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Bank Deposit Insurance and EMU by Dieter Braun

Deposit insurance is designed to preserve the stability of the banking system. This function is reinforced by the process of financial globalization. It is therefore necessary to imagine a specific system of deposit insurance for the future European monetary union. This article, referring to the recent literature on the subject, tries to propose some principles of organization and functioning for a deposit insurance properly community.

Any deposit insurance system aims to ensure the stability of the banking system. This vocation has even been extended in our contemporary systems of globalized finance, where potentialities of cumulative dynamics of propagation of financial disturbances outside their original "zones" (inter-finance appear mediated, secondary market of assets, etc.). In such a setting, it is no exaggeration to say that the deposit insurance systems help to stabilize not only the banking system, but the financial system as a whole.

While the action of the lender of last resort is the discretionary dimension of the measures to protect the financial system, deposit insurance has a contractual logic, which developed later than the action of the lender of last resort but has now established itself in many countries. E. Baltensperger and J. Dermine remind us in this regard: "Today, many countries have institutionalized deposit insurance or fund protection schemes. While in some cases these were created long ago (United States: 1933, Canada: 1967, Japan: 1971, revised in 1986), in many countries, especially European, they were introduced only recently (United Kingdom). United Kingdom: 1982, Germany: 1977, France: 1979, Belgium: 1985, Netherlands: 1979).

"This gradual extension of deposit insurance systems, even if the terms differ depending on the country pushes to wonder about the possibility of designing such a device across the Community. Surprisingly, this question appears somewhat hidden from the Community agenda. The statutes of the European Central Bank (ECB) and the European System of Central Banks (ESCB) seem to be best relegated to the rank of secondary issues with regard to prudential supervision and the prevention of systemic risks. It is important to disagree with such a view, and recent experience has amply demonstrated that the protection of the financial system is "in fact" one of the central concerns of central banks. So even if it is perfectly conceivable that the regulatory harmonization process, prudential supervisory rules or governance provisions of the deposit insurance system at Community level, is carried out of direct control of the ECB, ie implemented by a central body separate from the ECB, the ECB is necessarily "concerned" by these developments which condition its future action as lender of last resort (Kirrane [1993])

As deposit insurance is an integral part of this overall structure to ensure the stability of the European financial system, a reflection on this issue is now imperative. In accordance with the principle of subsidiarity and in order to maintain consistency with the guiding principles of supervision, each country should have a deposit insurance fund that would provide coverage coinciding with the jurisdiction of the supervisory and control authorities banks (responsibility of the country of the mother-house). On the other hand, the principles guiding the action of deposit insurance funds should be determined at European level so that there is no distortion in the Community of the conditions offered to depositors according to the chosen institutions and the country of location. Another major argument for harmonizing the principles governing deposit insurance and floor guarantee levels is that the country of origin liability rule must not conflict with the provision of sufficient protection to the financial system of the host country.

Any insurance scheme is intended to reduce the incentives for depositors' "rushes" and thereby stabilize the banking system. The very existence of such a system is thus supposed to strengthen confidence in the global banking system. This limit likelihood of chain reactions caused by bank runs, and thus avoid the social costs associated with it. However, as we will see, deposit insurance has a cost. Indeed, when funds are guaranteed, all deposits appear as attractive to depositors, regardless of the bank's risk of insolvency. Deposit insurance therefore removes the need for the depositor to question the specific quality of his bank, which is even more serious if the insured depositor discovers that his bank is not financially viable, they are motivated to withdraw deposits from the said bank. Thus, apart from the intervention of the supervisory authorities of the bank, it is theoretically up to uninsured shareholders and depositors to impose a discipline on banks in financial difficulty. This assertion must at least be qualified by the results of a recent empirical study published in the United States on the effectiveness of market discipline exercised by bank shareholders. This study showed, on the basis of the observation of share prices of American banks that were classified as "problem banks" between 1981 and 1987 and insider transactions in the six months prior to decommissioning, that neither the management bodies of the banks concerned seem to have anticipated the decommissioning before the audit.

