

Depositor and Investor Protection in the EU and the Netherlands: a Brief History*

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1. Introduction

A number of developing countries are currently introducing systems of deposit insurance while others, especially industrialised countries, are making changes to the systems that they already have in place. There are two reasons behind these changes. First, the systems are trying to find an answer to the rapid changes in the financial environment, which include trends of globalisation and conglomeration of the financial system and the blurring of distinctions between financial products. The trend of globalisation requires a level playing field in order to promote financial efficiency and prevent regulatory arbitrage. In the European Union (EU) this is reflected in the harmonisation of financial regulation, including deposit insurance, along the lines of the harmonised directives. The trend of conglomeration and the blurring of distinctions between financial institutions and products may result in a movement toward integration of deposit, securities and insurance protection. Second, the changes that are taking place and that are under consideration are to be seen as

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a response to developments in the theoretical approach to financial regulation, such as the increased awareness of the role of moral hazard and the importance of incentive mechanisms in regulation in general. This awareness is also reflected in, for example, the new Basle Capital Accord. The importance of the subject of deposit insurance in Europe is reflected not only by EU directives on the matter, but also by the recent establishment of a European Forum of Deposit Insurers.

Currently, the Netherlands, which has had a system of deposit insurance since 1978, is considering amending it. In the light of this, this paper provides some history of deposit insurance and investor protection in the Netherlands against the background of the history of such protection in the European Union. It discusses how countries have responded to the EU-directives and to the changes in the financial environment and what developments are likely to occur in the near future. The main findings of the present paper are the following. Deposit insurance systems in the EU are frequently privately run, funded *ex post*, and offer lower coverage when measured in terms of Gross Domestic Product per capita than systems in most other regions of the world.¹ The system in the Netherlands shares these two latter characteristics. The Netherlands was among the first European countries to introduce deposit insurance. Over time, all countries have adapted their systems in the spirit of the EU-directives on the matter, although it seems that some countries still need to undertake changes to comply with specific articles.

Economists advise that a deposit insurance system should be designed to minimize moral hazard, adverse selection and agency problems. They therefore recommend that the system be:

- 1) Clearly laid out in law and regulation;
- 2) Compulsory;
- 3) Offer limited coverage so that sophisticated customers can exercise market discipline;

¹ See Garcia (2000).

- 4) Adequately funded to maintain public confidence;
- 5) Risk-based in the premiums it charges;
- 6) Backed by government funding in the event of a systemic crisis;
- 7) Publicly run where public funds are at risk, but advised by the private sector;
- 8) Accountable but free from unreasonable political interference; and
- 9) Understood by member institutions and the public.

During the 1990s, some convergence towards best practices has taken place in the EU. EU-regulation has obliged member countries to make their systems mandatory. Moreover, there is a tendency towards *ex ante* funding and risk-related premiums.

This paper has five sections. After this introduction, the second section describes developments in the EU. The third section concentrates on the Netherlands. The fourth section provides an assessment and describes changes currently under consideration for the systems of guarantees for depositors and investors in the Netherlands. Section 5 summarises the paper's findings and raises some issues that need to be considered when amending systems of deposit insurance or investor protection. A follow-up paper will discuss potential changes in the Dutch systems of protection, including issues of funding and fair premiums and the possibility of initiating protection for insurance policy holders and pensioners.

2. Deposit insurance and investor protection in the European Union: a bird's eye view

2.1 First steps toward introduction and harmonisation of depositor protection. In general, Western European systems of protection for banks started typically in the late 1970s or early 1980s, although Belgium, Germany and Norway had initiated systems earlier. The systems that originated in this period tended to be bare-bones, offering protection only to depositors, only in a country's major financial institutions, its commercial (or universal) banks, and only to depositors

that were resident in the country offering the guarantee.² The systems bestowed some degree of consumer protection while attempting to strengthen systemic stability. In almost all other respects, the systems initiated at this time were diverse in composition.

Subsequently, EU countries have revised their systems of protection in response to the EU directives on deposit insurance and investor protection. An overview of these directives is given in Table 1.

TABLE 1 Timetable EU-harmonisation of deposit and investor protection

	Proposal/directive	Aim
1986	Recommendation on deposit insurance	Encouragement of introduction of deposit insurance
1994	Council Directive on deposit-guarantee schemes	Consumer protection and systemic stability; EU-wide coverage for credit institutions
1994	Proposal on Investor Compensation schemes	Extend protection to securities
1997	Directive on Investor Protection Schemes	A harmonised minimum level of protection for the small investor

The revisions introduced a degree of harmonisation among the systems and expanded them. Although countries in Europe initially enacted very different systems and responded to the EU directives of 1994 and 1997 in somewhat different ways, there are a number of commonalities with regard to depositor and investor protection in Europe, the time of initiation, its mandatory nature, the minimum coverage level applied to the sum of a depositor's account at a failed bank, the similar exclusions, and home country responsibility.

The commonalities were not a coincidence, but reflected the influence of discussions and Directives at the EU level. A first commonality is that a number of systems commenced at roughly the same time. In the 1970s the European Commission submitted the question of deposit insurance to a group of experts. Their discussions

² Germany's system for private banks, established earlier was more comprehensive. Some countries had separate systems for non-bank depository institutions.

were encouraged by the unfortunate experience of bank failures in some European economies. Depositors lost money and complained bitterly, for example, during the 1970s secondary banking crisis in the United Kingdom. Creditors in western time zones lost money when Bankhaus Herstatt failed in Germany in 1974. Spain experienced a serious banking crisis from 1977 to 1985. A bank was rescued in Italy in 1974 and its mode of resolution proved to be highly controversial. Banco Ambrosiano, an Italian bank chartered in Luxembourg, failed in 1982, illustrating the dangers of banks falling through the gaps in international regulation and foretelling the 1991 demise of the Bank of Credit and Commerce International (BCCI).

Following its early discussions, the Commission publicly addressed the matter of deposit insurance in a 1985 proposal on the reorganisation and winding up of credit institutions. The proposals on deposit insurance therein were very limited and were not welcomed. Nevertheless, the experience of bank failures and the fact that deposit insurance discussions were underway encouraged the adoption of new systems of protection, usually for bank depositors in the home state. In the period between 1977 to 1983, Austria, France, the Netherlands, Spain, Switzerland, Turkey and the United Kingdom initiated systems of deposit protection. In the same period, Belgium and Germany revised the systems that they had begun earlier.³

The process of initiation of deposit insurance systems was further encouraged when, in 1986, the European Commission issued a formal Recommendation on deposit insurance that aimed to encourage the adoption of deposit guarantee schemes in all member states.⁴ No maximum or minimum level of coverage was posited, and coverage was to be territorial with responsibility falling to the host country's monetary authorities, as an extension of their responsibility for monetary policy and lending of last resort.

At this juncture, seven member states (Austria, Belgium, France, Germany, the Netherlands, Norway, Spain and the United Kingdom)

³ Norway's system had been created earlier but was not revised at this time.

⁴ See Dale (1988 and 2000).

already had systems in place, as had Iceland. Denmark, Ireland, Italy, and Luxembourg adopted the Recommendation, however, and initiated systems of deposit protection between 1987 and 1989. The Recommendation was not universally accepted: Greece and Portugal still lacked systems when the time period for implementing the Recommendation had expired. These two countries put them in place only in 1993 and 1992, respectively.⁵

In June 1992, the European Community (EC) followed its earlier Recommendation with a proposal for a Council Directive on deposit-guarantee schemes. The proposal was amended in December 1992 and again in March 1993 before being enacted in May 1994. The stated objectives were to provide some degree of consumer protection while also strengthening systemic stability.⁶ Nevertheless, it is clear that an important motivating factor was a desire to harmonise, that is, to level the playing field for, the development of credit institutions within a single European banking market.

2.2 Expansions of protection in the EU. Any bare-bones system of deposit insurance will cover resident depositors in the most important of a country's financial intermediaries, usually its commercial or universal banks. Such a system can expand its scope in three directions: by (1) covering depositors in other types of depository or non-depository financial institutions, (2) extending coverage beyond the home country, and (3) including other types of financial instruments in addition to deposits.

In the United States, the first and third types of expansion have occurred. Deposit insurance commenced at commercial banks in 1934, but a separate system was soon added for savings and loan associations and a third scheme was created for credit unions in 1970. Although these three systems insure only deposits, a separate system of

⁵ Following the break-up of the Soviet Empire, a large number of deposit insurance systems began in the middle and late 1990s in central and eastern Europe. Developing countries worldwide continue to initiate systems of protection in the new millennium. See Garcia (2000).

⁶ See Dale (1998).

protection for investors at securities firms was created in 1970. Subsequently, in addition, each State in the U.S. now maintains a guarantee fund to protect policyholders at insurance companies. To date, these five systems of protection (for banks, savings associations, credit unions, securities firms and insurance companies) have all remained separate.⁷ Moreover, there is no movement to combine protection for depositors, investors or insurance-policy holders or to extend coverage to deposits taken outside the United States.

The situation has developed differently in Europe, however. In order to view the situation in the Netherlands against the background of protection in the EU, this section examines how similar expansions of guaranteed coverage have occurred in European countries through the promulgation of two EU Directives, the 1994 Directive on deposit-guarantee schemes and the 1997 Directive on investor protection schemes. There is, as yet, no general directive to protect policyholders at insurance companies in the EU.

