- Restrictions on certain activities of licensed banks.

Before the establishment of the NDIC, the government generally adopted a policy of preventing bank failures to avoid adverse effects on public confidence in the banking system. Thus, the government had given financial support to most ailing banks, particularly where they had substantial interest in such institutions. However, following the adoption of the SAP, which was aimed at deregulating the economy, it was no longer viable for government to provide direct support to failing banks regardless of the financial position or quality of management.

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60 See Table 6.1.
61 CBN Act 2007, s.2.
63 BOFIN, ss.16 & 17.
64 BOFIN, s.20.
Deregulation opened the floodgates for new banking institutions and products. Increased competition among banks necessarily implied increased risk-taking, which put depositors’ funds at risk. The emphasis was thus shifted from failure prevention to the protection of small, unsophisticated depositors. This led to the establishment of an explicit deposit insurance scheme in 1988, which is administered by the NDIC.

6.2.1 The Nigeria Deposit Insurance Corporation

I. Organization/Institutional Structure

The NDIC was originally established by the repealed NDIC Act 1988. The NDIC Act 2006 provides for the establishment of a corporation with perpetual succession and a common seal. The authorized share capital of the Corporation is subscribed in a proportion of sixty per cent and forty per cent by the CBN and the Federal Ministry of Finance respectively. The NDIC is governed by a Board of Directors, which consists of the Chairman, the Managing Director, two Executive Directors, a representative of the CBN, a representative of the Federal Ministry of Finance, and six other members. Employees and directors of insured banks are precluded from being appointed as directors of the Corporation.

The Corporation is required to keep proper accounts in respect of each financial year, and the accounts must be audited within six months after the end of the financial year. The management of the Corporation is required to prepare and submit to the

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66 See NDIC Act 2006, s 11.
67 Ibid, s 5.
68 Ibid, s 48.
Board, not later than three months after the end of each financial year, a report on the activities of the Corporation during the immediately preceding financial year. The report is also to be submitted to the Governor of the CBN and the Minister of Finance.69

The establishment of the NDIC as an entity distinct from the CBN gives the Corporation a degree of independence to carry out its functions effectively without undue interference and conflict of interest. The Corporation’s independence is further strengthened by the requirement for the appointment of the Corporation’s Board members to be confirmed by the Senate. Under the 1988 Act, appointment of Board members was the sole prerogative of the President. However, some provisions of the NDIC Act have significantly undermined this independence.

The Board of Directors is established by section 5(1) of the Act as the Governing body of the Corporation, and section 7 vests in the Board, the powers to perform the various functions that the Corporation has been charged with under the Act. Section 5(4) gives the President the exclusive right to appoint all the members of the Board of Directors.

The extensive powers vested in the President, with regard to the composition of the Board, have the propensity to attenuate the Corporation’s ability to perform its functions independently. It is important to note that the NDIC Act 2006 merely makes the powers of the President subject to confirmation by the Senate. The confirmation of executive actions by the Senate in Nigeria has been known not to entail more than a rubber-stamping and political horse-trading process. The powers of the President

69 Ibid, s.49
leave the Corporation's management susceptible to political pressure, as they will be keen to remain in favour with the President, to whom they invariably owe their tenure in office. This might result in political lobbying and interference.

The provisions regarding appointment and composition of the Board, mirror the provisions of the 1988 Act, which was enacted at a time when Nigeria was under military dictatorship, when it was customary for appointments into important positions to be made solely by the President, without consultation with any other person or authority. This is in contrast with the norm in a democratic government where parliamentary review and approval is required for key appointments.

It is arguable that the political implications of regulatory failure will deter the government from exerting undue pressure on the Corporation, since it takes responsibility for the overall performance of the economy. However, it is important to note that experience with African governments has shown that decisions are not always necessarily motivated by the public good. It has been aptly opined that 'leaders act on behalf of private factions, be they social classes, military cliques, or ethnic groups. They engage in economic redistribution, often from the poor to the rich and at the expense of economic growth. These are the central themes in policy formation in Africa and their prominence serves to discredit any approach based on a conviction that governments are agents of the public interest.'

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70 For example, the government can put pressure on the NDIC to provide official support to politically connected but badly managed banks. This has the tendency to distort market incentives and reduce market discipline.
71 For comments on a similar provision for the appointment of the CBN Governor, see Osunbor (1992) (p45) 26.
72 See for example, the requirement for the appointment of the FDIC Board discussed in Chapter 5.
A reform of the NDIC Act should include appropriate provisions making the appointment of the members of the Board subject to parliamentary review and approval. Such review should involve the process of appointment as well as the terms of appointment of the Board members. This will not only go a long way in ensuring that the independence of the Corporation is guaranteed, it will also ensure that only competent and reputable persons are appointed to sit on the Board.

While the need to prevent arbitrariness and to promote accountability is important, the various provisions of the Act making the NDIC accountable only to the executive arm of government and the CBN do little to serve this purpose. Statutory provisions, similar to the provisions under the U.S. FDIC, which make the FDIC accountable to both the Treasury and Congress, should be introduced. Such provisions will make the Corporation ‘independent’ but ‘accountable’.

II. Mandate and Powers

The primary goal of the NDIC has been described as the maintenance of ‘stability and public confidence in the banking sector by guaranteeing payments to depositors in the event of failure of insured institutions as well as promoting safe and sound banking practices through effective supervision.’ Paragraph 3 of the NDIC Service Charter

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74 See the provisions of FSMA 2000, s.212(4) & (5) which provide that the Chairman and other members of the Board of the FSCS are to be appointed by the FSA but the terms of their appointment (particularly relating to removal from office) must be such that they are independent of the FSA in operating the compensation scheme.

75 See 12 USC § 1827.

76 See FSA, CPS8 (Financial Services Compensation Scheme Draft Rules), July 2000, para 4.8, where the relationship between the FSA and the FSCS is described as independent on a day-to-day basis but accountable.


78 The NDIC Service Charter was introduced pursuant to a social contract initiative of the Federal Government of Nigeria to improve the standard of public services in Nigeria. This initiative is known as SERVICOM, which is an acronym for ‘Service Compact with All Nigerians’. All government
also describes the NDIC’s mission as the protection of depositors ‘through effective supervision of insured institutions, provision of financial and technical assistance to insured institutions, prompt payment of guaranteed sums and early resolution of failed insured institutions.’

The NDIC can be described as a ‘risk-minimizer’ deposit insurer, with powers and responsibilities for deposit insurance, bank supervision and failure resolution. The functions of the NDIC are set out in Section 2 of the NDIC Act 2006 and these are:

- Insuring all deposit liabilities of licensed banks and other deposit-taking financial institutions operating in Nigeria so as to engender confidence in the Nigerian banking system;
- Giving assistance to insured institutions in the interest of depositors, in case of imminent or actual financial difficulties, particularly where suspension of payments is threatened, to avoid damage to public confidence in the banking system;
- Guaranteeing payment to depositors in case of imminent or actual suspension of payments by insured institutions up to the maximum coverage limit stipulated under the Act;
- Assisting monetary authorities in the formulation and implementation of banking policy so as to ensure sound banking practice and fair competition;
- Pursuing any other measures necessary to achieve the functions of the Corporation provided such measures are not repugnant to the objects of the Corporation.
In order to perform the functions it has been saddled with under the Act, the NDIC also has the following powers:

- Power to appoint examiners for the periodic examination of insured banks;\(^79\)
- Power to conduct special examinations of insured banks where the Board is of the opinion that an insured bank may be carrying on business in a manner detrimental to the interests of its creditors and depositors; may have insufficient assets to cover its liabilities; or may be contravening the provisions of the Act;\(^80\)
- Power to remove any officer or director who has committed any violation of the law, rules or regulations of the Corporation or is engaged in unsound practices that may lead to the bank suffering financial loss;\(^81\)
- Power to terminate the insured status of any bank;\(^82\)
- Power to act as liquidator and receiver of closed banks;\(^83\)
- Power to invest funds not immediately required on Federal Government securities or in such other securities as the Board may from time to time determine;\(^84\)
- Power to establish a separate Deposit Insurance Fund for each category of insured institutions;\(^85\) and
- Power to require information relating to matters affecting the interests of depositors of insured banks.\(^86\)

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\(^79\) To good service delivery. Thus, SERVICOM Charters are not legally binding documents.

\(^80\) NDIC Act, s.28; the examiners appointed shall have access to any accounts, returns and information with respect to any insured bank, which are in the possession of the CBN. For a detailed description of the NDIC supervisory and examination process, see Umoh (1997) (n65) 89.

\(^81\) Ibid, s.7 (k).

\(^82\) Ibid, s.23.

\(^83\) Ibid, s.40

\(^84\) Ibid, s.13.

\(^85\) Ibid, s.10(2).
• Failure resolution powers of the Corporation are contained in sections 37 to 44 of the Act.

The Act also imposes certain duties on insured banks in order to ensure the effective implementation of the objectives for which the NDIC was created. These duties include:

• The production of all books, accounts, documents and all information upon request by the examiner in the exercise of his functions;\(^87\)

• The obligation to pay premiums to the NDIC. The premium payable under the Act is not to be charged to depositors in any form by the insured banks;\(^88\)

• The obligation to render returns of fraud or theft, which shall include a detailed report of such event, to the NDIC;\(^89\)

• Insured banks must inform the NDIC of any staff dismissed or advised to retire on grounds of fraud. Insured banks are also required to inform the Corporation before employing any staff who has left the services of another insured bank under the above circumstances.\(^90\)

The last two requirements are essentially designed to enable the NDIC minimize the incidence of bank failure caused by fraud.\(^91\) The Act also prescribes various offences and penalties to be imposed on insured banks where they fail to comply with the requirements.\(^92\)

\(^86\) Ibid, s.27.
\(^87\) Ibid, s.29(2).
\(^88\) Ibid, s.17(1), (3).
\(^89\) Ibid, s.35.
\(^90\) Ibid, s.36.
\(^91\) See Osunakpo (1990) (n41) 39.
\(^92\) See NDIC Act ss.27(4); 29(3); 17(7); 30(3).
III. Funding

Section 10 of the NDIC Act 2006 provides that the funds of the Corporation shall consist of assessed premiums paid by insured banks; income from the investments of the corporation; money borrowed from any source with the approval of the board; and money from any other source as may be approved by the Corporation.

Deposit Insurance premium is assessed on a flat rate based on the total deposit liabilities of insured banks.93 The NDIC can levy special premiums where the funds of the Corporation are insufficient for its functions.94 Although Section 52 enables the NDIC to borrow funds from the CBN for the discharge of its functions, it is doubtful if this option will ever be utilised, except for the purposes of deposit payouts following a major banking crisis. This is due to the fact that it may be interpreted as a sign of insolvency capable of undermining public confidence in the deposit insurance system. Thus, the main source of funding for the deposit insurance scheme is the premium levied on insured banks.