Deposit insurance carries with it a paradox: making banks safer for depositors could undermine the overall banking system, hence the need for a supervisory and prudential regulation system. Indeed, deposit insurance as well as lender-of-last-resort assistance generates perverse effects commonly referred to as moral hazard. This concept borrowed from the insurance theory refers to a phenomenon in which economic agents in a position to carry forward losses and costs other agents act to limit their self-protection by increasing their exposure to risk, even in defrauding or concealing information about their actual situation. Thus, we will talk about moral hazard if the actions of the lender of last resort and the protection provided by deposit insurance provoke or even amplify the processes against which they are supposed to provide a group insurance. Such a phenomenon results from the reduction of the sanction in the event of significant risk taking, which generates a disincentive for the beneficiaries of the protection to act in such a way as to protect themselves against future shocks. This alteration of present behavior may contribute to a future weakening of the financial system.

We can actually detect two kinds of moral hazard. - The reduction of self-protection measures taken by banks or other financial institutions, or even the increase of their risky activities due to the reduction of the cost of risk taking, a behavior which is all the more frequent as the correlation between high risks and high returns is narrow.

- The concealment of information by insolvent banks seeking help from the lender of last resort and the postponement of a possible bankruptcy or merger. Once the help is obtained, the banks always have an interest in concealing their real financial situation and adopting a "high risk - high yield" strategy to rectify a situation they know will only be temporary. The particular difficulty in dealing with the problem of moral hazard is that if the benefits of lender-of-last-resort assistance and the existence of a deposit insurance scheme are immediately apparent in terms of stabilizing financial system and reduced social costs associated with bankruptcies the costs themselves are deferred in time, so they are perceived in a more diffuse manner and more

difficult to measure. In doing so, there is a bias towards reinforcing the protective device "today", as the future costs thus created are minimized. Meaning that the value of the benefits of protection is perceived as greater than the present value of future costs associated with it.

This alteration of the micro-economic behavior generated by moral hazard can be limited, either by a direct binding action on the banks, it is about the device of prudential regulation and surveillance (which will not be the object here of developments substantial), or through deposit insurance schemes designed to limit risk-taking by internal provisions in the system (we will particularly focus on this issue). Of course, these two methods of fighting against moral hazard are not exclusive of each other and must be combined. In such a system the insurer thus plays a role of screen, everything happens as if the depositors had a claim on the insurance fund.

The Deposit Insurance Fund may therefore theoretically become himself insolvent. In doing so, the determination of the "price" of the insurance conditioning R_i , as well as the degree of coverage of deposits that determines G_i is of great importance. By way of illustration, the American Federal Deposit Insurance Corporation (FDIC) has proposed that, in order for the level of reserves to remain sufficient, the premium rate be based on an average of the net losses of the three preceding years, the problem being a risk of penalization of healthy banks. Other proposals that we will develop in the section devoted specifically to Europe seek to base the premiums paid by each institution on the risk inherent to its activity.

However, it should put this solvency constraint which requires the deposit insurance fund, to the extent that, the lender last resort, sensitive to the social costs that would result from a possible bankruptcy of the system deposit insurance, could extend its umbrella to the latter, replacing the reserves with an unlimited credit line. In fact, only an explicit commitment by the lender as a last resort to assume all the liabilities of the Deposit Insurance Fund can make the Deposit Insurance Fund fully credible when the potential net claims on it appear significant.

The proposals we are going to make for the establishment of a European Deposit Insurance Scheme will feed on the abundant literature that has developed recently as a result of the major difficulties experienced by the Federal Savings and Loans Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC) in the United States. Indeed, the wave of bankruptcies experienced by the Savings and Loan Institutions affected considerably the FSLIC which, faced with the collapse of the level of its reserves had to resort to a substantial external assistance to continue its action of closing the insolvent institutions (the Congress authorizing by law a loan of up to \$50 billion). In addition, after 55 years of operation, the FDIC recorded its first annual losses in 1988.