The 1994 EU Directive on Deposit-Guarantee Schemes

The systems put into operation in the early years of protection in Europe varied considerably from country to country.⁸ This led to the 1994 EU directive on deposit guarantee schemes, which aimed to harmonise, at a minimal level, the systems in place. The directive was also prompted partly by a second experience of bank failures in the region, this time in the early 1990s. For example, during the late 1980s and early 1990s, Denmark, Finland, and Sweden experienced major banking crises that led the latter two countries to place full guarantees on bank liabilities, guarantees that subsequently were replaced by limited systems of depositor protection.

But it was the closure of the Bank of Credit and Commerce International (BCCI) in July 1991 that was instrumental in the design of the 1994 Directive. BCCI was registered in Luxembourg, had its operational head quarters in London and operated subsidiaries/affiliates

⁷ Bills introduced into the U.S. Congress in 2002 unsuccessfully sought to unify the systems for banks and savings associations.

⁸ As evidenced in the EEC Recommendation (1986).

in 69 countries. The legal division of responsibility allowed the authorities in Luxembourg and the United Kingdom to "pass the buck," so that neither supervised BCCI's operations adequately. In July 1991, however, the authorities in London closed BCCI's U.K operations and this led to the withdrawal of funds from small and medium sized U.K. banks. "Within three years, a quarter of the banks in this sector had, in some sense, failed."⁹ The closure of BCCI's headquarters in Luxembourg led to the failure of its branches abroad. For example, BCCI failed in the Netherlands and was, in fact, the last bank to fail in that country.

Following the experience with BCCI, the 1994 EU Directive translated the concept of "home country control" into the field of deposit insurance. It aimed to provide protection to depositors of branches situated in a State other than that of the head office and to establish the responsibility of the home country scheme, not only to supervise the bank (as directed elsewhere), but also to compensate its depositors at a failed bank's branches in the host member country. To this end, the 1994 Directive expanded coverage to depositors at branches of member countries' banks operating within the EU. The Directive thus provided a missing link in the establishment of the single European banking market by insuring its depositors everywhere in the EU.

Part of the single market objective was the establishment of a harmonised minimum level of protection. The first harmonisation provision was that it was the obligation of every credit institution to become a member of a deposit guarantee scheme (unless it belonged to an alternative scheme that guaranteed its solvency). Mandatory membership was considered necessary to prevent runs by depositors that could lead to financial instability. Nevertheless, the directive lists certain classes of depositors that may be omitted from the scheme. The rationale for the exclusion of such depositors is that they do not need, or deserve, social protection. A large number of member countries have chosen to adopt the list of optional exclusions.

Expansion beyond the bare-bones level of instruments covered by the guarantee was required by both the 1994 Directives on deposit-

⁹ Logan (2001, p. 5).

guarantee schemes and the 1997 Directive on investor-protection schemes. For example, Article 1 of the 1994 EU directive on deposit-guarantee schemes, defines a deposit as "any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transaction and which the credit institution must repay under legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution." The definition also extends to shares held in U.K. and Irish Building Societies. This is a relatively wide definition of a deposit.

In a third harmonisation provision, the 1994 Directive also required the extension of coverage beyond banks to other forms of depository or credit institutions. Article 1 defines a credit institution as "an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account." This definition would encompass savings banks, mortgage banks, credit unions and other credit institutions dealing with the public. These definitions would require countries to broaden their deposit insurance scheme, or schemes, to cover all instruments fitting the definition of a deposit in any and all types of institutions fitting the definition of a credit institution.

It was mentioned above that many systems of protection in Western Europe began at about the same time. A fourth commonality is that systems of protection are mandatory within the EU. The Directive required countries to maintain or introduce a system and to officially recognise it. Moreover, the Directive set home-country responsibility for providing a minimum level of coverage, placed a temporary ban on exporting high coverage, allowed branches of foreign banks to top up their cover by joining the host country scheme, established three mandatory exclusions on own funds, interbank and money-laundered deposits, provided a list of optional exclusions, restricted advertising while requiring information to be provided to depositors.

The 1994 Directive left plenty of room for countries to tailor their system(s) of protection to local circumstances. Little attention was paid to combating moral hazard through coinsurance, limiting coverage,

risk-adjusting insurance premiums, or avoiding bank rescues and bailouts.¹⁰ During the negotiations leading to the Directive, German views prevailed and the proposal for a mandatory ceiling on protection and for a requirement for coinsurance was rejected, on the grounds that the dangers of moral hazard argument had been overstated. Consequently, the Directive permits countries to decide whether to choose or avoid coinsurance and it sets no upper limit on the coverage that countries can offer. Moreover, it exempts credit institutions from the obligation to join a system of deposit insurance, where their solvency was protected by an alternative system, as in the case of Germany's savings and co-operative banks.¹¹

By imposing an unambitious, three-month, deadline for compensation, a deadline that could be extended, the Directive allows variability in the timing of payouts. It puts no pressure on member countries to provide U.S.-style three-day compensation.

The Directive also imposes some ambiguous restrictions on advertising that permit countries to adopt different standards with respect to competition through advertising and to leave the possibility that depositors are insufficiently informed about their rights. For example, in its preamble the Directive states, "Whereas, information is an essential element in depositor protection and must therefore be the subject of a minimum number of binding provisions, whereas, however, the unregulated use in advertising of references to the amount and scope of a deposit-guarantee scheme could affect the stability of the banking system or depositor confidence; whereas Member States should therefore lay down rules to limit such references."

The Directive also gives members latitude in regard to financing the schemes they establish, while discouraging the use of government funds for this purpose. In the words of the Preamble, "Whereas it is not indispensable, in this Directive, to harmonise the methods of financing schemes guaranteeing deposits or credit institutions themselves, given,

¹⁰ See Dale (2000).

¹¹ From 2005, the German government will no longer be allowed to protect the banking system.

on the one hand, that the cost of financing such schemes must be borne, in principle, by credit institutions themselves and that, on the other hand, the financing must be in proportion to their liabilities; whereas this must not, however, jeopardise the stability of the banking system of the member State concerned."

Finally, the Directive sets a somewhat contradictory obligation for a member government to establish and officially recognise a system of deposit protection, but exempts it from any obligation to support it financially – even in a crisis. In fact, States are not liable if the systems they set up fail. "Whereas this Directive may not result in the member States or their competent authorities being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognised."

Following the 1994 Directive, which was adopted also by non-EU members of the European Economic Area, Austria, Belgium, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden and the United Kingdom all amended their systems of deposit protection in 1995 or 1996. Germany and Luxembourg were rather later in making changes (in 1998 and 1999, respectively). The amendments in Denmark, Finland and Sweden most probably reflected primarily these countries' experiences with extensive guarantees granted during their financial crises in the early and mid-1990s. It would seem probable, however, that most countries needed to make changes to conform to the 1994 EU Directive on deposit-protection schemes.

Some countries, for example, the Netherlands and the United Kingdom, did not make substantial changes to their systems of protection at this time.¹² Belgium undertook a moderate list of revisions to its old-

¹² The modest changes made by the Netherlands are discussed below in Section 3. In 1995, the U.K modified its protection scheme only moderately to conform to the EU directive. It increased the percentage of coverage under its system of coinsurance from 75% to 90% and it raised the maximum insured payment to the greater of £20,000 or ECU22,222. See Cranston (1997).

established systems of protection. Other countries, Germany and Italy, for example, found it necessary to make more significant changes to conform to the EU Directive. These two countries, like Denmark and France, might need to consider making adjustments if only because they offered higher than minimum EU coverage and overprotection may create moral hazard and because the directive temporarily prohibited exporting high coverage. Sweden had experienced a serious banking crisis in the early 1990s and introduced unlimited coverage to prevent a melt-down in the banking system. In response to the 1994 EU Directive, Sweden created a new system of limited protection. Unfortunately, data about changes undertaken by the EU-countries are far from complete. Based on the available data, Boxes 1, 2 3 and 4 describe the changes undertaken by Belgium, Germany, Italy and Sweden.

The 1997 Directive on Investor Protection Schemes

A blurring of distinctions between financial firms and financial products as the 1990s progressed caused the EU to decide that it had become difficult to separately identify deposits from other forms of consumer savings and credit institutions from other financial firms. Moreover, the EU considered that these other financial instruments, held at other types of financial institutions, warranted protection.

Consequently, investor protection was one of the objectives of the 1993 Directives on Investment Services and Capital Adequacy that required that an investment firm must be authorised to be fit and proper and sufficiently capitalised in its home State before venturing abroad.¹³ However, regulation and supervision were acknowledged to be insufficient to protect investors in all circumstances. Thus, the European Parliament and Council issued a proposal on Investor Compensation schemes and reissued it in amended form in 1994. Ultimately, the EU Parliament enacted a second protection Directive, that of March 1997 on investor-compensation schemes. This Directive provided "a harmonised minimum level of protection at least for the

¹³ Directive 93/22/EEC of 10 May 1993, O.J. 1993, L141/27 and Directive 93/6/EEC of 15 March 1993, O.J. 1993, L141/1. See Cruickshank (1996).

small investor in the event of an investment firm being unable to meet its obligations to its investor clients."¹⁴

Article 1 of the 1997 Directive defines an investor as "any person who has entrusted money or instruments to an investment firm in connection with investment business." In turn, an investment firm is defined as in EU Directive 93/22/EEC as "any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis."¹⁵

Apart from extending coverage to additional types of financial instruments held at an enlarged group of financial institutions, the 1997 Directive attempted to enact provisions that paralleled those of the 1994 Directive. Thus, it required mandatory participation, established home country responsibility, temporarily prohibited competition through exporting higher coverage for fear of moral hazard, allowed branches of foreign banks to top up their coverage, provided for a minimum level of coverage (ECU20,000) with three mandatory and a number of optional exclusions, permitted coinsurance, allowed diversity in funding arrangements, restricted advertising, but required the provision of information to investors, and relied on the principle of *caveat emptor*.