As noted earlier, a fundamental principle of insurance contracts is that the premiums charged for an insurance product must adequately reflect the risk posed to the insurer. For deposit insurance purposes, a risk-based assessment system not only ensures equity but also adequacy of funding and it helps to mitigate the risk of moral hazard. The problem with risk-adjusted premiums however is that of practicability, especially for developing countries. This centres on the availability of indices to measure risk and the difficulties in calculating risk ex ante. In Chapter 3, it was suggested that

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93 This is fifteen sixteenth of 1% per annum for licensed banks and eight-sixteenth of one percent per annum for other deposit-taking financial institutions of the total deposit liabilities standing in its books as at 31 December of the preceding year. See NDIC Act. s.17.
94 See NDIC Act. s.17(5).
developing countries should apply ‘simplicity’ and ‘gradualism’ in introducing risk-based assessment systems.

Banking supervision in Nigeria has been transaction and compliance based. Supervisory measures are reactionary and applied uniformly to all financial institutions regardless of their risk posture. This is reflected in the average cycle of periodic on-site examination (once a year), which is the same for all institutions.95

As part of recent measures to reform the supervisory process in Nigeria, the CBN and NDIC jointly approved a ‘Framework for Risk Based Supervision in Nigeria’,96 and implementation of this framework commenced in September 2006. The adoption of risk-based supervision has become necessary for two main reasons. First, new technology and products, and the nature of financial transactions have changed the nature of banking. Second, the need for compliance with the Basel Core Principles on Supervision and the New Capital Accord.97 The adoption of risk-based supervision would also enable the NDIC to introduce a risk-based premium assessment system.

Section 17(2) of the NDIC Act 2006 gives the NDIC power to vary the rate or basis for assessment of deposit insurance premium or to charge premium at a rate which reflects the risk posed to the Deposit Insurance Fund. The transition from a flat-rate assessment system to a risk-based system must be carefully planned and managed. Policymakers and stakeholders must fully comprehend the objectives and resource requirements of the new system. This necessarily implies a transition period of

96 Ibid.
97 Ibid.
extensive research and consultation. In introducing the new assessment system, the following points should be considered:

- An important precondition for the implementation of a risk-based assessment system is that risk evaluation must be based on available and verifiable information;
- In differentiating banks into risk categories, the number of categories should depend on the information that is available to the deposit insurer and the resources at the disposal of the deposit insurer for evaluating such information;\(^9\)
- A fair balance should be maintained between the need for a transparent process and the need to protect confidentiality of information. Care should be taken so that depositors do not use the risk-profiling criteria or premium categorization as a means for choosing where to place their funds. It is also possible that the movement of financial institutions across the different categories of risk might be misunderstood as a sign of insolvency, which may trigger depositor runs;\(^9\)
- In determining the rate to be ascribed to each premium category, the need to ensure adequate funding for the system should be balanced on the one hand, with the need to provide an incentive-compatible system for insured institutions on the other. The rates charged should be seen more as a means of


\(^{99}\) Ibid.
encouraging better risk-management in insured institutions than a means of increasing revenue for the deposit insurer.¹⁰⁰

Whereas ‘simplicity and gradualism’ has been recommended for new deposit insurance systems, after twenty years of operation, the NDIC can not strictly be described as a new system. Nonetheless, a simplistic approach should be adopted in introducing the proposed assessment system. The process should not be made complex but should be easily understood by insured banks and depositors. An intensive public-awareness campaign would ensure that depositors clearly understand the purpose of the new assessment system.

The NDIC should also ensure that the system is not too complex for it to implement, considering the capacity building challenges faced by the Corporation.¹⁰¹ The adequacy of the overall supervisory framework, particularly the availability and reliability of information should be the most important consideration.

IV. Coverage

All deposits of licensed deposit-taking institutions are insured with the Corporation. However, the following types of deposits are not covered by deposit insurance:

- Insider deposits (deposits of staff and directors of licensed banks);
- Counter-claims from a person who maintains both a deposit and loan accounts, the former serving as a collateral for the loan; or

¹⁰¹ This is considered later in this chapter.
• Such other deposits as may be specified from time to time by the Board. 102

The NDIC excludes coverage of foreign deposits in domestic banks because such deposits do not affect the level of money supply in the domestic economy. 103 Inter-bank deposits are however covered by the NDIC and such deposits form part of the premium assessment base. They are generally viewed as deposits in the receiving bank on which premium is to be charged. This has also been justified on the basis that it removes the incentive for banks to develop a series of ‘swap games’ for premium avoidance. 104 The inclusion of inter-bank deposits in deposit insurance coverage is a departure from sound practice as it could potentially exacerbate the moral hazard problem associated with deposit insurance. There are proposals to exclude inter-bank deposits from deposit insurance coverage under a new deposit insurance law.

At the establishment of the Corporation in 1988, deposit insurance coverage was pegged at N 50,000 per depositor per insured bank. The coverage limit remained until 2006 and the adequacy of this amount was a subject of contention. In 1994, the research department of the NDIC conducted a survey to access the public perception of the Corporation’s activities, and majority of respondents to the survey opined that the N 50,000 coverage limit was generally inadequate. 105 Following the promulgation of the NDIC Act 2006, the coverage limit has been increased to N 200,000 for licensed banks and N 100,000 for licensed deposit taking financial institutions. 106 It is however interesting to note that the old coverage limit remained the same despite the fact that its value was significantly reduced by inflation over the years. When the

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102 NDIC Act, s.16.
104 Ibid.
105 See Umoh (1999) (n103) 51.
106 NDIC Act 2006, s.20.
NDIC commenced operations in 1989, the value of the maximum coverage limit was equivalent to $10,860; at the time the limit was increased, it was equivalent to $390. At the current exchange rate, the new coverage limit is equivalent to $1,110 for licensed banks and $555 for licensed deposit-taking financial institutions.

There have been several calls for an increase in the maximum coverage limit in Nigeria with majority of depositors and insured banks advocating full coverage of deposits. In Chapter 4, it was recommended that deposit insurance coverage should be set at a level that bears some relationship with the average measure of income or wealth in a nation. The IMF recommends using ‘twice per capita income’ as a rule of thumb in fixing coverage limits.\footnote{107} Nigeria’s per capita income currently stands at approximately $1,000;\footnote{108} hence based on the measure of income, the coverage limit can be described as inadequate.

The previous coverage limit of N 50,000 was set in 1989 (through a survey) to ensure that approximately eighty five per cent of the total deposits in insured banks would be fully covered by deposit insurance.\footnote{109} This raises two basic issues in relation to the coverage limit:

\footnote{109} See Umoh (1999) (n103) 52.
1. Moral hazard considerations, if any, did not play a significant part in this policymaking process. It appears that the primary concern was the protection of small, unsophisticated depositors.

2. The policymakers did not give any consideration to a likely change in the circumstances on which the limit was based; hence the NDIC Act makes no provision for the coverage limit to be reviewed as these circumstances necessarily change over time.

In relation to these issues, the new coverage limit of ₦200,000 is a welcome development as this is the first time the limit will be reviewed since the introduction of deposit insurance in Nigeria. However, in real terms, the new coverage limit (approximately $1,110) is not commensurate with the country’s per capita income, and is less than the value of ₦50,000 in 1989. In relation to the second issue raised above, section 20(2) of the NDIC Act 2006 gives the NDIC the power to vary upwards the maximum coverage limit.

V. Bank Supervision

Bank supervision is an important aspect of the NDIC’s risk-minimizing mandate. As noted earlier, an effective system of bank supervision is a necessary precondition for the successful implementation of a deposit insurance scheme. The NDIC’s involvement in banking supervision complements the supervisory functions of the CBN but with an emphasis on consumer protection. The main objective is to reduce the risk to the deposit insurance fund and the risk of failure by ensuring that unsafe and unsound practices are promptly detected.

10 See Ogunleye (2007) (n52) 332.
The supervision process entails onsite examination and offsite surveillance of insured financial institutions. Bank examination involves onsite assessment of insured banks, which is carried out through the Field Examination Department of the NDIC. The Department conducts two types of bank examinations, which are: routine and special examinations.

Off-site supervision involves the surveillance of the activities of insured financial institutions through the analysis of their statutory returns and monitoring of their compliance with laws and regulations. It consists of three main supervisory activities. The first involves the continuous evaluation of the financial condition and performance of insured banks, and monitoring compliance with prudential guidelines. The second activity involves the assessment of the deposit base of insured institutions for purposes of determining deposit insurance premium, while the third is the financial and technical assistance to insured financial institutions and the management of failing banks, which includes the review of turn-around plans and failure resolution options.

The aim of off-site supervision is to give the supervisory authorities early warning signals of emerging problems at insured institutions. However, the attainment of this goal depends not only on the accuracy and reliability of the data gathered from the process employed, but also on the quality of its subsequent analysis and evaluation.

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112 Routine examinations are conducted at periodic intervals, usually once a year, and carried out in conjunction with the Bank Supervision Department of the CBN.
113 Special examinations are carried out under circumstances stipulated in the NDIC Act, s.30.
114 See Umoh (1999) (n103) ch.6.
In order to improve the accuracy and reliability of the data gathered in the surveillance process, the NDIC is presently upgrading its main tool for off-site surveillance, the Bank Analysis System (BAS),\textsuperscript{116} to the more advanced electronic Financial Analysis and Surveillance System (e-FASS).\textsuperscript{117} While this is a plausible development, there is a dearth of skilled and experienced manpower in the Corporation, and this makes it difficult to provide qualitative analysis and evaluation of returns generated from the surveillance process. This poses a capacity building challenge for the Corporation’s management, and recently, the NDIC has focussed on capacity building efforts through training and development of relevant skills for off-site surveillance and modern information technology systems.\textsuperscript{118}

In addition to these efforts at capacity building, the NDIC also requires technical assistance from relevant international organizations toward the full training of its staff. It should also be noted that the shortage of skilled and experienced personnel is not a problem that pervades the entire Nigerian financial sector. Rather, the problem lies in the increased competition from the private sector, that the regulatory agencies face for the services of such skilled employees. The private sector is generally more attractive to prospective employees because of the better remuneration it offers.

VI. Failure Resolution/Payment of Insured Deposits

\textsuperscript{116} BAS is a computer programme for data gathering and preliminary analysis.
\textsuperscript{117} e-FASS is a web-enabled analytical and validation programme. The system automatically picks data from an institution’s database and generates electronic reports.
Generally the NDIC can resolve a troubled financial institution through rehabilitation,\textsuperscript{119} the use of bridge banks, liquidation or depositor payoff.