This major crisis in the US deposit insurance system sparked a lively debate among economists and bankers and an interesting reflection on what should expect to be an optimal deposit insurance system. We therefore propose to use this work to try to imagine a system that does not reproduce the shortcomings of the current systems.

Deposit insurance systems currently in force around the world are either systems directly under the public authority, for example, in the United States, Canada, the United Kingdom or Spain, in the United States. the case of these two European countries, there is a deposit protection body which includes representatives of both the central bank and deposit-taking institutions; or private

systems, in this case it is usually systems created on a collective basis by the banks themselves, Germany, the Netherlands, Belgium, Italy and France are attached to this case of figure. However, even these private organization solutions are mostly under the control and supervision of governments or monetary authorities, the responsibility for financial system stability being inherently a public responsibility.

In the case of the future united Europe, it seems to us possible to imagine a system in which different Deposit Insurance Funds would coexist whose activity would be organized according to the principle of the responsibility of the country of origin, but which would be subject to Common operational arrangements decided at Community level. We are currently far from such a situation, since in Europe deposit insurance has an essentially national basis. Thus, only the German, Belgian and Italian deposit insurance schemes extend their coverage to branch deposits of domestic banks abroad, with the reservation in the case of the last two countries that the host country does not provide itself protection; while all systems provide coverage to the deposits of foreign banks in their territory. With regard to foreign currency deposits in the national territory, some European deposit insurance schemes give them protection, as in Germany, Italy and Spain, while others do not in France, Belgium and the United Kingdom. On the other hand, each Fund would be subject to the supervision of a Community body set up for that purpose. In doing so, despite the multiplicity of Deposit Insurance Funds, we would achieve a unified, principled system that reflects the most recent thinking on the subject.

Any deposit insurance system must be accompanied by prudential regulation to constrain banks in a manner consistent with its sustainability. In addition, any deposit insurance system must incorporate provisions into its internal operating rules that outweigh perverse incentives for risk-taking caused by moral hazard. In this case, it is necessary to introduce measures that promote the compatibility of the bank's interests with those of the insurance fund.

To the extent that a significant portion of the losses incurred by deposit insurance in the United States has been analyzed as resulting from bankruptcies deferred over time, one of the most frequently cited reform proposals is to promote a more comprehensive settlement of bankruptcies responding to more explicit rules. However, the permissive condition for such a change in bankruptcy management procedures is the provision of information on banks' financial position taking into account changes in the market values of banks' assets and liabilities. Similarly, proposals to impose "net worth" or capital standards as well as risk-based insurance premiums specific to each bank's operations would be greatly enhanced by standardization of accounting policies ranging from in the sense of mark-to-market accounting. Finally, a final proposal for the organization of a European deposit insurance scheme is the limitation of the scope of coverage not by account but by depositor.

As we have just briefly mentioned, the cornerstone of an efficient deposit insurance system is the adoption of a mark-to-market accounting system. The current system of historical value accounting, in which banks record their assets and liabilities at acquisition cost and readjust this value only in the event of asset disposals or reduction of commitments, is based on a design of banking activity that dates back to the 1930s. Under this approach, banks make loans and acquire securities with the intention of holding them until maturity. Changes in the market value of assets, generated by interest rate movements, are

therefore ignored because they are considered transitory and have no effect on the bank's ability to recover the total value of the assets at maturity. Indeed, if we neglect credit risk, which is partially taken into account in the current system via the banks' provision for losses, banks can expect to receive the full value of their investment at maturity, that is, the payment of the contractual interest as well as the principal. However, the mobilization of bank balance sheets, the growing marketization of financial activities or the development of securitization favor the pre-maturity sales behavior of banks' assets and competition by non-financial agents for bank deposits with market instruments (Kirrane [1994])

The current accounting system has two major weaknesses.