Given the prevalence of universal banking in Europe, the broadened definitions that governed membership in a protection scheme and also the instruments it encompassed would require countries to offer coverage in both banks and securities firms. Countries needed to decide how best to do that. All member countries revised their systems subsequently, typically setting up a separate scheme for securities firms. In the cases of the Netherlands and the United Kingdom, the resulting changes were more extensive than those required for these two countries in order to conform to the 1994 EU Directive. The UK decided to integrate its separate systems in 2001 and the Netherlands is considering doing so. Box 5 describes changes in the UK in detail.

¹⁴ See paragraph 4 of the EU Directive on investor-compensation schemes.

¹⁵ See Article 1 of the 1993 Directive, *op. cit.* The definition can be extended to include undertakings that are not legal persons in certain instances.

Protection for Insurance Policyholders¹⁶

There is, as yet, no general directive requiring protection for policyholders in the insurance industry. However, the blurring of distinctions between financial products can be expected to inspire policy makers to think about this issue. Moreover, the decline in equity values world-wide is likely to reduce the value of insurance companies' (particularly life insurance companies') asset portfolios and may cause solvency problems at weaker institutions. Such a development might well trigger the discussion and prompt a third EU Directive to protect insurance policy holders.

Even without a directive, funds to protect policyholders have been established in at least 21 OECD countries. Such funds are of two types. The first protects policyholders (typically in full) in one or a few branches of the insurance industry. The second type partially covers most contracts written by participating insurance companies.

Funds to Protect Specific Classes of Insurance

These are established typically where insurance is compulsory, as in the case of motor vehicle liability insurance.¹⁷ For members of the EU it is mandated by Article 1 of the second European directive on compulsory motor vehicle insurance. Some countries (France, Italy and Spain) also maintain funds for compulsory insurance covering hunting accidents, while France, Italy, Japan and Poland have funds to cover classes of agricultural or industrial accidents. These funds usually provide full coverage.

General Funds to Protect Insurance Policyholders

Only 4 EU countries (France, Ireland, Spain and the U.K.) have established funds to cover life insurance policyholders. In Ireland and the U.K., such coverage is limited to natural persons. France has applied a cap to the coverage offered. The U.K. limits recovery to a percentage of the claim. Ireland imposes both a cap and coinsurance.¹⁸

¹⁶ See OECD (2002).

¹⁷ A majority of OECD countries maintain funds in this instance.

¹⁸ As far as non-EU countries are concerned, Canada, Ireland, Japan, Korea, Poland and the U.S. have established funds to cover life insurance policyholders. Canada, Korea and the U.S. have applied a cap to the coverage offered. Others (Japan) limit recovery to a percentage of the claim.

The system in the United Kingdom, since 2001, is funded *ex ante*, while that in Ireland is funded *ex post*. France uses a combination of *ex ante* and *ex post* funding. Assessments are based on premiums in Spain and the U.K.

Box 1 - BELGIUM

Belgium needed to make a number of moderate adjustments to the systems of depositor protection that it had had in operation for almost 60 years.

The Systems Before the 1994 Directive ()*

Belgium began a rudimentary system of protection, operated by the *Institute de Reéscompte et de Garantie* (the IRG) in 1935. The system was formalised with the creation of a deposit insurance fund in 1974 and by more detailed arrangements in 1985. At the beginning of 1985, two funds were established, one for banks and one for private savings institutions. Publicly-owned institutions were not included. Both schemes were run by the IRG and were financed mainly by member institutions, although contributions to the fund were retained by the bank to be called upon as needed by the fund. Participation was voluntary, but in practice all eligible institutions belonged. Only deposits in Belgian francs (later in any EU currency) were covered. Maximum coverage was Bfr500,000 per account; however, depositors had no legal right to reimbursement, which remained at the discretion of the IRG and would only be considered in the event of a bank's bankruptcy. If insufficient funds were available to compensate a depositor as promised, compensation would be reduced proportionately to fit available resources. Additional compensation could then become available at a later date after the IRG had called on additional contributions from members. Belgium used its systems only once, when a savings bank failed.

The Systems in Belgium after the 1994 Directive

The new system in Belgium required mandatory participation for all Belgian banks, savings institutions and public credit institutions. The two separate funds were combined into one. Members were required to send their contributions to the fund, instead of retaining them in house. Contributions were set at 2% of the deposits taken from clients. An additional 0.4% could be called in when the fund had insufficient resources. However, a credit institution could cease paying premiums when the sum of its contributions had reached a level of 0.5% of its guaranteed deposits.

The Belgian government gave a temporary guarantee of BF 3 billion to cover the cost of any intervention that the fund might need to make at a publicly-owned credit institution. Depositors were given a right to reimbursement when their credit institution became bankrupt or was otherwise unable to repay the funds it owed. The guarantee was applied to the sum of a depositor's accounts at a failed bank and the coverage limit no longer applied to each account separately. Belgium adopted EU mandatory exclusions (on interbank funds, own funds and money-laundered accounts) and the list of optional exclusions, including those applicable to depositors who had obtained non-market concessions from the bank.

Box 1 - BELGIUM (continued)

Belgium again revised its system of protection in a statute of December 1998.^(*) The statute created a Fonds de Protection des Depots et des Instruments Financiers (FONDS) to replace the Institut de Reescompte et de Garantie (IRG). The law gave the FONDS the option of operating separate protection systems for credit institutions and for investment firms. In February 1999, the FONDS chose to unify the separate systems of protection into a systeme de protection des depots et des instruments financiers. This system covers credit institutions, stockbrokers, and asset management firms.

(*) See Belgium (1995)

(**) See EU Commission (2001)

Box 2 - GERMANY

By the 1990s, Germany already had several systems of protection in operation and they could not be easily reconciled with the 1994 EU Directive.

Deposit Insurance in Germany before the 1994 Directive ()*

In 1999 the German banking system included three types of banks. Private commercial/universal banks held 25% of system assets. This sector of the market was relatively highly concentrated: the four largest banks held 57% of private banking assets in 1999. The German banking system as a whole, however, exhibited low concentration in 1999 because there were large numbers of savings, co-operative and other banks that held 36%, 13%, and 26%, respectively, of system assets. Publicly owned banks were important: they held over 36% of system assets in 1999.

Each of the three groups of banks maintained its own voluntary system of deposit insurance. The system for private banks was initially organised by the German Bankers' Association, following the 1974 failure of Bankhaus Herstatt. The aim was to offset the public banks' competitive advantage arising from their public ownership and explicit guarantee under a scheme run by the Association of Public Banks. The savings and co-operative banks both also established schemes that protected their institutions from failure, in addition to guaranteeing deposits in the event of failure. All of the three systems were voluntary and are financed by premiums levied, *ex ante* or *ex post*, on their members.

The German System for Private Banks

The private system was funded both *ex ante* and *ex post*. The premium of 0.03% of liabilities could be increased up to 250% for riskier banks. There was no public funding, although experts had commented that it might be forthcoming in an emergency. Although formally voluntary, non-participants had to disclose this fact, which imposed a strong incentive to join. Yet members could be expelled by their peers. Coverage in the scheme for private banks was set at 30% of capital. The fact that the minimum capital requirement was EUR5 million meant that coverage could be at least ECU1.5 million. Moreover, as the average capital

Box 2 GERMANY (continued)

level was much higher, average coverage could, in fact, be ECU90 million. (9) Both domestic and foreign depositors were covered in domestic and foreign currency and in both domestic and foreign branches of member banks. Thus there was little or no monitoring by depositors, whose discipline was replaced by that exercised by the other members of each particular fund.

The scheme offered no statutory right to compensation; nevertheless, no depositor had ever been refused reimbursement and no member bank had been denied financial assistance. The scheme was run privately under the bylaws of a private association, and in fact operated like a club.(10) It had no public supervision, was run by 10 commissioners, and could expel members for supplying wrongful information or for being consistently ranked in the weakest risk category. Members operated conservatively because of peer monitoring, the risk of expulsion, strong offsite supervision by the Federal Supervisory Office (FSO) and the Bundesbank, and a legal system that severely punished bankruptcy.

The German Response to the 1994 EU Directive

The systems of protection in place in Germany deviated from the requirements of the 1994 EU Directive in a number of respects. Rather than adjust its systems, Germany initially objected to the Directive, in general, on the grounds that there was no need for a Community measure because national steps were sufficient. In particular, Germany objected to the Directive's export prohibition membership. The deposit insurance system for private German banks offered very high coverage. The export prohibition would, therefore, require German banks operating in other EU countries to reduce the cover they offered. That would impede the ability of German banks to compete abroad. The EU's topping-up provision would enable branches of foreign banks operating in Germany to obtain much higher coverage than they offered at home. This provision would expose Germany's generous system of compensation to bank failures arising from less-than-adequate home-country supervision and to foreign banks that maintained riskier profiles than the conservative German banks. The German authorities thought that mandatory membership was unnecessary because the German systems, with voluntary membership, had operated successfully since 1976. In fact, in 1993, the system run by the German Bankers' Association omitted only five banks that held relatively few deposits.