The NDIC is required to give assistance, in the interest of depositors, to banks faced with imminent or actual financial difficulties particularly where there is the threat that payments might be suspended.\textsuperscript{120} Section 37(1) of the NDIC Act enables the NDIC to give assistance at the request of an insured bank and under such circumstances as may be specified by the Corporation if the bank:

a) has difficulty in meeting its obligations to depositors and other creditors; or

b) persistently suffers liquidity deficiency; or

c) has accumulated losses which have nearly or completely eroded the shareholders' fund.

Section 37(2) gives the NDIC the following options in assisting a failing bank:

a) Grant loans on such terms as may be agreed upon by the Corporation and the bank;

b) Give guarantee for a loan taken by the insured bank;

c) Accept an accommodation bill with interest;

Section 38(1) provides that the NDIC in consultation with the CBN may:

\textsuperscript{118} This has involved training and exposure of NDIC staff to modern techniques of banking supervision at foreign regulatory agencies such as the Federal Reserve, FDIC, Toronto Leadership Centre, Financial Stability Institute, and the Financial Services Authority. See Ogunleye (2007) (n52) 332.

\textsuperscript{119} Since the establishment of the CBN, rehabilitation of distressed banks had always been the preferred option for resolving failing financial institutions. However, following the introduction of the Structural Adjustment Program (SAP) and the deregulation of the banking sector, depositor protection became the primary consideration in choosing a resolution option.

\textsuperscript{120} NDIC Act, s.2(1)(b).
i. take over the management of the bank until its financial condition has substantially improved;

ii. direct specific changes to be made to the management of the bank:

iii. arrange a merger with another bank or contract to have the deposit liabilities assumed by another insured bank.

Where the Corporation directs that a failing bank should merge or consolidate with any other financial institution, the institution merged or consolidated with the failing bank will assume the deposit liabilities of the failing bank or settle any other financial liability. Any asset of the failing bank will be transferred or vested in the other financial institution.121

Whenever the licence of an insured financial institution is revoked by the CBN, the NDIC is mandated to act as liquidator of such failed bank, with powers conferred on a liquidator under the Companies and Allied Matters Act 1990 and shall be deemed to have been appointed as provisional liquidator for the purpose of that Act.122 The Corporation is required to cause notice to be given by advertisement for depositors of the institution under liquidation to send their claims to the Corporation.123 In its role as liquidator, the NDIC is expected to realise the assets of the failed bank and wind up its affairs. The Corporation is entitled to receive from the liquidation any such amount on account of its subrogation to the claims of depositors, and the net amount available for distribution would be paid to depositors and other creditors.124 This net amount is referred to as the liquidation dividend.

121 [Ibid. s. 38 (c).]
122 [Ibid. s. 40 (1).]
123 [Ibid. s. 41 (1).]
Where the licence of an insured bank has been revoked, the Act requires that the Corporation shall make payments of insured deposits to depositors within 90 days either by cash, negotiable instrument or by transferring the deposits to another insured bank in an amount equal to the insured deposits of such depositors. Paragraph 6 of the NDIC Service Charter also provides that insured depositors of closed insured deposit-taking institutions are to be paid within ninety days of the closure of the institution and the appointment of the NDIC as liquidator by a court of competent jurisdiction.

Prompt payment of insured deposits is essential to the maintenance of depositor confidence and the prevention of bank runs. The Corporation has always attempted to effect the payment of the maximum insured deposits as soon as practicable. However, the recent run on Northern Rock in the UK has shown that a time limit of three months is not sufficient to sustain the level of confidence needed to prevent a bank run. Furthermore, because of the low maximum coverage limit, payment of insured deposits is unlikely to assuage concerned depositors until liquidation has been completed and the Corporation starts to pay out significant sums to depositors as liquidation dividends.

6.2.2 NDIC and Bank Failure in Nigeria

The deposit insurance scheme was introduced at a time of crisis and the Corporation had been involved in managing distressed banks even before it could settle down and muster enough resources for the gigantic task. The introduction of the Structural Adjustment Programme necessitated the liberalization of the financial sector, which

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124 Ibid, s.41(2).
125 Ibid, s.21(1).
eased restrictions on market entry, interest rates, bank ownership, foreign exchange and capital movement. The immediate explosion in the number of financial services providers and products was however not accompanied with an adequate supervisory and regulatory framework. The implications of the economic policy, coupled with the political crisis experienced in Nigeria in the early nineties, meant that the NDIC was created at a time when the banking sector was significantly weakened.\(^{128}\)

The problem in the financial sector was further exacerbated by the decision to transfer all public sector funds from the banks to the CBN in order to reduce excess liquidity in the system. As many banks relied on government funds for liquidity, this decision triggered a serious liquidity problem in the sector.\(^{129}\) Shortly after the NDIC commenced operations in 1989, it had to provide assistance in the form of accommodation bill facilities worth ₦2.3 billion granted to ten distressed banks.\(^{130}\)

This measure helped in restoring a degree of public confidence in the system, however the problems persisted and the Corporation had to grant further assistance to banks in 1992 and 1993.\(^{131}\)

The persistence of the problem in the banking sector made the NDIC to evaluate its failure resolution policy and to explore other appropriate means of addressing bank distress. The regulatory philosophy of preventing bank failure was expanded to include the protection of depositors’ funds and minimization of the disruptive effects of bank failure when it occurs. Several banks have become distressed since the

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128 Half of the total number licensed banks were distressed or insolvent, with two-thirds of assets and 75\% of deposits at risk. See P Lewis and H Stein ‘Shifting Fortunes: The Political Economy of Financial Liberalization in Nigeria’ (1997) 25 World Development 1, 5.
130 See NDIC Presentation to the Senate Committee on Banking, Insurance and Financial Institutions 21 March 2005.
inception of the Corporation to date and the Corporation has used several options permitted in its enabling law, which include:\(^{132}\)

- The provision of accommodation facilities, worth \(N\) 2.3 billion, to 10 banks in 1989;
- Take-over of management and control of 28 distressed banks by the CBN/NDIC to protect their assets and depositors' funds;\(^{133}\)
- Acquisition, restructuring and sale of 7 distressed banks to new investors: and
- Closure of 36 banks for failure to comply with regulatory/supervisory requirements.

It appears that bank liquidation has become the preferred option for resolving distressed banks by the NDIC. The Corporation has sought to close distressed banks in a cost-effective way with minimum disruption to the banking system. The liquidation process can only commence after a bank’s licence has been revoked by the CBN.\(^{134}\) Previously, after the revocation of the licence the Corporation was required to apply to the Federal High Court for a winding up order of the affairs of the bank and to be appointed as liquidator. This procedure has now been abrogated under the NDIC Act 2006 and the NDIC assumes the role of liquidator by default following the revocation of a bank’s licence.\(^{135}\) The procedure to be followed by the NDIC, in carrying out its functions as receiver/liquidator of a failed bank, is contained in Part IX of the NDIC Act 2006.

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\(^{132}\) See Ogunlewe (2007) (n52) 334.

\(^{133}\) Recent examples include the removal of the Board and Management of 3 banks in 2005, and the removal of the Board and Management of Spring Bank Plc in June 2007.

\(^{134}\) See BOFI 1991, s.39.

\(^{135}\) NDIC Act, s.40.

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Table 6.3 provides the details of distressed/failed banks that have been liquidated in Nigeria since the inception of the Corporation. There are various factors that have contributed to bank distress in Nigeria; these factors include liquidity risk, foreign exchange risk, credit risk and political risk.\textsuperscript{136} Table 6.4 however shows that credit risk has been a major factor in the crisis in the banking system. In most cases, bad loans exceeded fifty per cent of the total loan portfolio and realization of these loans would have been sufficient to recapitalize the distressed banks. Table 6.5 also shows the extent to which excessive specialization contributed to the problem. There was a high concentration of insider loans to a certain group of borrowers, consisting mainly of directors and major shareholders.

The problem of non-performing loans is not peculiar to Nigeria; it has been observed that ‘bad debts are by far the most common cause of bank failure.’\textsuperscript{137} What appears to be a specific problem is the extent to which insider abuse has contributed to the problem. Generally, banks have devised means of dealing with credit risks which include the use of individual credit limits, risk-related interest rates, collateralization, and diversification of loan portfolios. While these mechanisms have been found to have limited effectiveness,\textsuperscript{138} the problem of credit risk management becomes more complex where there have been incidents of insider abuse. Where loans are given out to directors and shareholders, the prospects of recovering such loans becomes

\textsuperscript{137} V Beattie and others \textit{Banks and Bad Debts: Accounting for Loan Losses in International Banking} (John Wiley, London, 1995) 1.
particularly low.\textsuperscript{139} In this regard it is important to consider the contribution of the Failed Banks Decree towards the recovery of bad loans in Nigeria.

6.2.2.1. The Failed Banks Decree 18 of 1994

The promulgation of the Failed Banks Decree of 1994 represents a major development in the experience of the NDIC with bank failure. A major contributory factor to distress in the sector was the issue of bad debts.\textsuperscript{140} The closing reports of many of the failed banks revealed a high degree of insider dealing characterized by the granting of unsecured credit facilities to owners, directors and connected companies. In most cases, these facilities exceeded the banks’ lending limits.\textsuperscript{141} Thus, in addition to other regulatory measures that were introduced at the time, the government also introduced the Failed Banks (Recovery of Debts) and Financial Malpractices Decree.

The main objectives of the decree were to facilitate the recovery of debts owed to distressed banks, and to introduce a framework for the prosecution of persons involved in financial malpractices that led to bank failure. Although most of the offences were already covered by existing criminal laws and procedure, such laws and procedure were considered slow and insufficient to deal with the special nature of bank failure.

Section 1 of the decree established a special court, known as the Failed Banks Tribunal. The tribunal had the power to:

\footnotesize{\textsuperscript{139} See Interview with Moses Uzoegbu, Deputy General Manager, Risk Management & Operations, Chartered Bank Plc ‘On Debt Recovery in Nigeria’ \textit{Credit Risk & Lender’s Deskmate}, July-September, 2004.}

\footnotesize{\textsuperscript{140} See Umoh (1997) (n65) Ch. 10; JU Eh hodaghe ‘The Impact of Failed Banks on the Nigerian Economy’ (1996) 6 NDIC Quarterly 1 & 2, 24.}
• Recover the debts\textsuperscript{142} owed to a failed bank, which remain outstanding at the date the bank is closed or declared a failed bank by the CBN;\textsuperscript{143}

• Try the offences specified in part III of the decree;\textsuperscript{144}

• Try the offences specified in the Banks and Other Financial institutions Decree 1991, and the NDIC decree 1988; and to

• Try other offences relating to the business or operation of a bank under any enactment.