- On the one hand, as we have just mentioned, with such accounting policies, the bank's capital does not reflect any changes in market interest rates, and these are likely to generate significant difference between the net book value (CVN) and the net economic value (NEV) of the bank. This disadvantage has been considerably magnified by the changes that have affected our financial systems. Indeed, in a deregulated and globalized financial world where the volatility of interest rates has increased enormously, bank failures due to market interest rate movements become more likely. In fact, market interest rate movements affect the VEN but not the VCN, provided that the assets or debts are traded at market value. Changes in interest rates only have an effect on the assets and liabilities of the bank that are perfectly off balance when the maturity structure of the assets coincides exactly with the maturity structure of the bank's debts. If, for example, the maturity of the assets is greater than that of the debts, any increase in interest rates will reduce the VEN (and vice versa).

- On the other hand, the current accounting system allows banks to manipulate the book value of capital because of the asymmetrical treatment of capital gains and losses depending on whether or not they are realized. Thus, since only realized capital gains and losses affect the book value of banks' capital, they selectively realize capital gains on certain assets that have increased in market value and do not recognize potential losses. On others, via a non-assignment of these, may provide deliberately erroneous information on their actual financial situation.

The adoption of mark-to-market accounting by providing shareholders, creditors and supervisors and regulators of banks with a more relevant measure of their capital would be a conceptually attractive solution to the shortcomings and shortcomings of the current system. Indeed, one of the most important information provided by a bank's accounting system is the capital or residual value calculated as the difference between the value of the bank's assets and that of the liabilities. This residual value has a dual function. On the one hand, it represents a risky investment for shareholders because it is the amount of funds they can potentially lose if unanticipated losses force the bank to bankruptcy. On the other hand, by absorbing these losses, net worth is a kind of "buffer" that protects the bank's creditors and depositors against financial losses. A "good" measure of a bank's capital must therefore accurately reflect the effects of the bank's exposure to risk. This issue is important because better information on the net economic value of banks would give supervisory and regulatory authorities the opportunity to intervene earlier and thus reduce the cost of closures of insolvent institutions. In addition, the net economic value that

conditions the bank's ability to absorb future losses can be analyzed as an indicator of the bank's ability to bear the risks.

The deposit insurance fund has a special interest in the adoption of such accounting policies because in the event of insolvency, the ultimate cost that it will bear is determined, not by the book values, but by market value less the market value of the debt.

The comparison between deposit insurance and other types of insurance such as third-party automobile insurance or medical insurance is relevant, insofar as, in all these cases, the insurer covers the commitments of the insured vis-à-vis third parties, there is thus a dissociation between the person who bears the insurance and the direct beneficiary of it. It may be interesting to also apply the instruments available to traditional insurers to protect against risk in the case we are interested in (deposit insurance). Thus, the net economic value of the bank can be seen as a form of deductibility or deductible for deposit insurance. Such a design justifies that risk-based residual value standards are imposed on banks in accordance with the logic of the Cooke ratio. These residual value standards should be floor levels below which the insurer would significantly strengthen its supervision and impose restrictions on the insured's business, such as limits to the growth of banks considered to be undercapitalized. The solvency of banks and any reorganization decisions in case of problems should therefore be determined on the basis of the net economic value (VEN), rather than the net book value (NBV). Such a measure, in addition to better reflecting the true financial situation of the banks and thereby avoiding certain additional losses for the Insurance Fund in the event of a large gap between the VEN and the PNT, would reduce some of the perverse from accounting to book value, such as incentives, for banks, to problem to sell their high quality assets and thus realize gains by keeping their riskier assets to avoid recognizing losses.