Germany took its general and particular objections to the European Court. It argued, first, that the Directive violated the EC Treaty; second, that the authors had given insufficient reasons for its provisions; third, that the export prohibition was incompatible with the Community's objective of providing a high level of consumer protection, and, fourth, that it was contrary to the Treaty's principle of proportionality. The German Government argued that the topping-up provision infringed the Second Banking Directive's principle of home-country supervision and the Treaty's principle of proportionality. With regard to the Directive's obligation for compulsory membership, Germany argued, first, that it violated the EC Treaty's principle of proportionality because Germany already had a "well-established national practice" in a deposit insurance scheme with voluntary membership, and, second, that it imposed an excessive burden on credit institutions.

Box 2 - GERMANY (continued)

The Court rejected all of the German arguments and dismissed both the general and the specific applications for annulment.^(*) Thus, in order to comply with the 1994 Directive, Germany enacted the Deposit Guarantee and Investor Compensation Act in August 1998 to implement both the 1994 and the 1997 Directives. The statute established two new, compulsory protection schemes (one for private banks and the other for public banks). These systems bestow a right to compensation to a limit of ECU20,000, with 10% coinsurance. The accounts of other banks and financial institutions, public bodies and insiders were excluded. Both schemes were privately managed by the bankers' associations but fell under the supervision of the Federal Banking Supervisory Office (FBSO). They were funded by premiums set by the Ministry of Finance.

Germany claimed that its privately run schemes did not fall under the EU Directive because they were not subject to public regulation. Consequently, despite establishing new systems of protection, the private guarantee systems continue to function with only minor adjustments. For example, the system for private banks now insures deposits over ECU20,000, those excluded by coinsurance, and others excluded from the official scheme. The three schemes for public banks savings banks, and co-operative banks continue to function.

(*) See Beck (2000).

(*) There is a degree of uncertainty concerning coverage in the German private system for private banks. A depositor could place a deposit at a well-capitalized bank, but later find that the bank's capital, and his/her coverage, had fallen sharply subsequently.

(*) Beck (2000).

(*) See European Court Reports (1997).

Box 3 - ITALY(*)

Until the 1970s, the Italian public was confident that failures would occur only at small banks. To rescue small failing institutions, a mutual guarantee scheme was set up for savings and loan associations in 1927, for agricultural credit associations in 1961, and for co-operative banks in 1978. The country faced the first post-war possibility of a large bank failure in 1974, when Banca Privata Italiana failed and was rescued with public funds.^(*) The method of intervention was strongly criticised but was not rectified until after Banco Ambrosiano failed and was rescued in 1982, again using public funds. At this time, discussion was under way in the EU about establishment of deposit insurance community wide. There was debate in Italy too, but the emphasis was on establishing a scheme in order to avoid the use of public funds to bail out banks. The discussion crystallised with the failure of Cassa di Risparmio di Prato, which was placed into receivership in 1988. The Interbank Fund for Deposit Protection (IFDP) in Italy was initiated in 1987 in order to avoid a public bailout of this latest banking casualty.

The System in Italy before the 1994 Directive

The IFDP was run by a consortium of banks that joined voluntarily. Members needed to meet

Box 3 - ITALY (continued)

certain prerequisites, could be sanctioned, and expelled. The principle of host-country responsibility was followed, branches of foreign banks operating in Italy could join, but branches of Italian banks abroad were not covered. Membership was confined to banks. There was no fund, but banks in the system set aside resources that combined to a maximum of 4,000 billion lire systemwide (1% of insured deposits) that could be called in when needed. As there was a limit on contributions, depositors would have no right to reimbursement if resources proved to be insufficient. In fact, reimbursement was at the fund's discretion and required approval by the Bank of Italy. Contributions were not adjusted for risk. In principle, coverage was high, at one billion lire (over ECU500,000). In practice, all deposits up to 8,000 million lire had full coverage. Such coverage was 10 times the European average and was extended to every account, not to the sum of a depositor's accounts at the bank. Moreover, interbank deposits were covered.

The Italian Response to the 1994 EU Directive

The IFDP deviated from EU requirements in a number of respects. It was voluntary, privately run, operated under the host-country responsibility, did not guarantee depositors a right to compensation and did not make the mandatory exclusions. Moreover, it offered very high coverage and thus exposed the system to abuse from foreign branches topping up their cover and it guaranteed interbank deposits. (In 1998 Denmark, Finland, France, Germany, Norway and Sweden, in addition to Italy, had coverage limits that exceeded the EU minimum.)

A legislative decree of 1996 took some major steps to bring Italy into compliance with the 1994 Directive. It made participation in a deposit insurance scheme mandatory, reduced the coverage level to 200,000 lire (ECU103,000) per depositor, and made provision for the mandatory exclusion of interbank deposits, a credit institution's own funds, and money laundered deposits.

Subsequently, staff of the Fondo Interbancario di Tutela dei Depositi (FITD) discussed further amending their system with the Bank of Italy and the Italian Banking Association. They considered changing the level of protection and the *ex post* funding arrangements and enhancing mechanisms for measuring and controlling risk.⁽⁴⁾ In the event, the Statutes and By-Laws, enacted in April 2001, made surprisingly few changes. The Italian scheme continues to be privately run by member banks, but is officially recognised. It continues to offer high coverage. Article 2 of the statute states that "All Italian banks, except for mutual banks, shall be members of the fund." Membership would appear to be compulsory, yet members can withdraw from the fund or be expelled from it (Article 5), raising the possibility that a bank could continue to operate and take deposits while it is uninsured. It is hard to reconcile this possibility with the requirement in Article 3.1 of the EU 1994 Directive that, "Each Member State shall ensure that within its territory one or more deposit-guarantee schemes are introduced and officially recognised. Except in circumstances envisaged in the second subparagraph and in paragraph 4, no credit institution authorised in that Member State pursuant to Article 3 of Directive 77/780/EEC may take deposits unless it is a member of such a scheme."⁽⁴⁾

Box 3 - ITALY (continued)

Moreover, there is a limit placed on the total amount of reimbursements that may be made in any one year. Article 27.9 states that that total may not "exceed one fourth of the moneys available for interventions." Consequently, depositors have no right to reimbursement.

The Statute did make a change with regard to funding the scheme. A fund, ranging between 0.4 and 0.8 of repayable funds, replaces *ex post* assessments. But an *ex post* element of funding remains. If the fund falls below its minimum level, banks are required to replenish it within four years (Article 21). They also have an obligation to make regular payments to defray the fund's operating expenses, when requested. Contributions can be increased, or decreased by 7.5% according to the institution's size. Larger institutions pay at a lower rate than smaller institutions. Contributions are also adjusted according to indicators representing the adequacy of the institution's provisions for losses and its capital adequacy.

(*) See Montanaro (1996).

(*) By Ministerial decree, an extraordinary advance, derogatively named a "Sindona advance" was made to compensate the bank taking over the failed bank's assets and liabilities.

(*) See Fondo Interbancario di Tutela dei Depositi (1998 and 2000).

(*) The second subparagraph exempts banks from the obligation of membership if they belong to a system that protects them from failure, while the exemption in paragraph 4 requires banks to make alternative arrangements for deposit protection before expulsion.

Box 4 - SWEDEN

Sweden experienced a serious banking crisis in the early 1990s and placed a full guarantee on bank liabilities to avoid a melt-down in the banking system. The 1994 EU Directive necessitated that Sweden create a system of limited protection, *ab initio*. The new deposit guarantee scheme, designed to conform to the Directive, was enacted in 1995 and came into effect on 1 January 1996. It guarantees deposits at credit institutions and those securities firms that are permitted to receive cash deposits from customers. Unlike most EU members, Sweden elected to cover just short-term deposits (of both natural and legal persons) and not to adopt the EU's option list of exclusions. Coverage, at SEK 250,000 or EUR 27.086(*), is higher than the EU minimum. The depositor does not need to submit a claim for reimbursement and there is no provision for offsetting a depositor's debts to the bankrupt institution against his deposit.

The Deposit Guarantee Board maintains a fund, for which it has a target of 2.5% of insured deposits, and charges premiums that are adjusted for risk, as measured by capital adequacy. The fees are designed to cover both administrative costs and anticipated compensation. The Board has a right to borrow from the National Debt Office, if necessary, and it invests its accumulated resources there. It is a separate and independent body with a small staff housed at the Financial Supervisory Authority and reports to the Ministry of Finance. The Board has made agreements with the Riksbank, the Financial Supervisory

Box 4 - SWEDEN (continued)

Authority and the National Debt Office to borrow staff if a bank fails.

The 1997 EU Directive on investor compensation schemes caused Sweden to enact new legislation which came into effect on 1 May 1999. It covers securities (to SEK 250,000) held at licensed Swedish investment firms and branches of foreign investment firms operating in Sweden. Beneficiaries have to file a claim after their firm has been declared bankrupt and can expect payment within 3 months. Members of the scheme pay fees to cover administrative costs to the Deposit Guarantee Board, which operates the scheme. Ex post assessments are levied to cover compensation.