The Tribunal consisted of a single judge, with both civil and criminal jurisdictions. In order to eliminate the delay that had become a feature of the Nigerian judicial system, under Section 4 of the decree, the Tribunal was required to decide matters brought before it within twenty one days from the first day of sitting. To achieve this, Section 3 of the decree gave the Tribunal the power to decide any ancillary matters, including remand, bail and any other preliminary issues connected with an offence or hearing. Section 1(5) of the decree specifically restricts the High Court from exercising its supervisory jurisdiction by way of judicial review over the decisions of the Tribunal, and appeals from such decisions could only be made to a special military appeal tribunal.\textsuperscript{145}

\textsuperscript{141} Se SA Oluwemi 'Banking Sector Reforms and the Imperatives of Good Corporate Governance in the Nigerian Banking System' (2005) 16 NDIC Quarterly 1, 72.

\textsuperscript{142} 'Debt' in the interpretation section is defined as any loan, advance, credit, accommodation, guarantee or any other credit facility, together with the interest thereon, which remains outstanding.

\textsuperscript{143} The application for debt recovery was required to be filed by the receiver or liquidator of the failed bank, s.15(1) of the decree empowered the tribunal to have a debtor's property, against which an order is made, sold by auction or by private contract, and the proceeds applied towards settling the debt.

\textsuperscript{144} Under part III of the decree, any director, manager, officer or employee of a bank is guilty of an offence if he grants or approves a loan without adequate security or collateral; grants a loan in contravention of any law or regulation; or receives any gratification for granting a loan.

\textsuperscript{145} This is known as an 'ouster clause', and was a main feature of military legislation in Nigeria. See F. Avinge Law Making Under Military Regimes: The Nigerian Experience (Oluw, Benin City, 1994) ch.10.
The establishment of the Failed Banks Tribunal was particularly complementary to the efforts of the NDIC in failure resolution. The treatment of bad assets and loans is central to an effective resolution framework, particularly the legal issues pertaining to the recovery of loans and the disposal of assets. The Failed Banks Tribunal was effectively used by the NDIC to realise risk assets and to recover from debtors of failed banks and from insiders who abused their positions to fraudulently appropriate loans worth millions of Naira to themselves.146

The concept of the Failed Banks Tribunal has been described as a ‘speedy, simple, efficient and effective judicial machinery devoid of legal technicalities for aggressively recovering debts owed to failed banks.’147 Banking malpractices in Nigeria can rightly be classified as an ‘elitist’ crime. Such crimes are often committed for economic gains with the individuals or corporations involved belonging to an elite political and economic class. Most recalcitrant bank debtors also belong to this class, which shields them from the consequences of their actions.

The influence wielded by the perpetrators of these malpractices limits the ability of the criminal justice system to bring them to account for their actions, the failed Banks Tribunal was a potent tool in the prevention and punishment of such malpractices and in the recovery of debts, as the Tribunal was instrumental in the recovery of ₦6 billion in bad debts.

The above-mentioned success notwithstanding, the tribunals set up under the Decree were dissolved in May 1999, with the onset of democratic governance in Nigeria. The

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146 See Umoh (1999) (n103) ch.9.
use of military-style Tribunals is generally considered an aberration in a democratic
society. This is mainly because of the violations of human rights and due process
provisions in the processes and procedure followed by such tribunals. Human rights
and due process considerations become particularly important as the Failed Bank
Tribunal was vested with civil and criminal jurisdiction, with no possibility of
review by the High Court.

Following the dissolution of the Tribunal, its jurisdiction was transferred to the
Federal High Court and since then no new or pending case has been concluded. This
underscores the need for the establishment of specialist courts to deal with banking
and other allied matters in Nigeria. The special nature of banks and the need to
promote financial stability is the justification for the various structures that exist for
the supervision of the industry. This same justification can be extended for the
establishment of such courts, with special procedures, which would ensure the speedy
resolution of cases involving the recovery of debts owed to failed banks, and in turn
ensure that depositors and creditors of such banks are promptly reimbursed.

117 GA Ogunleye ‘Overview of Recovery of Debts Through the Failed Banks Tribunals: The NDIC
Experience’ in Proceedings of the National Seminar on Banking and Allied Matters for Judges (CIBM,
Lagos, 2002).
118 See generally F. Iruka ‘Military Tribunals and Due Process in Nigeria’ (Constitutional Rights Project
CRP, Lagos, 1999); G Irokalibe ‘The Failed Banks and Failed Institutions Tribunals and Their Impact
on the Rule of Law’ in F Okeye (ed) Special and Military Tribunals and The Administration of Justice
in Nigeria (Human Rights Monitor HRM, Kaduna, 1997)
119 In relation to the Failed Banks Tribunal, these considerations include the arbitrary powers of the
tribunal; absence of judicial review; stringent bail conditions; and absence of a right of appeal to
### Table 6.3 - Distressed/Failed Banks in Nigeria (1988 to date)\(^{150}\)

<table>
<thead>
<tr>
<th>Banks</th>
<th>Date of Closure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abacus Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>ABC Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Allied Bank of Nigeria Plc</td>
<td>16 January 2006</td>
</tr>
<tr>
<td>All States Trust Bank Plc</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Alpha Merchant Bank Plc</td>
<td>8 September 1994</td>
</tr>
<tr>
<td>Assurance Bank of Nigeria Plc</td>
<td>16 January 2006</td>
</tr>
<tr>
<td>Century Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>City Express Bank Plc</td>
<td>16 January 2006</td>
</tr>
<tr>
<td>Commerce Bank Plc</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Commercial Trust Bank Ltd</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Credite Bank Nigeria Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Crown Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Financial Merchant Bank Ltd.</td>
<td>21 January 1994</td>
</tr>
<tr>
<td>Great Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Group Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Hallmark Bank Plc</td>
<td>16 January 2006</td>
</tr>
<tr>
<td>Highland Bank of Nigeria Plc</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>ICON Ltd. (Merchant Bankers)</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Ivory Merchant Bank Ltd.</td>
<td>22 December 2000</td>
</tr>
<tr>
<td>Kapital Merchant Bank Ltd</td>
<td>21 January 1994</td>
</tr>
<tr>
<td>Lead Bank Plc</td>
<td>16 January 2006</td>
</tr>
<tr>
<td>Lobi Bank of Nigeria Ltd</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Merchant Bank of Africa Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Metropolitan Bank Ltd.</td>
<td>16 January 2006</td>
</tr>
</tbody>
</table>

\(^{150}\) Source: [http://www.ndic-ng.com/failed_institutions.htm](http://www.ndic-ng.com/failed_institutions.htm), accessed 3 July 2007. The table does not contain details of some banks whose licences have been revoked by the CBN because the Federal High Court has not granted winding up orders and has not appointed the Corporation as liquidator for the banks.
<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nigerian Merchant Bank Ltd</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>North-South Bank Nigeria Plc</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Pan African Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Pinnacle Commercial Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Premier Commercial Bank Ltd.</td>
<td>22 December 2000</td>
</tr>
<tr>
<td>Prime Merchant Bank Ltd</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Progress Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Republic Bank Ltd.</td>
<td>29 June 1995</td>
</tr>
<tr>
<td>Rims Merchant Bank Ltd</td>
<td>22 December 2000</td>
</tr>
<tr>
<td>Royal Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
<tr>
<td>Trade Bank Plc</td>
<td>16 January 2006</td>
</tr>
<tr>
<td>United Commercial Bank Ltd.</td>
<td>8 September 1994</td>
</tr>
<tr>
<td>Victory Merchant Bank Ltd.</td>
<td>16 January 1998</td>
</tr>
</tbody>
</table>
Table 6.4 - Portfolio of Distressed Nigerian Banks (1989-2000)\textsuperscript{151}

<table>
<thead>
<tr>
<th>Period</th>
<th>Number of Distressed Banks</th>
<th>Total Loans (₦ Billions)</th>
<th>Bad Loans (₦ Billions)</th>
<th>Amount Required for Recapitalization (₦ Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>7</td>
<td>4.3</td>
<td>2.9</td>
<td>1.1</td>
</tr>
<tr>
<td>1990</td>
<td>9</td>
<td>6.4</td>
<td>4.7</td>
<td>2.0</td>
</tr>
<tr>
<td>1991</td>
<td>15</td>
<td>5.4</td>
<td>4.1</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>16</td>
<td>15.7</td>
<td>6.8</td>
<td>5.5</td>
</tr>
<tr>
<td>1993</td>
<td>38</td>
<td>29.1</td>
<td>18.4</td>
<td>13.6</td>
</tr>
<tr>
<td>1994</td>
<td>55</td>
<td>39.4</td>
<td>26.2</td>
<td>23.4</td>
</tr>
<tr>
<td>1995</td>
<td>60</td>
<td>66.5</td>
<td>44.5</td>
<td>38</td>
</tr>
<tr>
<td>1996</td>
<td>50</td>
<td>51.8</td>
<td>40.8</td>
<td>42.5</td>
</tr>
<tr>
<td>1997</td>
<td>47</td>
<td>49.6</td>
<td>39.7</td>
<td>42.4</td>
</tr>
<tr>
<td>1998</td>
<td>15</td>
<td>24.2</td>
<td>18.6</td>
<td>16.2</td>
</tr>
<tr>
<td>1999</td>
<td>13</td>
<td>29.1</td>
<td>20.9</td>
<td>15.3</td>
</tr>
<tr>
<td>2000</td>
<td>7</td>
<td>26.4</td>
<td>20.0</td>
<td>10.3</td>
</tr>
</tbody>
</table>

\textsuperscript{151} Source: NDIC Annual Report and Bank Returns.
Table 6.5 - Extent of Insider Credits in Selected Failed Banks in Nigeria

<table>
<thead>
<tr>
<th>Bank</th>
<th>Percentage of Insider Loans as a Ratio of Total Loan Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abacus Merchant Bank Ltd.</td>
<td>47.00</td>
</tr>
<tr>
<td>ABC Merchant Bank Ltd.</td>
<td>50.66</td>
</tr>
<tr>
<td>Alpha Merchant Bank Plc</td>
<td>55.00</td>
</tr>
<tr>
<td>Amicable Bank of Nigeria Ltd.</td>
<td>56.00</td>
</tr>
<tr>
<td>Century Merchant Bank Ltd.</td>
<td>32.00</td>
</tr>
<tr>
<td>Commerce Bank Plc</td>
<td>52.00</td>
</tr>
<tr>
<td>Commercial Trust Bank Ltd</td>
<td>55.90</td>
</tr>
<tr>
<td>Credite Bank Nigeria Ltd</td>
<td>76.00</td>
</tr>
<tr>
<td>Financial Merchant Bank Ltd</td>
<td>66.89</td>
</tr>
<tr>
<td>Group Merchant Bank Ltd.</td>
<td>77.60</td>
</tr>
<tr>
<td>Highland Bank of Nigeria Plc</td>
<td>38.00</td>
</tr>
<tr>
<td>Kapital Merchant Bank Ltd.</td>
<td>50.00</td>
</tr>
<tr>
<td>Nigeria Merchant Bank Ltd.</td>
<td>99.90</td>
</tr>
<tr>
<td>North-South Bank of Nigeria Ltd.</td>
<td>32.00</td>
</tr>
<tr>
<td>Pinnacle Commercial Bank Ltd.</td>
<td>20.00</td>
</tr>
<tr>
<td>Prime Merchant Bank Ltd.</td>
<td>80.70</td>
</tr>
<tr>
<td>Republic Bank Ltd.</td>
<td>64.90</td>
</tr>
<tr>
<td>Royal Merchant Bank Ltd.</td>
<td>69.00</td>
</tr>
<tr>
<td>United Commercial Bank Ltd.</td>
<td>81.00</td>
</tr>
</tbody>
</table>

6.2.2.2. Challenges in Resolving Failed Banks in Nigeria

An effective and orderly failure resolution mechanism is essential to avoid or minimize the disruptive effects of bank failure. In Nigeria, certain conditions have prevented the effectiveness of the failure resolution mechanism; these conditions will be discussed below.