(*) Exchange rate on 18 March 2003

Box 5 - The UK

Before the reform legislation of 2000, supervision in the United Kingdom was conducted on industry lines by a large number of different bodies. This regulatory hodgepodge had "been created by a series of piecemeal responses to specific events or to perceived gaps."^(e) Prudential supervision for banks was undertaken by the Bank of England, for building societies by the Building Societies Commission, and for insurance firms by the Department of Trade and Industry. Securities firms were overseen by the Securities and Investments Board, the Securities Futures Association, the Investment Management Regulatory Organisation, the Personal Investment Authority and by several Recognised Professional Bodies. The changing configuration of the financial markets in the U.K., as elsewhere, particularly the emergence and growing importance of conglomerates, led to a lively discussion of how best to change supervisory structures and practices.^(f)

The debate broadly saw three approaches to the structure of regulation: institutional, functional, and by objective. Under the institutional approach to regulation, different rules applied to banks, insurance companies and investment firms and were administered by specialist regulatory agencies. Functional regulation focused on the business undertaken by an institution irrespective of which institutions were involved. (Thus life insurance was regulated similarly regardless of whether it was provided by a bank or an insurance company.) This approach required specialist functional regulators. The third approach was to focus on the objectives being sought by regulation, concentrating on prudential, systemic, or conduct-of-business issues. While it may well be possible to combine prudential and systemic regulation, conduct of business regulation uses different approaches and cultures and was therefore a candidate for separate treatment. The debate also ranged over who should be the regulator or regulators. Should the Bank of England continue to play a regulatory role or should a new body (or bodies) take over the job?

In the event, in the Financial Services and Markets Act of 2000, the United Kingdom chose to consolidate supervision (both prudential and conduct-of-business) for all financial firms in one regulatory/supervisory body, the Financial Services Authority (FSA). The Bank of England retained authority for systemic stability, in addition to its monetary policy responsibilities.

Box 5 - The UK (continued)

Depositor and Investor Protection before the 1997 Directive

At the same time, the U.K decided to reorganise its several systems of protection for depositors, insurance policyholders, and investors. Until the end of 2001, there were separate protection schemes for depositors in commercial banks, in building societies, in friendly associations, for investors in securities firms, for policyholders at insurance companies and for pensioners.

These schemes had met with varying degrees of success. For example, the banks' Deposit Protection Board needed to demand £80 million in *ex post* levies from its members in 1992 to compensate consumers at failed banks. The Investors' Compensation Scheme made levies of totally £224.5 million in order to pay compensation over the five year period 1997-2001. The Policyholders' Protection Board made levies of £341.7 million in the four-year period 1992-1995 to cover the reimbursements it made.

Protection in the U.K. after the 1997 Directive

The statute of 2000 created a new body - the Financial Services Compensation Scheme (FSCS). The FSCS's web site [www.fscs.org.uk] describes its role as that of "a safety net for customers of authorised financial services firms." It combines under one roof the many predecessor protection schemes. It "can pay compensation if an authorised firm is unable, or likely to be unable, to pay claims against it" that is, in general, if the firm is insolvent or has gone out of business. The scheme covers deposits, insurance and investments." It became operative in December 2001 when the Financial Services and Markets Act of 2000 went into effect. It covers firms regulated by the Financial Services Authority (FSA) and EU firms authorised by their home-country regulator. It is funded by *ex ante* levies on authorised firms. There are limits on the compensation that can be paid. The limits, which vary from scheme to scheme, apply to the sum of each depositor's, policyholder's, or investor's holdings in a failed firm. For deposit-taking firms the limit is £31,700, including £2,000 in full, plus 90% of the next £33,000. For claims against insurance firms, the limit is £2,000 in full plus 90% of the balance, except that compulsory insurance is covered in full. Claims against an investment firm are covered to £48,000 (that is, 100% of the first £30,000 plus 90% of the next £20,000). The scheme covers private individuals and small businesses. Those seeking compensation have to file a claim in order to be considered for reimbursement.

The scheme has three subgroups of member institutions, each with different premium obligations. The first group consists of institutions that accept deposits, the second group consists of firms in the insurance business and the third is for designated investment firms. These groups broadly correspond to the former Deposit Protection Scheme, the Policyholders' Protection Scheme, and the Investors' Compensation Scheme, which were replaced by the FSCS in December 2001. A financial firm's contributions are determined by its sub-group, but it can belong to more than one subgroup.

The *ex ante* levies on participating firms cover general and specific management expenses and payments for compensation. Specific management expenses and compensation costs are funded only by members in the appropriate group. Levies to cover compensation

Box 5 - The UK (continued)

expenses are forward looking. The FSCS estimates its compensation costs, in excess of the existing fund balance, during the upcoming 12 months and sets its premiums accordingly. It expects to impose only one levy a year but can make additional calls on member resources should the need arise.^(*) The annual limits on levies to cover compensation are: (1) for depository firms, 0.3% of a participant firms' protected deposits; (2) for insurance firms, 0.8% of a participant firm's net premium income from protected policies; and (3) for investment firms, the total levy must not exceed L400 million. Levies are not adjusted for the risk that an individual institution poses to its fund. A firm will be allocated to a subgroup according to its "regulated permissions" and "could be allocated to one or more Contribution Groups, and therefore, Sub-Schemes, by virtue of its permitted activities."^(*)

The FSCS is governed by a board of 10 directors appointed by the FSA. Nevertheless, it is meant to be independent of the FSA. The appointment of the Chairman of the FSCS is subject to approval by the Treasury Department. Although the FSCS is independent of the FSA, it is accountable to it and ultimately to the Treasury. The FSCS has set up three industry committees to advise it—one each for the deposit, insurance, and investment segments.

^(*) Taylor (1995, p.3).

^(*) See Goodhart et al (1998).

^(*) For the financial year 2002-2003, the members of the investments sub scheme contributed L56.4 million, while the members of the other two sub schemes paid no compensations levies.

^(*) See [www.fscs.org.uk/industry/funding].

3. A further look into the history of depositor and investor protection in the Netherlands

3.1 Introduction. In some countries, such as the United States, it is relatively easy to find a history of depositor protection in that country. The Federal Deposit Insurance Corporation (FDIC) has published its history and makes it, and many other documents, available on its web site [www.fdic.gov]. But such a wealth of data is the exception rather than the rule. In most other countries, the history of deposit insurance appears not to have been written and the background materials needed to write it are relatively inaccessible. A historian may need to rely on relatively few, short written descriptions to be supplemented by burrowing in the archives, and drawing upon the living memory of a

few knowledgeable people, particularly those involved in the creation of the system, in order to determine what happened.

The history of investor protection is even harder to trace. Such protection has existed in the United States since the Securities Investor Protection Corporation (SIPC) was created in 1970. But few people would pretend that the U.S. public understands how SIPC operates. Its web site [www.sipc.org] has improved since it was criticised by the U.S. General Accounting Office in 2000, but still remains a faint shadow of the FDIC's site. Similarly, depositor protection was harmonised in the EU directive of 1994 before investor protection was tackled in the EU directive of 1997. It seems likely that the public in Europe in general, and in the Netherlands in particular, understands the protection that is available to depositors better than it comprehends that available to investors.

In the Netherlands, only brief descriptions of deposit insurance have been published.¹⁹ Even less information is currently available on the two systems of protection available for investors. This section of the paper will, therefore, attempt to provide a more comprehensive set of summary data on the institutional features of deposit insurance and investor protection as they have been practised in the Netherlands since 1978. It will also attempt to trace the changes that have been made over time and determine how these changes fit into the adjustments to the regulatory systems for banks, insurance companies and securities firms to enable the supervisors to function effectively in the changed, and still changing, financial environment.

3.2 The Start of Deposit Insurance in the Netherlands: the 1978 Act.

Discussions concerning the introduction of deposit insurance date back in the Netherlands to 1965, following the merger of four large banks that prompted debate on the need to revise the existing 1956 Act on Supervision. A second trigger for introducing deposit insurance was the bankruptcy of a small Amsterdam bank, Teixeira de Mattos, in 1966. The fact that depositors lost their money was covered

¹⁹The published materials are Bikker and Prast (2001) and Mooij and Prast (2002a, b).

extensively in the press and DNB was heavily criticised. A third trigger was the debate on deposit insurance being conducted by the European Commission, as discussed in Section 2 above. A revised Act on Supervision was not enacted until 1978, however, following slow and deliberate debate and subsequent additional revision to conform to an EEC supervisory directive that was designed to co-ordinate banking legislation across EU countries. The introduction of a deposit insurance system was, therefore, delayed until the scheme could be included in the 1978 revised Act on Supervision. Nevertheless, the Netherlands was one of the first EU members to respond to the discussions underway in the European Community by establishing a system of deposit insurance.

The deposit insurance system introduced in 1978 reflected some particular features of the Dutch financial system. First, the banking market was then dominated by a small number of large banks. Second, these banks were so sound that it was virtually impossible to imagine that they would fail. Failures were expected to occur only among small banks. And, indeed, this expectation has been borne out by subsequent events. Third, the law required the central bank, which, as the banking supervisor, was to act as the deposit insurer, to consult with banking trade associations. The associations' views were instrumental in the design of the system.²⁰ The large banks preferred to share the costs of any such failures among themselves after the event, rather than contribute to a fund and pay its associated administrative costs. The large banks also anticipated that the insurance fund would earn a lower return on the monies they contributed to it than they, themselves, could earn in house.²¹

In the Act, the definition of credit institutions was widened to encompass all institutions that received funds (repayable at less than two years notice) from the public and granted credit and/or made investments for their own account. Supervision was extended to capital market institutions and near banks, such as mortgage banks.

²⁰ This model of consultation was the formal equivalent of the system of paternal supervision that had prevailed until 1952. See Prast (2001)

²¹ See Bikker and Prast (2001).

Membership in the deposit insurance system was expanded accordingly. Within a few years after the introduction of the deposit insurance system, two banks went bankrupt: Amsterdam American Bank in 1981, and one of the mortgage banks (de Tilburgsche Hypotheekbank) in 1982. Two other mortgage banks were rescued with the help of insurance companies who took them over.²² The last bank to fail in the Netherlands was the Amsterdam branch of BCCI, in 1991. This implies that since the introduction of the deposit insurance system, three banks have failed. No information is available as to the amount of total and insured deposits at these institutions. Summary information on the deposit insurance scheme, as it existed in 1978, is shown in column 2 of Table 2.

3.3 Factors Influencing Protection Schemes in the Netherlands

3.3.1 Introduction

Four factors, in particular, have influenced changes to the deposit insurance system in the Netherlands. First, as shown in Section 2 of the paper, discussions leading to the 1994 directive on deposit-guarantee schemes required deposit insurers in many EU countries to make changes to their systems of deposit protection that harmonised systems in the different member countries to a minimum extent and provided a more level playing field by limiting competition through deposit insurance coverage. The second factor was a changing landscape of the financial markets in Europe in general and in the Netherlands, in particular. Third, the blurring of distinctions between different types of financial firms and the increasingly complex design of financial instruments led the EU in 1997 to a second EU directive on investor compensation schemes. The fourth factor is the reorganisation of supervisory agencies that took place in the second half of 2002. These factors will be discussed below.

3.3.2 Harmonisation of regulation: the EU Directives of 1994 and 1997. The EU's two Directives have required member countries to adapt their systems of deposit protection to the changing financial

environment. The first Directive, that of May 1994 on deposit guarantee schemes, established certain minimum standards for deposit insurance systems in member countries and temporarily precluded competition from branches of foreign banks that offered higher coverage than their domestic competitors ("the export prohibition"). This directive led to the introduction of a revised scheme in the Netherlands in 1996, although the authorising law was enacted earlier, in July 1995. The Netherlands did not change its system of protection greatly. The deposit insurance system in operation in the Netherlands in 1996 is summarised in column 3 of Table 2.

As mentioned above, the blurring of distinctions between financial firms and financial products caused the EU to decide that it had become difficult to separately identify deposits from other forms of consumer saving and that these other forms of savings warranted protection. This formed the third impetus to change in the Netherlands and the EU. To provide protection to investors in the securities markets, as described in Section II above, the EU Parliament enacted a second directive, that of March 1997 on investor compensation schemes. This directive provided "a harmonised minimum level of protection at least for the small investor in the event of an investment firm being unable to meet its obligations to its investor clients."²³

The 1997 directive led to a second, and more substantial, revision in the Dutch system of protection that took place in 1998. It caused not just the revision of the deposit guarantee system for banks, but the creation of a separate system to protect investors in securities firms. A large percentage (approximately 80%) of securities business is conducted in the Netherlands by banks. Consequently, to conform to the 1997 EU directive, the banks' system of protection was extended beyond deposits to encompass securities in what is called "the Collective Guarantee Scheme of Credit Institutions for Repayable Funds

²² To enable this acquisition of the mortgage banks by insurance companies, the Minister has announced that he would not automatically withhold his consent if insurance companies and banks were to merge. This was a change in the financial structure policy that had reigned thus far. See Mooij and Prast (2002a, b).

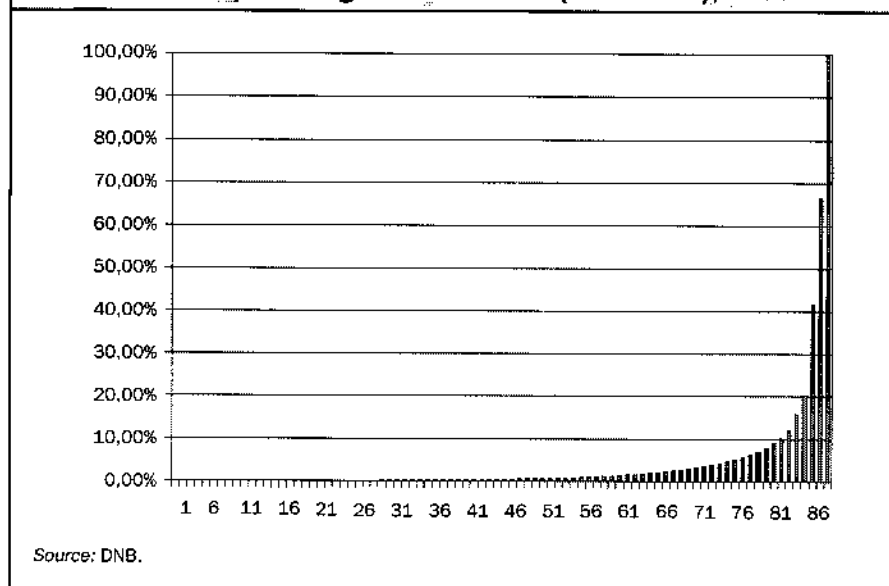
²³ See paragraph 4 of the EU Directive on investor-compensation schemes.

and Portfolio Investments (CGS).²⁴ This enlarged scheme continued to be run by DNB. Protection for the remaining 20% of the securities industry was attained in a separate scheme, the Investor Compensation Scheme (ICS). The ICS was operated by the Securities Board of the Netherlands (later the Financial Markets Authority) from 1998 to 2002. In September 2002, as part of a major supervisory reorganisation described below, responsibility for the ICS was transferred to DNB. The major features of the CGS and the ICS are summarised in columns 4 and 5, respectively, of Table 2.

3.3.3 The Changing Financial Environment

Concentration has been an enduring factor in financial markets in the Netherlands. Mergers between major banks have taken place since the 1960s and have led to a highly concentrated banking sector. The percentage of banking assets held by the five largest

FIGURE 1 - Bank concentration in the Netherlands. Assets of individual banks as percentage of total assets (cumulative), 2000



²⁴ The regulations regularizing the changes are embodied in DNB (2002).

Dutch banks was 82% in 2000. This degree of concentration was much higher than the European average of 55% in 1999 and more than four times that observed systemwide in Germany.²⁵ The cumulative distribution of asset holdings in the year 2000 is shown in Figure 1, which emphasises the dominance of the three largest banks.

Since the late 1980s the financial sector in the Netherlands has changed considerably. Deregulation²⁶, financial engineering, globalisation, conglomeration, the blurring of distinctions between banking, insurance, and securities activities, the EU's single market for financial services, the creation of the euro, and growing recognition of the importance of financial integrity and consumer protection have affected financial markets world-wide. These developments caused changes in supervisory law and practice in the Netherlands and revisions in its system of deposit protection.

Figure 2 uses G10 data to illustrate the trend of internationalisation and financial conglomeration in the Netherlands. It shows that the number of deals consummated within the Netherlands during the 1990s within the same segment of the financial sector was particularly high in the first half of the decade. In the second half of the 1990s, the number of cross-border deals within the same segment of the industry became prominent.

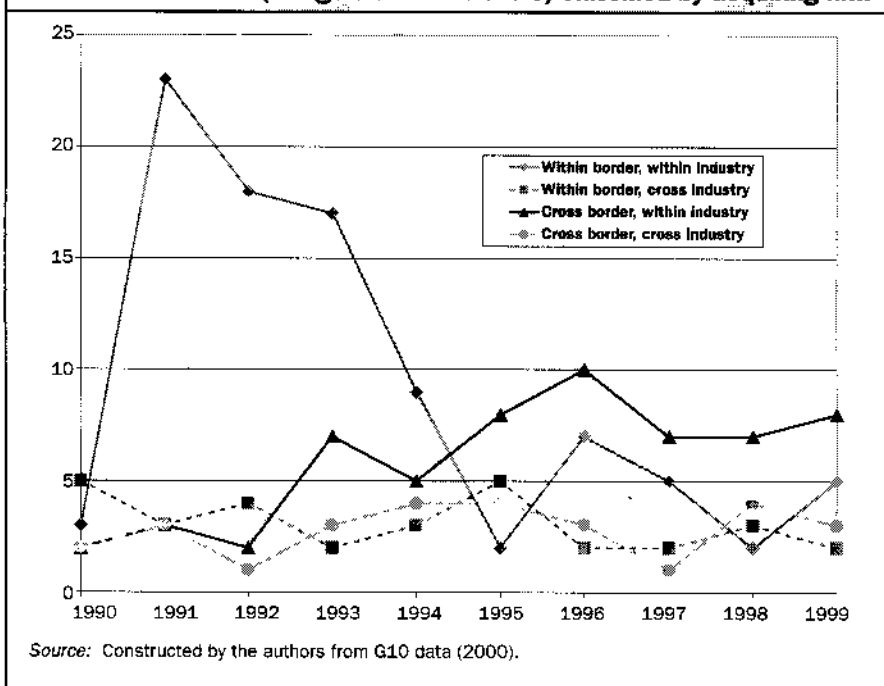
3.3.4 Changing Supervisory Structures

The EU directives, together with the changes in market composition, have necessitated a reorganisation among supervisory supervisory systems and a revision of supervisory practices in the

²⁵ See Prast (2001). The private banking system in Germany is more heavily concentrated, however, as discussed in Section 2 above.