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152 Source: Closing Reports, Receivership & Liquidation Department, NDIC.
153 See Chapter 4, para.4.8.
I. Absence of Contingency Planning and Prompt Corrective Action

A framework for contingency planning for banking crises was jointly articulated by the CBN and NDIC in 2001. The framework provided for the roles and responsibilities of regulators and regulated institutions in a crisis. These included specific thresholds for Prompt Corrective Action (PCA) measures; failure resolution options; and approved contingency plans by each regulated institution.

Despite this effort, most of the plans submitted have been considered as ‘inadequate or unrealistic’, and no serious attempts have been made towards implementing any of the contingency plans. This could be attributed to the fact that PCA must be statutorily formalised to have the desired effect. The successful liquidation of a failed bank is based on the value of assets to be realised from the liquidation exercise. PCA would allow distressed banks to be closed promptly before the value of their assets turn negative. In the absence of a statutory based PCA mechanism, the potential for regulatory forbearance still exists, particularly because of the fear of litigation in the event that a bank has to be closed.

A corrective action framework should include the powers for regulators to require that internal control systems are in place and are being complied with. The supervisor should also be given the right to have access to relevant information and more powers to conduct on-site examinations where necessary. The CBN recently announced plans to deploy ‘live-in examiners’ in all supervised banks in a bid to ensure adherence to internal control mechanisms.

Although there have been many incidents of bank failures, Nigeria has not yet experienced a systemic crisis of a serious magnitude since the inception of the Corporation. In the absence of a well articulated and implemented contingency framework, the ability of the system to cope with a systemic crisis remains largely uncertain, and this remains an undermining factor in the level of public confidence.

II. Corporate Governance

There is the need to strengthen the corporate governance regime in the Nigerian banking system. The lack of effective internal control mechanisms has been a major factor in the distress of most Nigerian banks, which has been characterised by insider lending. With the dissolution of the Failed Banks Tribunals, it has become particularly difficult to recover bad debts arising out of such imprudent transactions or to apply criminal sanctions.\(^{156}\)

The Basel Committee on Banking Supervision notes that ‘a system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations.’\(^{157}\) Principle 8 of the Basel Core Principles for Effective Banking Supervision also enjoins supervisors to ensure that banks put in place a credit risk management process with prudent policies for controlling credit risk. Principles 10 and 11 also recognize the need for supervisors to set limits to restrict bank exposures to concentration within the portfolio, and to

\(^{156}\) On the supervisory initiatives for good corporate governance, see IO Imala ‘Regulatory Framework for Ensuring Good Corporate Governance: A Focus on the Banking Industry in O Alo (ed) Issues in Corporate Governance (FITC, Lagos, 2003).

prevent abuses arising from exposure to related parties and to address conflict of interest.\textsuperscript{158}

The need for effective internal control systems should be made a priority in the reform of the deposit insurance system. It should however be noted that the insider abuses were still perpetrated despite the existence of some supervisory internal control mechanisms. Internal control mechanisms must thus be complemented by an effective system of prudential regulation and monitoring, backed up by effective supervisory enforcement powers. Presently, there is little or no supervisory enforcement mechanism in the Nigerian banking industry apart from the threat of revoking an errant bank’s licence. This further underscores the need for the introduction of a statutory PCA mechanism, which would stipulate mandatory supervisory action based on the degree of non-compliance.

\textbf{III. Least Cost Resolution}

The laws governing the operation of the NDIC do not provide any mandatory requirement for the Corporation to adopt a least cost resolution test in the resolution of a failed bank. As a matter of policy, the NDIC has adopted a least-cost approach in resolving failed banks. The effectiveness of this is however limited in the absence of PCA intervention powers. The powers of the NDIC to protect the deposit insurance fund are limited, even where risks have been identified following the exercise of its bank supervisory powers. In this regard, it is important to note that the NDIC has no power to determine the timing of closing a distressed bank. The power to revoke banking licences is conferred exclusively on the CBN. The NDIC only steps in to act as liquidator after a licence has been revoked.

\footnotesize{\textsuperscript{158}See Basel Committee on Banking Supervision \textit{Core Principles for Effective Banking Supervision} (2006). Available at http://www.bis.org/publ/bcbs129.pdf, accessed 7 July 2007.}
IV. Legal Framework for Liquidation

As noted earlier, prior to the promulgation of the NDIC Act 2006, the NDIC was required to apply to the Federal High Court to be appointed as liquidator of a failed bank. This requirement resulted in lengthy delays in the commencement of winding-up activities in failed banks, especially where the shareholders or management of the failed bank instituted court actions to challenge the revocation of their bank’s licence and the appointment of the NDIC as liquidator. The NDIC now automatically assumes the role of liquidator upon the revocation of a bank’s licence.

The licence of a distressed bank must be revoked by the CBN before the commencement of liquidation and the trend of bank shareholders instituting court actions to challenge the revocation of their bank licences is expected to continue. The generally slow nature of the judicial process in Nigeria resulted in a situation where depositors and creditors have to wait for several years while court suits challenging the revocation of licences are determined. This problem has been addressed under section 40 (7) of the NDIC Act 2006, which stipulates that where any such action involves an application for an interim interlocutory injunction to restrain the NDIC from paying depositors of a failed bank, the trial court shall refer such an application to the Court of Appeal for determination. The Court of Appeal is mandated to determine the application within sixty days of the referral.

159 See Ogunleye (2007) (n52); Ogunleye (2005) (n58); Umoh (1999) (n103).

160 Suits instituted by shareholders and directors of 2 banks whose licences were revoked in 2002 and 2003, challenging the revocation of their licences and the application of the NDIC to be appointed as liquidator, are still pending in the Federal High Court. In the case of Rims Merchant Bank, its licence was revoked in 2000 and the bank’s shareholders challenged the revocation in court. The action was eventually dismissed in 2003 after 3 years of delay. Similar court actions instituted by shareholders of 9 banks whose licences were revoked by the CBN in January 2006 have prevented the winding-up of the banks and payment of insured deposits. See http://www.ndic.org/failed_institutions.htm, accessed 3 July 2007. These delays have resulted in difficult living conditions for depositors. See ‘Consolidation: Failed Banks Depositors May Wait Longer’ Daily Sun, Monday, 26 February 2007.
The reform introduced by the NDIC Act 2006 is commendable. However, it is important to note that the problem has not been completely eliminated, as provisions of section 40(7) apply only to applications seeking to restrain the NDIC from paying insured deposits. As noted earlier, because of the low deposit insurance coverage, the payment of insured deposits is unlikely to provide any relief to depositors until liquidation has been completed and the Corporation starts to pay out significant sums as liquidation dividend. Furthermore, there is no evidence that the Court of Appeal possesses more specialized knowledge of banking related matters than the Federal High Court to enable it deal with such applications speedily and effectively.

The foregoing underscores the need for the creation of specialist or dedicated courts to deal with banking related matters. The need for the prompt and orderly resolution of failed banks has been given judicial affirmation by the Court of Appeal in the case of Savannah Bank of Nigeria Plc v. NDIC, where the Court enthused thus:

‘I cannot grant a blanket order suspending further liquidation. To do so would compound the problems of appellant and cause untold hardship to the depositors. It is only in the course of liquidation that the depositors get back some of their money. Assets in the form of equipment, buildings and furniture will deteriorate with time, if not realized.’

6.2.3 NDIC: Interrelationship with Safety Net Participants

Effective interrelationship among financial safety net participants is essential to the success of a deposit insurance scheme. This is important both when safety net functions are assigned to different participants and when the responsibilities are

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162 Per Ogunade, JCA.
shared. Although deposit insurance is the exclusive preserve of the NDIC, the Corporation also shares various responsibilities with the CBN and other regulatory bodies.

Co-ordination of the activities of the regulatory and supervisory institutions in the financial sector is achieved mainly through the Financial Services Regulation Coordinating Committee (FSRCC). Although the Committee was created in 1994 through an initiative of the CBN, it was only accorded legal recognition by an amendment to the CBN Act in 1998, and subsequently by the CBN Act 2007. It was formally inaugurated in May 1999.

The membership of the Committee consists of the Governor of the CBN (as Chairman); the Managing Director of the NDIC; the Director General of the Securities and Exchange Commission; the Commissioner for Insurance; the Registrar-General of the Corporate Affairs Commission; and a representative of the Federal Ministry of Finance. It is interesting to note that despite the pivotal role which the NDIC plays in the Nigerian banking sector, the Corporation was conspicuously initially unrepresented in the statutory list of members contained in Section 38A of the CBN Act 1991. The NDIC was only co-opted as a member ‘in order to enhance the effectiveness of the Committee’.

The objectives of the Committee are to:

- Co-ordinate the supervision of financial institutions, especially conglomerates:

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163 See Chapter 4, para. 4.10.
164 See CBN Act 2007, s. 43.
- Reduce regulatory arbitrage usually created by differing regulations and supervision standards among supervisory authorities;
- Deliberate on problems experienced by any member in its relationship with financial institutions;
- Eliminate any information gap encountered by any regulatory agency in its relationship with any group of financial institutions;
- Articulate strategies for the promotion of safe, sound and efficient practices by financial intermediaries; and
- Deliberate on such other issues as may be specified from time to time.