²⁶ As far as cross-sector mergers are concerned, the 1978 Act on the supervision of the credit system required a declaration of no objection (by the Minister of Finance or DNB) for participation (over five percent) by credit institutions in other institutions. Although the Act did not explicitly forbid credit institutions to merge with insurance companies, the system of declarations of no objection was in fact used to prevent these mergers until 1990.

FIGURE 2 - Financial consolidation in the Netherlands: number of deals in the financial sector (mergers and take-overs) classified by acquiring firm



Netherlands.²⁷ The changes are now leading to a debate over whether and, if so how, to adapt the system of deposit insurance to the new financial and supervisory environment. As mentioned above, the need to fit the two systems of protection into the new supervisory landscape gives an opportunity to make changes to the systems of protection. For example, the possibilities of combining the CGS and ICS, of adopting risk-based premiums and ex ante financing are being debated.

Initially, supervision in many countries was applied separately to commercial banks, insurance companies and securities firms. To a considerable extent, such sectoral supervision continues to be practised in the United States, where legislation for many years separated commercial from investment banking and continues to isolate banking from commerce. But such a separate-industry model

²⁷ See Mooij and Prast (2002).

was never particularly appropriate in many of the financial markets in Europe, where universal banking has frequently prevailed. As discussed in Section 2 above, in some countries, such as the United Kingdom, the growth of financial conglomerates has led to the creation of a single supervisor that oversees all three segments of the financial markets.²⁸

Conglomerates evolved over time in the Netherlands, as the process in Figure 2 illustrates. During the 1980s, for example, banks in the Netherlands increasingly undertook securities activities. Further, following the removal, in 1990, of a prohibition on combining banking and insurance activities in the Netherlands, mergers and acquisitions among financial firms from different industry segments lead to the creation of conglomerates in the local market.

Nevertheless, the separate-industry model of supervision continued to dominate the supervisory scene in the Netherlands until the 1990s. De Nederlandsche Bank (DNB) was responsible for systemic stability and it also supervised individual banks and money exchange offices with regard to their safety and soundness and their business practices. The Bank also ran the CGS. The Pensions and Insurance Authority oversaw pensions and insurance companies, and the Securities Board guided securities firms and the exchanges and ran the ICS.²⁹ This apportionment of responsibilities is illustrated in the boxes in Figure 3.

During the 1990s, however, the changed financial landscape increasingly pointed to the need for a revision of regulatory and supervisory responsibilities. For example, the development of 'bancassurance' in the Netherlands has led to increasing co-operation by the bank and insurance supervisors. To complete this process the two supervisors will be unified no later than 1 January 2005. Thus, supervisory structures have changed in recognition that technological change has facilitated the blurring of banking, insurance, and securities markets. In 1999, a Council was established to co-ordinate the supervision of the three components of the financial services industry. In 2002, a major reorganisation was accomplished. Supervision would

²⁸ See Green and Lannoo (2000) and Section 2 of this paper, above.

²⁹ See Brouwer (2002) and Mooij and Prast (2002a, b).

no longer be conducted by industry, but rather on a cross-sectoral basis with emphasis on (1) systemic stability, (2) the soundness of individual financial institutions, and (3) the proper conduct of business.

The responsibilities for these three functions are now apportioned as follows. The Bank retains responsibility for systemic stability and prudential supervision of credit institutions. It co-operates closely with the Pensions and Insurance Supervisory Authority to undertake the prudential supervision of insurance companies. As mentioned above, these two supervisors are expected to be fully integrated no later than 1 January 2005. The Bank took over from the Authority for Financial Markets the prudential oversight of securities firms. It continues to operate the CGS and has acquired responsibility for the ICS. The Securities Market Supervisor changed its name to the Authority for Financial Markets and has taken responsibility for conduct-of-business supervision for all financial firms. The Council of Financial Supervisors, created in 1999 to co-ordinate regulation across the different industry supervisors, remains in operation after the 2002 reorganisation to facilitate supervisory co-operation. A Covenant between the three supervisors sets the "rules of the game." The reallocated responsibilities

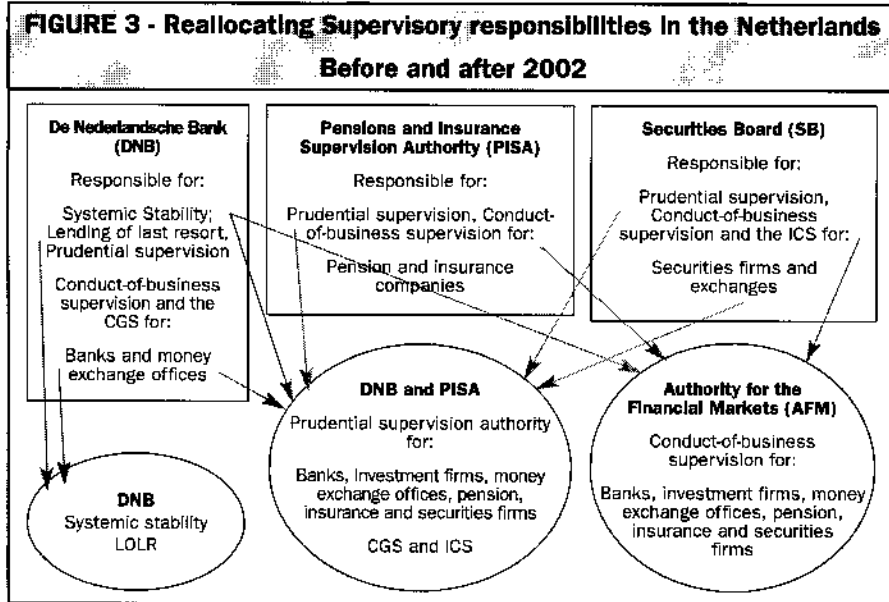


TABLE 2 - Features of Depositor and Investor Protection in the Netherlands

Feature	1978	1996	1998 CGS	1998 ICS
Objectives	Avoid bank runs Protect small depositors	Avoid bank runs Protect small investors	Avoid bank runs Protect small investors	Protect small investors
Compulsion	Obligatory	Obligatory	Obligatory	Obligatory
Membership	Banks	Banks	Banks	Securities firms non-banks
Branches of foreign banks or securities firms	?	Yes for branches of foreign banks	Yes, for branches of foreign banks	Yes for branches securities of firms non-banks
Dutch banks or securities firms	?	Operating within the EEA	Operating within the EEA	Operating within the EEA
Suspension of payments	Court at request	Court at request	Court at request	Court at request
Revokes License/cancels registration	DNB	DNB	DNB	Securities Board
Liquidator	Appointed by Court	Appointed by Court	Appointed by Court	Appointed by Court
Governance				
Implementor	DNB	DNB	DNB	Securities Board
In consultation with	Bankers' Associations	Bankers' Association	Bankers' Association	Bankers' Association and representatives of brokers
Funding	Ex post	Ex post	Ex post	Fund and ex post
Immediate source	DNB	DNB	DNB	ICS Fund
Final source	Members	Members	Members	Members
Basis	At discretion of banks/DNB	At discretion of banks/DNB	At discretion of banks/DNB	Fixed amount + number of clients
Risk-based	No	No	No	No
Limits on payment	5% of own funds, systemwide, 5% of individual bank's capital	5% of own funds, systemwide, 5% of individual bank's capital	5% of own funds, systemwide, 5% of individual bank's capital	5% of own funds, systemwide, 5% of individual bank's capital
Backstop	DNB	DNB	DNB	?
Coverage	Persons, foundations, small enterprises	Persons, foundations, small enterprises	Persons, foundations, small enterprises	Persons, foundations, small enterprises
Instruments covered	Deposits	Deposits	Deposits and investments	Investments
Limit	Hfl 25,000, indexed	Hfl 44,000	E 20,000	E 20,000
Per person	Yes	Yes	Yes	Yes
Exclusions	Banks, insurance companies, pension funds, government bodies	Banks, insurance companies, pension funds, government bodies, insiders, money launderers	Banks, insurance companies, pension funds, government bodies, insiders, money launderers	Banks, insurance companies, pension funds, government bodies, insiders, money launderers
Coinsurance	No	No	No	No
Speed of Payment	As soon as possible after claim received	3 months from claim, plus an extension	3 months from claim, plus an extension	3 months after claim is filed plus an extension
Public Relations				
By members		Upon request (not allowed to use it as marketing tool)	Upon request (not allowed to use it as marketing tool)	Upon request as (not allowed to use it marketing tool)
By implementor			Brochure, help desk, web site DNB	Help desk and website Securities Board

Sources: DNB archives.

are illustrated in the circles and ovals in Figure 3.

4. Depositor and investor protection in the Netherlands and the EU: an assessment

The IMF has for a number of years collected and published information on systems of deposit protection around the world.³⁰ Subsequently, the World Bank put out information on the worldwide web that was based on IMF material, supplemented by surveyed responses.³¹ The main conclusions of the IMF are the following. The IMF was interested in establishing a set of best practices for deposit insurance, so that staff could provide consistent advice. After identifying some dos and don'ts for deposit insurance, it used its regional resources to survey countries' practices. It found that characteristics diverged from continent to continent. Deposit insurance systems in the EU tended to be older than those in many other parts of the world, to more frequently be privately run, funded *ex post*, and offer lower coverage when measured in terms of Gross Domestic Product per capita than most other regions of the world.³² The system in the Netherlands shared these two latter characteristics.

Having surveyed country practices in 1995 and 2000, the IMF was able to identify convergence towards some of its favoured practices in the interval, especially in Europe. The improvements included making membership compulsory, maintaining a deposit insurance fund, relating the coverage limit to the sum of a depositor's holdings in a bank, and charging premiums related to risk in mature protection systems. The system in the Netherlands is already compulsory and offers coverage per depositor.

The World Bank's contribution has been to present surveyed results in an excel spreadsheet and make it available on the world wide web so that researchers could more easily use them in regression analysis. Its staffers ran regressions to argue against introducing deposit insurance without careful consideration. The regressions suggested that

³⁰ See Kyei (1995) and Garcia (1999 and 2000).

³¹ See Demirguc Kunt and Sobaci (2001).

³² See Garcia (2002).

the presence of an explicit system of deposit protection increased the likelihood of a financial crisis.³³ Other researchers disagreed, pointing out that while a well-designed system of protection could avert financial crisis, a poorly designed system could exacerbate it. Thus, the association found between the presence of deposit insurance and the experience of a financial crisis might be accounted for by a preponderance of poorly designed systems. Counter regression results demonstrated that explicit systems of protection were, in fact, less likely to be associated within financial crisis than implicitly defined systems.³⁴

The IADI Survey

After the Financial Stability Forum's Working Group on Deposit Insurance published its guidance on deposit insurance in September 2001, some of the countries that had been most active in the Working Group founded the International Association of Deposit Insurers (IADI) in May 2002 led by the Canada Deposit Insurance Corporation (CDIC).³⁵ The CDIC submitted a questionnaire to all countries known to have a system of deposit insurance. This questionnaire is not publicly available, and the results are not yet available.

The Maxwell Stamp Report for the European Commission

In June 2001, Maxwell Stamp PLC submitted a report to the EU Commission on the compliance of countries in the European Economic Area (EEA) with the 1994 Directive on deposit-guarantee schemes. Maxwell Stamp's final report concluded "All countries are compliant with the spirit of the Directive, and indeed most are compliant with the particular articles."³⁶ All countries have made provisions to guarantee deposits up to EUR20,000, have adopted the mandatory exclusions, recognised the guarantee schemes maintained by branches of banks from other member states, and have made

³³ See Demirguc-Kunt and Detragiache (1998 and 2000).

³⁴ See Gropp, and Vesala (2001)

³⁵ See [www.IADI.org].

³⁶ See European Commission (2001, p.3).

provisions to inform depositors about the guarantees. The report found some instances of non-compliance, however. It was concerned particularly, for example, that the Directive's definitions have not all been incorporated into national legislation and that depositors in some states do not have a right to take legal action against their deposit guarantee scheme.³⁷

The EFDI Questionnaire

In late 2002, the newly formed European Forum of Deposit Insurers (EFDI) submitted a comprehensive questionnaire to its members. Membership in the Forum is open to European countries, encompassing members of the EU, prospective members and non-members. The questionnaire was submitted to all members of the Forum in late 2002. It requested information on the year the system was founded, the laws that govern it, whether there is more than one scheme in operation, whether the system is publicly, privately, or jointly run, is independent, what are its institutional relationships with the central bank and the supervisory authority, its governance and accountability, whether contributions are made *ex ante* or *ex post*, information on membership, the amount of insured deposits, the fund's resources, types of interventions used, changes made to the system, whether premiums are risk-based, and if so, how, whether membership extends to branches of foreign institutions, and whether bilateral agreements are in operation with other European countries. The results of the survey are interesting but are confidential to members of the Forum.

Looking Forward to the Future of the CGS and the ICS in the Netherlands

DNB adapted its supervisory regulations in 2002 to implement the legislative changes embodied in the 1998 Supervisory Act. These regulations included those pertaining to the CGS scheme of protection for deposits and investment funds held at banks. The Securities Board

³⁷ The Maxwell Stamp report found that the Directive's definition of "deposit" had been universally adopted in national legislation, but that national definitions of "joint account," "unavailable deposit," "credit institution," and "branch" sometimes deviated from those in the Directive.

and the Bank have co-operated in promulgating separate regulations pertaining to the ICS. But the Bank may need to change these regulations as it integrates the ICS into its operations. It regards the need to promulgate these regulations anew as an opportunity to rethink the two systems of depositor and investor protection in the Netherlands. The issues to be addressed are whether to (1) combine the CGS and IGS, (2) shift to *ex ante* funding partially or entirely, (3) impose charges (either *ex ante* or *ex post*) that are adjusted for the risk that each institution poses for the fund. These issues need to be examined in the context of the structure of the financial sector in the Netherlands, which is characterised by a high degree of concentration in the banking sector and has a marked degree of conglomeration as compared to many other countries. For example, a high degree of concentration raises the issue of banks that are "too big to fail." Where banks are likely to be given financial assistance instead of being allowed to fail, deposit insurance becomes of less importance. It may be viewed as irrelevant for the bulk of the industry and applicable only to smaller institutions.

5. Summary and conclusions

To be effective, regulatory organisations and supervisory practices need to keep abreast of changes in the composition of the financial markets. In many countries, this need has already led to a reorganisation of regulatory/supervisory activities. With the rise of conglomerates, there has been a movement away from the old, institutional approach to regulation that oversaw all of the activities undertaken by a given class of institutions. Under institutional regulation, banks were regulated and supervised separately from insurance companies and securities firms. The first supervisory movement was tentative, towards functional regulation, where a given type of activity would be regulated and supervised equally by a single regulator regardless of which type of financial firm was conducting it. Here, the banking regulator would oversee banking activities wherever they were conducted, and the

securities' regulator would oversee securities activities across all kinds of financial firms. Both institutional and functional regulation encountered problems in a European world dominated by financial conglomerates. Moreover, the EU's early focus was on banking and securities activities, to the neglect of insurance.

The obsolescence of segmented regulation and problems with functional regulation led to a further supervisory development at the end of the 1990s. Regulation began to be organised according to its objective. One regulatory objective was to preserve the stability of the financial system. A second objective was to require individual financial firms to attain certain prescribed standards in order to protect their safety and soundness and to correct non-compliance with these standards. The third objective was to make sure that financial firms conducted their business operations in an ethical manner "to ensure that the consumer received a fair and honest service."³⁸ Regulation by objective would also encompass the financial system in its wider context of including insurance companies in addition to banking and securities firms.

The changes in the configuration of the financial markets and in the location of their supervisors necessarily had repercussions on the design and location of systems of protection for depositors, investors and policyholders. The response of some European countries to the changing configuration of the financial markets and to the EU Directives on deposit-guarantee schemes and investor-protection schemes has been described in Section 3 above. If the Netherlands is considering revising its systems of protection, a number of issues are at stake, concerning the objectives for the scheme(s), the incentives they offer to curb unduly risky behaviour, their ownership, membership, integration, governance, funding, the coverage they provide, and their public relations. Further research will need to examine these issues carefully and look into the pros and cons of various solutions.

³⁸ Taylor (1995, page 1) advocates regulation by objective under "Twin Peaks", consisting of a Financial Stability Commission to ensure adequate prudential supervision and maintain a sound financial system and a Consumer Protection Commission to enforce conduct-of-business regulation.

The relative emphasis placed on financial stability, as compared to consumer protection, will influence the design of a system of protection. In the context of the European Union, deposit and investor protection is more a matter of consumer protection than financial stability. This approach is partly a reflection of the composition of the European financial system. Given the concentrated nature of the European banking and insurance systems, there is a reluctance to allow financial firms, particularly large firms, to fail. Where financial firms fail infrequently, there will be less of a need to design customer protection systems to be a tool of financial safety and soundness. Other tools will be employed to promote this goal.

European emphasis on consumer protection is also a reflection of the EU Directives' focus on the creation of harmonised financial markets. In Europe, instead of designing protection systems to avoid moral hazard, this pitfall is countered and financial stability is ensured more by other means. Capital-adequacy and other regulatory requirements are emphasised, as is their strict enforcement by strong financial supervisors, and in Germany at least, by monitoring by peer institutions.

The objectives that the Netherlands wishes to achieve from its systems of protection, therefore, need to be carefully considered before undertaking a revision of those systems. The EU Directives' focus on harmonisation has set consumer protection as the dominant rationale for protection. In this situation, the Netherlands may want to consider adding protection for insurance policyholders to the guarantees already enjoyed by depositors and investors.

In making this decision in the Netherlands, DNB needs to weigh the potential efficiencies from diversifying a combined fund across different components of the financial services industry against the difficulty of setting premiums equitably.

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