With regard to information sharing, all the members of the FSRCC executed a Memorandum of Understanding (MoU) to promote information sharing among the regulatory bodies. The NDIC also collaborates with the CBN in the planning and conduct of bank examination. To this effect, section 53 of the NDIC Act 2006 makes provision for:

- The NDIC to have access to the report of bank examinations conducted by the Banking Supervision Department of the CBN;
- The Corporation to make a report of its examination and any other information essential to safe and sound banking practice available to the CBN;
- The CBN to make available to the Corporation, relevant information on the insured institutions licensed by it;
- The Banking Supervision Department of the CBN to inform the Corporation of any regulatory contraventions committed by insured banks; and

See CBN Act 2007, s. 44.
• The Corporation to co-operate with the CBN on matters affecting any of the insured banks.

The foregoing provisions are designed to ensure that the NDIC gets all the information and assistance it needs in performing its functions, particularly in the protection of depositors’ funds and the minimization of risk to the deposit insurance fund. They are also designed to prevent unnecessary duplication of efforts and conflict. To give effect to the provisions, the CBN and the NDIC meet at the beginning of every year to decide on a bank examination programme. The NDIC’s involvement in bank examination has shortened the bank examination cycle to once a year. The current arrangement is that licensed banks are divided into two, with both bodies taking alternate responsibility for supervising each group on a yearly basis.\textsuperscript{167}

The provisions of Section 5(1)(d) of the NDIC Act, which requires that a representative of the CBN should sit on the NDIC’s Board of Directors is also aimed at ensuring co-ordination of policies and prevent conflicts caused by differing mandates.

Effective interrelationship between the safety net participants has now become more imperative with the introduction of the risk-based supervision framework and the proposed introduction of a differential premium assessment system. The new system necessarily involves a high level of reliance on off-site surveillance by the supervisory authorities. Therefore, an effective information sharing strategy will reduce the regulatory and reporting burden on insured banks by eliminating unnecessary duplication.

\textsuperscript{167} See Ogunleye (2007) (n52).
6.2.4 Public Awareness

Deposit insurance schemes play an important role in financial stability by promoting public confidence in the financial system. For this role to be effectively performed, depositors need to be fully aware of the existence of the scheme, its nature and limitations.168

Public awareness has been a major challenge in the implementation of the deposit insurance scheme in Nigeria. Awareness of the existence and mandates of the Corporation is very low. It is better known for its supervisory functions and it is sometimes misunderstood to be a conventional insurance company.169 Findings of a recent survey conducted by the NDIC shows that ignorance of the scheme cuts across all sections of the Nigerian populace, including bankers.170 This lack of awareness has also resulted in the failure by most depositors of failed banks to submit their claims before the expiration of the former statutory period of eighteen months.171 Deposit pay-offs embarked upon by the corporation have generally been characterised by a low level of response from depositors.172

The NDIC has recently embarked on a public awareness campaign to enlighten the public on the activities, benefits and limitations of the deposit insurance system. The Corporation has also provided public information on the claims process for depositors of closed banks. It is however important that any public awareness program is designed and implemented before bank failure occurs. The public awareness strategy

168 See Chapter 4, para. 4.9.
170 MK Ahmad ‘NDIC as a Deposit Insurer and Liquidator: Challenges and Prospects’ (2003) 13 NDIC Quarterly 2, 22 at 29.
should be grouped according to different target audiences; this is particularly necessary in a developing country like Nigeria where information can not be passed to all classes of society through the same medium.

6.3. Reform of Deposit Insurance in Nigeria

Based on the foregoing analysis of the deposit insurance scheme in Nigeria, it is evident that certain aspects of the scheme are in need of reform. The NDIC Act 2006 was the first attempt to reform deposit insurance in Nigeria. Significant changes have been introduced by the Act, which include:

- Creation of separate insurance funds for each category of insured financial institutions;¹⁷³
- Increase in the maximum coverage limit from ₦ 50,000 to ₦ 200,000 and ₦ 100,000 for licensed banks and licensed deposit-taking financial institutions;¹⁷⁴
- Granting of powers to the NDIC to introduce a differential premium assessment system;¹⁷⁵
- Granting of powers to the NDIC to make regulations for the implementation of the Act.¹⁷⁶

The Act also improves the failure resolution process by giving the NDIC power to:

- Present petitions for winding-up;¹⁷⁷
- Act as liquidator for failed banks without the requirement to apply to the Federal High Court.¹⁷⁸

¹⁷³ NDIC Act 2006, s.10(2).
¹⁷⁴ Ibid, s.20(1).
¹⁷⁵ Ibid, s.17(2).
¹⁷⁶ Ibid, s.56.
¹⁷⁷ Ibid, s.40(2).
• Establish bridge banks;¹⁷⁹ and to
• Extend the time for submission of deposit insurance claims.¹⁸⁰

While most of the above mentioned reforms are laudable and would improve the efficiency of the deposit insurance scheme in fulfilling its mandates, it is apparent from the analysis in this chapter that more far-reaching reforms are necessary. The major inadequacies of the scheme are extrapolated from the discussion and summarized below with suggestions for further reform.

I. Coverage Limit and Prompt Payment of Guaranteed Deposits

As noted earlier, the current maximum coverage limit of ₦200,000 for licensed banks and ₦100,000 for licensed deposit taking institutions is inadequate. Most depositors would rather withdraw their deposits at the slightest hint of insolvency than go through the cumbersome claims process to recover this arguably meagre amount. While the recent increase is significant, the new limit is still not sufficient for the deposit insurance scheme to fulfil its mandate effectively. It is pertinent to note that the perceived ignorance of the existence and benefits of the scheme is attributable to apathy on the part of depositors, who consider the benefits of the scheme as insignificant.

Given that it has taken almost twenty years for the current coverage limit to be reviewed, the provision of section 20(2), which gives the NDIC power to vary the coverage limit is a welcome development. This is similar to the provision in the U.S.

¹⁷⁹ Ibid. s.40(1).
¹⁸⁰ Ibid. s.20(4).
Federal Deposit Insurance Reform Act, giving the FDIC the power to undertake periodic reviews of the adequacy of the coverage limit and to make necessary adjustments where inflation or any other factor necessitates this.

Closely related to the adequacy of the deposit insurance coverage is the timing of the payment of guaranteed sums after a bank failure. Depositors need to be given the assurance that their funds are safe and also accessible in order to prevent bank runs. In practice, there has been considerable delay in reimbursing depositors because of the lack of depositor records and protracted court actions by shareholders of failed banks.  

Any reform of the deposit insurance scheme should not only ensure that depositors are promptly reimbursed within days of a bank failure, but should also make provisions for the Corporation to have early access to the necessary records ex ante. An early detection process should also be introduced so that the Corporation can start making arrangements for compensation as soon as it is detected that an insured bank is inevitably going to be closed.

II. Differential Premium System

While the Nigerian system is due for the introduction of a risk-based deposit insurance assessment system, it is suggested that gradualism and simplicity should be adopted in the implementation of the system. The success of such a scheme necessarily depends on the availability and credibility of relevant information for the deposit insurer. The success of the newly introduced risk-based supervision framework is also a major determining factor.

\[181 \text{ See } Ahmad (2003) (n170) 30.\]
A well managed transition process is recommended. This will promote understanding and acceptance of the proposed system. A transition plan should be put in place which would set out the objectives of the proposed system and the resource and legal requirements for achieving the stated objectives. The transition process should also involve a public enlightenment campaign to educate depositors and insured banks on the workings of the new system.

III. Independence

The NDIC Act 2006 has made the powers of the President relating to the appointment of the NDIC Board members subject to confirmation by the Senate. However, as argued earlier, the mere requirement for confirmation is not enough. It is suggested that further reform of the Act should also make the process and terms of appointment subject to parliamentary review. The process and terms of appointment must be such as would ensure the independence of the Corporation. Parliament should also be given general oversight responsibility over the activities and accounts of the Corporation.

Independence of the NDIC and other supervisory agencies is particularly important given the proposed introduction of a PCA mechanism. It has been shown that the introduction of PCA rules in developing countries can only improve bank regulation and create right incentives if the rules are part of a comprehensive reform process that strengthens the independence of the bank regulator and improves transparency.182

IV. Prompt Corrective Action

The absence of a statutory basis for prompt corrective action to allow early intervention in problem banks by regulators has been considered to be a deficiency in the Nigerian regulatory framework. Section 32(1) of the NDIC Act 2006 makes reference to prompt corrective action. The section empowers the Corporation to take prompt corrective action where an examination of any insured institution discloses that its management are engaged in unsafe and unsound practices; or have violated any law or regulation. Where such violation may lead to insolvency or dissipation of assets the NDIC is empowered to direct the management of the concerned bank to take specific corrective measures. Section 31(2) provides that where such corrective action is not implemented within thirty days, the NDIC shall, in consultation with the CBN, initiate such corrective action which it may deem necessary.

The main aim of PCA mechanisms is to prevent harmful regulatory forbearance and to mandate regulators to become more involved with troubled banks well before insolvency to allow recapitalization or prompt legal closure. It is difficult to see how the terse and general provisions of Section 32 can achieve this aim. It is proposed that more specific and detailed provisions, similar to the US PCA provisions, are required. Such provisions should include specific thresholds, based on capital and liquidity ratios, which should trigger mandatory regulatory action. Under PCA, more stringent regulatory restrictions would apply as a bank’s condition deteriorates. Such thresholds and corresponding mandatory action should be clearly specified ex-ante.

As noted in Chapter 5, the introduction of a PCA mechanism would significantly increase the information requirements of the supervisors and also increase the need for effective co-ordination between various supervisors. Independence of the regulatory authorities should also be ensured to prevent political manipulation.
6.4. Provisional Conclusion

The banking system in Nigeria has been generally unstable. From the historical overview in this chapter, this can be attributed to two main factors: first, the changing structure of bank ownership; and second, government economic policies. As in most jurisdictions, the financial safety net in Nigeria is a product of history and was introduced at a time of crisis. In this chapter, elements of the deposit insurance problem have been identified, analysed and solutions have been proffered.

The deposit insurance scheme in Nigeria is going through a critical evolution period with the promulgation and implementation of the NDIC Act 2006, particularly the proposed introduction of a differential premium assessment system. As posited earlier, the first and most important step in the design or reform of a deposit insurance scheme is to set out and understand the public policy objectives which the scheme is to implement. Whereas it would appear that the NDIC has been successful as a supervisory agency (complementing the CBN), it has so far been largely ineffective as a means of depositor protection and a source of confidence to the banking system.

In Nigeria, bank depositors did not enjoy any form of explicit protection until the introduction of the deposit protection scheme in 1988. The level of protection offered by the scheme has been a contentious issue in Nigeria, as it has been in other countries examined. While it is necessary to limit the level and scope of deposit insurance coverage in order to contain the moral hazard problem, the level of protection must also be sufficient to fully protect the small unsophisticated saver. This is very important if deposit insurance is to establish any form of confidence and stability in the banking system.
Since the inception of the deposit insurance scheme in Nigeria, the banking system has not suffered a serious systemic banking crisis. If this occurs in the near future, it is doubtful if the deposit insurance scheme is adequately designed and equipped to cope with the effects of such a crisis. Thus the appropriate time to introduce changes to the scheme is during a relatively crisis-free period. The fact that the deposit insurance scheme in Nigeria has just undergone its first major reform process in about twenty years understates not only the importance of the scheme, but also the inherent complexity and difficulty of introducing and implementing deposit insurance schemes. This complexity is evident in the constant modification of deposit insurance schemes around the world and the growing academic and policy debates at the international level on the design of financial safety nets in general and deposit insurance in particular.

It is hoped that further reform to the system would address the issues highlighted here, which include the adequacy of the protection offered, the legal and regulatory framework, the failure resolution process and the capacity building challenge among others. Most importantly, a self assessment methodology should be put in place to ensure a periodic assessment and review process, which would enable the design features of the scheme to be modified to meet specific country needs and other challenges that come up over time.
CHAPTER 7
CONCLUSIONS AND RECOMMENDATIONS

7.0. Introduction

This chapter sums up the various themes and conclusions in this thesis. These are grouped into analytical themes and policy conclusions. The analytical themes provide a summary of the theoretical analysis involved in the thesis, while the policy conclusions recapitulate the various operational and structural issues considered in the thesis. The policy conclusions are synopsized generally and also in terms of the jurisdictions that have been examined.

7.1. Analytical Themes

The main analytical themes in this thesis can be summarized as follows:

7.1.1 The Rationale for Banking Regulation:

The rationale for banking regulation is derived from the desirability of a stable financial system for sustained economic growth and the nature of banking contracts, which distinguishes the banking sector from other services.¹ The special nature of banking is found in the nature of fractional reserve banking and the potential for maturity mismatch, which means that temporary illiquidity problems can result in insolvency. Where isolated bank failures result in a general loss of confidence in the

¹ See Chapter 2.
banking system, the risk of contagion means that such isolated cases could have widespread systemic effects.\(^2\)

Bank contracts are also special because of the nature of information asymmetry between the bank, as suppliers of financial services and products, and the consumer. This means that consumers do not possess the relevant knowledge and expertise to make the necessary judgements in the course of their interaction with banks.

The special nature of banking means that the rationale for regulation and supervision can be justified on two general public interest grounds. First, banking regulation exists to protect the financial system from instability and second, it exists to protect consumers of financial services and products.

### 7.1.2 The Rationale for Deposit Insurance:

Deposit insurance schemes enhance confidence in the financial system; hence it reduces the incentives for bank runs to occur by ensuring that isolated problems in a troubled institution do not result in a general loss of confidence in the banking system.\(^3\) Deposit insurance also guarantees a minimum level of protection to bank depositors against the consequences associated with bank failure.

\(^2\) Banks are particularly vulnerable to a loss of confidence, and it has been observed that 'a bad bank that enjoys the public's confidence may operate in peace (at least for a little while) whereas a good bank can risk failure if it becomes subject to a bank run and all its deposits are withdrawn on short notice.' See F. Hupkes 'Insolvency – Why a Special Regime for Banks' Seminar on Current Developments in Monetary and Financial Law May 7-17, 2002, Published in Current Developments in Monetary and Financial Law, Vol. 5, IMF, April 29 2005, ch.25.

\(^3\) It has been argued in this thesis that it is the knowledge of the existence of deposit insurance schemes, as opposed to their mere existence, that helps to promote financial stability. Hence in countries where there is a very low level of public awareness on the existence and purpose of deposit insurance, deposit insurance contributes little to the level of confidence in the banking system.
Thus, there is also a two-fold justification for the existence of deposit insurance schemes: the first is the promotion of financial stability and the second is the protection of small and unsophisticated depositors. There have been attempts to identify a primary justification for the existence of deposit insurance schemes. While some jurisdictions have identified financial stability, consumer protection has been identified elsewhere. It has been argued in this thesis that these two objectives are not mutually exclusive, and that an effectively designed deposit insurance scheme can achieve both.

7.1.3. The Deposit Insurance Problem

The benefits associated with deposit insurance notwithstanding, the concept has its perceived problems. Chief among these problems are the moral hazard and the agency problems, which have the tendency to weaken incentives in the banking system. A new dimension has also been added to this as a result of globalization and cross-border banking.

Despite the existence of these problems, there is still a prevailing argument for deposit insurance. This is based on the vital role that deposit insurance plays in promoting financial stability by providing confidence, and the importance of protecting small and unsophisticated depositors. The main consideration for policymakers is not whether or not deposit insurance should be adopted but how it can be effectively

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1 These are the two primary objectives which are common to most jurisdictions. Policy objectives vary according to national conditions and other possible objectives are listed in Chapter 3. In most cases, these objectives are incidental to the pursuit of financial stability and depositor protection.

5 There are also the related issues of sector integration and the development of financial conglomerates. See discussion in Chapter five.

6 The benefits of deposit insurance in promoting financial system stability have been described as being 'too valuable to lose'. See M Horvitz 'Preventing Banking Sector Distress and Crises in Latin America' in Proceedings of a Conference held in Washington DC, April 15-16, 1996, World Bank Discussion Paper No. 560 (The World Bank, Washington DC, 1996) 53.

7 The benefits of deposit insurance are discussed in Chapter three.

designed and structured, in an incentive-compatible way, to minimize the deposit insurance problem. Therefore, the deposit insurance problem has primarily become one of design and structure. Although a set of sound principles has been developed for policy purposes, these principles need to be considered within the context of country-specific circumstances and objectives.

While there has been considerable debate generated in the literature on the relationship between deposit insurance and moral hazard, it should be noted that deposit insurance is not the only source of bank risk-taking incentives. Thus the search for a solution to the perennial problem of risk-taking must go beyond the confines of deposit insurance. Internal control mechanisms, prudential regulation and supervision, and the legal and institutional framework should also be strengthened to contain risk-taking.

7.2. Policy Conclusions

7.2.1 Deposit Insurance and the Financial Safety Net

Deposit insurance forms an integral part of the financial safety net. As such, in designing a deposit insurance system, consideration should be given to the overall effectiveness of the banking supervisory and regulatory framework.

An effective legal framework for supervision and regulation should make provisions for monitoring and enforcing limits on risk-taking by banks. Effective regulation and supervision helps to counteract the effects of moral hazard in weakening market discipline and the incentive structure. In the absence of effective supervision,
excessive risk-taking will have the effect of exposing the deposit insurer to significant contingent liability.

With recent and ongoing changes in the financial services industry in terms of globalization, structure, scale and scope of financial institutions, services and products, it is imperative that policymakers consider the structure of financial safety nets. This would ensure that the safety and soundness of the entire financial sector is maintained by preventing regulatory gap, conflict and overlap. With respect to the general regulatory structure, policymakers must consider whether an institutional, functional or integrated model of financial regulation should be adopted.

Policy makers should have particular regard to the interrelationship between deposit insurance and the lender of last resort (LoLR) function. Whereas the LoLR function is largely based on discretion, explicit deposit insurance is governed by rules that are set out ex ante. LoLR discretion is generally based on the ability to distinguish between illiquid and insolvent institutions. This distinction is blurred in practice because of information asymmetry and the fact that it is almost impossible to place a value on a bank’s assets in a crisis. Where a loose liquidity support policy is adopted, a potential conflict may be created with a deposit insurer with a risk-minimizing mandate, which often requires early intervention and possible closure.8

Regulatory allocation and co-operation arrangements can be formalized through legislation, memorandum of understanding, legal agreements or a combination of these methods. Such arrangements must be made clear ex ante.9

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8 See Chapter 4, para.4.10.2.
9 Ibid.
7.2.2 The Choice between Explicit and Implicit Deposit Insurance:

In comparison with implicit deposit insurance, explicit deposit insurance has a number of significant advantages. In summary, explicit deposit insurance is preferred because it is rules-based, and as such there is clarity, certainty, consistency and transparency.\(^{10}\)

7.2.3 Design Features of Deposit Insurance Systems

An appropriately designed deposit insurance system is the most effective panacea or solution to the deposit insurance problem. In designing a deposit insurance system, the first and perhaps the most important consideration for policy-makers is the identification of policy objectives.\(^{11}\) The purpose and aims of the scheme should be clearly defined and understood.\(^{12}\) The various design and structural issues should then be considered in the context of these policy objectives. The primary structural and design issues considered in this thesis and the set of sound practices developed are summarized here.

1. **Institutional/Organizational Structure:** this should be determined primarily by the nature of the deposit insurer’s mandate.\(^{13}\) To avoid potential conflict of interests and to ensure independence and accountability, it is preferable that the deposit insurance function is administered by a separate agency.\(^{14}\)

2. **Mandate/Powers:** the deposit insurer’s mandate can either be broadly or narrowly defined. It appears that the choice is mainly that of public policy

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10 See Chapter 3, para.3.4.3.
11 See Chapter 4, para. 4.1.
12 Although the main objectives of deposit insurance schemes are usually financial stability and consumer protection, other possible objectives are mentioned in Chapter 3, para.3.2.1.
13 The wider the deposit insurer’s mandate, the greater the need for a separate institution to administer the deposit insurance function.
14 See Chapter 4, para.4.2.
dictated by the objectives which the scheme aims to achieve. The deposit insurer should be given appropriate legal powers to fulfil its mandate.\textsuperscript{15}

(3) \textbf{Membership:} deposit insurance should be made compulsory for all eligible institutions to avoid adverse selection, control risk exposure and to ensure the system’s financial viability.\textsuperscript{16}

(4) \textbf{Coverage:} deposit insurance coverage can be determined in terms of level and scope. In order to limit moral hazard, the level of coverage should be restricted. Coverage levels should be consistent with local economic factors, the deposit insurer’s policy objectives and availability of funding. Deposit insurance coverage should be set at a level that would prevent destabilising bank runs but should not be made so extensive as to eliminate all forms of market discipline. The level and scope of coverage should be prescribed in law without ambiguity and before any crisis occurs.\textsuperscript{17}

(5) \textbf{Funding:} the source and mode of funding is critical to the effectiveness of a deposit insurance system. The financial capacity of the deposit insurance scheme creates credibility and public confidence which is essential in preventing bank runs. In determining the source of funding, two essential guiding principles should be applied:

I. Those who will enjoy the benefits of deposit insurance should pay for it; and

II. The source of funding should be credible enough to maintain public confidence.

\textsuperscript{15} Ibid, para. 4.4.
\textsuperscript{16} Ibid, para. 4.6.
\textsuperscript{17} Ibid, para. 4.5.
The mode of funding should also be clear and easily understood by the authorities, participating institutions and the public. The deposit insurance fund should be properly managed and readily available to cover losses as they arise, and there should be credible provisions for back-up funding.\(^\text{18}\)

(6) **Intervention and Failure Resolution:** an effective intervention and failure resolution policy is essential to the success of a deposit insurance scheme. There should be an effective exit mechanism for winding down failed banks and provide prompt payment of insured funds. The policy should not be to prevent individual bank failures at all costs but to ensure that such failures, when they occur, are resolved promptly and that depositors have instant access to insured funds. In order to reduce the costs of resolution and to prevent systemic crisis, prompt corrective action (PCA) mechanisms should be introduced.

In designing the failure resolution framework, policy makers should be guided by the need to maintain public confidence in the system; the need to maintain market discipline; the need to minimize losses; and the need for an equitable, consistent and transparent process. Different failure resolution options have been considered in Chapter four. However, in determining the appropriate resolution option, the ultimate test is to balance the need to minimize costs against the need for effectiveness. Hence, the failure resolution option for a particular case should be the most cost-effective option.\(^\text{19}\)

(7) **Public Awareness:** deposit insurance schemes promote financial stability by sustaining public confidence. This objective cannot be achieved where there is

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\(^{18}\) *Ibid*, para.4.7.
a low level of awareness on the existence, purpose and limitations of deposit insurance.\textsuperscript{20}

(8) \textbf{Interrelationship Issues}: overlap of regulatory mandates and powers among financial safety net participants creates potential tension and conflicts of interest, which could result in the overall regulatory objective of financial stability being undermined. To avoid this, there should be clear provisions for allocation of regulatory powers, information sharing and inter-agency coordination.\textsuperscript{21}

7.3. Country-specific Conclusions and Recommendations

7.3.1 The United Kingdom

The primary objective of the UK deposit protection scheme is the ‘essentially social purpose’ of consumer protection. The FSCS is designed as a relatively narrow scheme, responsible for the management of the fund and compensation of consumers.

Relatively speaking, few institutions have failed since the introduction of explicit deposit protection in the UK. Recent developments, which led to the Bank of England’s rescue of Northern Rock, have raised significant concerns about the fitness for purpose of the UK compensation scheme.

The following conclusions and recommendations can be summarized from the analysis of the UK compensation scheme:\textsuperscript{22}

\textsuperscript{19} Ibid. para.4.8.
\textsuperscript{20} Ibid. para.4.9.
\textsuperscript{21} Ibid. para.4.10.
• The present method of funding the scheme, which is mainly ex post, is inadequate to sustain the required level of consumer confidence and to effect prompt payment of guaranteed sums in the event of a significant bank failure. Furthermore, the UK scheme, until recently, included an element of co-insurance as an incentive for consumers to exert market discipline. With the removal of co-insurance and the absence of a risk-based assessment system, there is currently no effective mechanism in place to counteract moral hazard.

• Despite the recent increase in the coverage limit the continuing practice of full government guarantee of bank deposits suggests that the level of protection offered under the scheme is insufficient. This should be raised if the purposes of deposit protection are to be achieved. In deciding the appropriate coverage level, the need for market discipline should be balanced against the need for confidence in the banking system.

• Recent events have shown that the level of public awareness of the existence, purpose and limitations of the scheme is very low. For a deposit insurance system to be effective in maintaining confidence, it is important that the public is informed about its benefits and limitations. The lack of clarity surrounding the operation and the level of cover provided by the UK scheme contributed to the run on Northern Rock.

• The proposed introduction of a Special Resolution Regime for dealing with problem banks is a welcome development. However, further reform should incorporate a Prompt Corrective Action mechanism (PCA). The FSCS should also be granted risk-minimizing powers and a wider role in the failure resolution process.

22 See Chapter 5, para.5.1.3.
7.3.2. The United States

The most notable reforms in US deposit insurance have resulted from the crisis in the Federal Savings and Loans Insurance Corporation (FSLIC). In contrast to the UK compensation scheme, efforts at minimizing the deposit insurance problem in the United States are focussed on banks and their officers. This policy direction is epitomized by the adoption of risk-based premium assessment and PCA mechanisms.

The US scheme also provides a more generous level of protection than the UK scheme. Although there is no element of coinsurance under the FDIC scheme, in a bid to retain market discipline, the coverage limit has been pegged at $100,000. The justification for the coverage limit is, however, questionable as the various complexities in the legal provisions dealing with coverage allow most depositors to enjoy full coverage by holding deposit accounts in different rights and capacities.

A common problem with limited coverage deposit insurance schemes is that coverage limits lose their real value over time and the difficulties and delays involved with statutory amendments make an expeditious adjustment of such limits impossible. To this extent, the provisions introduced by the FDIRA, giving the FDIC power to review the insurance limit at five year intervals is an important statutory innovation.

Given that the mandate of the FDIC is to minimize the loss to the deposit insurer when a bank failure occurs, and not to prevent all bank failures, it appears that the main challenge for the FDIC is to resolve any problems at insured institutions at the least possible long-term cost to the insurance fund. This is dependent on the reliability of capital ratios based on book-value standards to identify high risk banks, and
supervisory ability and political will to act promptly and appropriately when risks are identified.

7.3.3 Nigeria

Deposit insurance was introduced in Nigeria as part of the banking sector reforms in the government’s economic deregulation policy of 1986. The deposit insurance scheme has been in place for approximately twenty years, and while there has been rapid transformation in the Nigerian banking sector in this period, the deposit insurance scheme has only just undergone its first significant reform. It is submitted that the reforms introduced in the NDIC Act 2006 are not far-reaching and still leave the scheme with considerable challenges in achieving its stated objectives. The following conclusions and recommendations can be summarized from the analysis of the Nigeria Deposit Insurance Scheme:

- The laws setting up the scheme do not give the deposit insurer freedom from political interference. Legislation should be introduced to make the Corporation independent of the executive arm of government but accountable to parliament.
- A special bank insolvency regime and a legal framework of prompt corrective action, which would enable the supervisor to deal effectively and expeditiously with distressed banks, should be established. These should be accompanied by a statutory least-cost resolution mandate.
- The series of protracted litigation and the difficulties encountered in recovering assets of failed banks underscores the need for the establishment of

23 See Chapter 6, para. 6.1.
24 Ibid, para. 6.3.
a special financial services tribunal with special procedures to deal expeditiously with banking-related matters.

- The level of deposit insurance coverage is neither sufficient to protect depositors nor to create the desired level of public confidence in the banking system. The confidence-building role of deposit insurance assumes greater importance in the Nigerian context because Nigerians are generally sceptical about keeping their savings in Nigerian banks due to past experiences with bank failures. This has led to massive capital flight to economies where banking is presumed to be safer.

- A major cause of bank failure in Nigeria has been identified as non-performing loans characterized by insider-related lending. The need for effective internal control systems should be made a priority. This should be complemented by an effective system of prudential regulation backed up by adequate enforcement powers.

- Gradualism and simplicity should be applied in the planned introduction of a differential premium assessment system. A well managed transition process, which would set out the objectives and the required resources, is recommended. The process should also include an enlightenment campaign for all stakeholders.

- The fact that there has been only one significant reform of the Nigerian scheme underscores the need for a self-assessment methodology to be put in place and the need for the NDIC to make credible use of the rule-making powers that it has been granted under Section 56 of the NDIC Act 2006.
7.4. Cross-border Issues

The emergence of a global market in financial services with the use of increasingly complex and integrated cross-border structures has prompted the need for an international system of bank supervision. While there have been efforts to develop international standards for prudential regulation and crisis prevention, little has been achieved in terms of harmonizing crisis management systems.

The establishment of an international deposit insurance agency has been proposed. Whereas this is desirable to protect international bank depositors and to ensure a level playing field, the proposal would encounter practical difficulties because of cross-country differences in regulatory culture and approach, and disparity in the level of financial development. Harmonization of basic features of national schemes is a more realistic objective than the creation of an international scheme. Harmonization is also more feasible on a regional basis, as there is likely to be more convergence of regulatory culture at this level. In this regard, the relatively successful attempt at EU harmonization has been considered in this thesis.

Any benefits of deposit insurance policy harmonization must be balanced against the need to design deposit insurance to suit country-specific factors. In the absence of an international framework for crisis management, the use of cross-border co-operation agreements on burden and information sharing has been advocated in dealing with the failure of internationally active banks.
7.5. Final Thoughts

A stable and competitive banking system is critical for the economic development of any nation, and financial safety nets play an important public policy role in maintaining the stability and competitiveness of the banking system. These safety nets, however, create perverse effects, which throw up peculiar challenges for policy makers. In this thesis, these challenges have been termed the ‘deposit insurance problem’.

The conclusion in this thesis is that there is no fixed panoptic set of solutions to the deposit insurance problem. Rather, institutional, cultural, legal, experiential and other country-specific factors should determine deposit insurance structure and design. In designing a deposit insurance system, policy makers must ensure that the features of the system are consistent with the specified policy objectives and that the features of the scheme create the right type of incentives to minimize the adverse effects of deposit insurance. Policy consistency and incentive compatibility should necessarily be complemented by closer and more effective supervision of the banking system.

While there is no one-size-fits-all approach to deposit insurance, the sound practice principles in this thesis have been developed to consider the trade-offs involved in the design of deposit insurance schemes. With globalization and sector integration taking a prominent stage in academic and policy debates, and with an increasing number of countries adopting deposit insurance schemes, the harmonization of minimum standards will be expected. It is hoped that this sound practice guide will be useful to policy makers in establishing internationally acceptable standards.
In conclusion, it must be emphasized that the deposit insurance problem, while basically an issue of design, is not ultimately so. The conclusions in this thesis must be placed within the context of other political and social factors, as well as an effective legal framework. As the aphorism goes, 'prevention is better than cure', and as such it is submitted that a prophylactic approach focussing on effective risk management, prompt corrective action and timely intervention should be put in place. Where banks fail, adequate and prompt reimbursement of depositors should be ensured. Ultimately, a deposit insurance system should promote public confidence and should complement and reinforce the existing regulatory and supervisory framework.
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