The introduction of insurance premiums differentiated according to the risk inherent in the activity of the insured is another way in which insurance traditionally protects against moral hazard. Such a proposition has obviously been accepted in the think-tank of economists on an optimal deposit insurance system. However, some argue that such a measure is ultimately redundant with the introduction of risk-based residual value standards. Such an assertion seems to us to be erroneous and these two proposals should rather be conceived as a set of mutually reinforcing incentives. Indeed, as we have just explained, the residual value plays for the insurer the role of a deductibility or franchise. In doing so, a deposit-taking institution that voluntarily decides to operate at a higher residual value than is conventionally required exposes the insurer to a lower risk, so it must be financially rewarded by a lower insurance premium. . The insurance premium structure must be based on a forward-looking risk assessment, which is more beneficial than setting the "price" of insurance on the basis of past losses (FDIC proposal), insofar as, in the latter case, it is a question of imposing an ex-post penalty rather than attempting to influence ex-ante behavior. Of course, the adoption of mark-to-market accounting would considerably strengthen the operational nature of such a provision, especially if the insurer requires insured banks to establish scenarios for assessing major macroeconomic fluctuations (particularly in terms of interest rates) on the prospective market value of their portfolio of assets and liabilities.

As we have previously pointed out, in a banking system with a deposit insurance system, a substantial part of insolvency risk can be transferred to the Insurance Fund since in case of the

latter bankruptcy assume the losses. In return, the Deposit Insurance Fund must be given real decision-making power in bankruptcy, and use it to clearly state the rules of the game. The longer an insolvent depository institution remains in business, the more its managers are tempted to engage in risky lending operations hoping for high returns, which are obviously associated with high probability of losses, plus uninsured depositors have time to withdraw their deposits and therefore more potential losses ultimately transferable to the Deposit Insurance Fund increases. Faced with this state of affairs, proposals have been made to make the resolution of bank failures more transparent and, in so doing, to make banks' managers more accountable. The most interesting proposals in this area are those that propose early reorganisations or closures of insolvent banks on the basis of clearly pre-established rules of the game in order to limit the present and future potential losses on deposit insurance. Ainsie, G. Benston et G. Kaufman outlined a method for settling bank insolvency, based on two proposals: - adopting a mark-to-market system to identify problem banks before net worth becomes negative, so here we find an additional argument in favor such accounting policies; - an order to reorganize or close down deposit-taking institutions in the event that regulatory capital (measured at the market value of assets and debts) falls below a pre-determined level.

The interest of such proposals is that the value of the security deposits can be reduced substantially if a problem bank is closed at a time close to its economic insolvency. However, in the current state of practice, legal insolvency almost systematically requires that the book value of the assets fall below the book value of the debts, which, as we have previously shown, has no relation direct requirements with economic insolvency. The Deposit Insurance Fund must therefore have the legal authority to impose a reorganization on banks before they become truly insolvent (that is, before their net economic value becomes negative). Such an explicit commitment would mean that no deposit-taking institution is free from the risk of mergers, reorganizations or closures, so it should be accompanied by an explicit statement of non-protection of the bank's shareholders in the event of bankruptcy. However, the Deposit Insurance Fund should take into account in its assessment of the banks and in the reorganization or bankruptcy injunctions that it professes an element that is difficult to quantify but fundamental to the final decision, namely, what we can call the cognitive capital accumulated by the bank during its years of activity and that is irretrievably lost in the event of bankruptcy (but not in case of merger). The importance of this cognitive capital is conditioned by the extent and eventual specialization of the bank's activities, the expertise of its staff, long-term customer relationships and so on. The market obviously cannot evaluate this type of loss for the banking system, only the information system developed by the bodies responsible for assessing the solvency of banks allows, if not to evaluate, at least to understand qualitatively this type of cost inherent in a bank failure.

However, despite the multiple benefits of adopting mark-to-market accounting, the difficulties should not be underestimated. The market value of a financial instrument can be defined as the current price at which it can be bought or sold. While this type of information is easily accessible for certain assets and debts, it is more difficult to obtain for others, that is to say for those who are not actively traded (bank loans or deposits). and for off-balance contingencies.

Cases not presenting any major obstacle to the implementation of a mark-to-market:

- securities in the portfolio that are tradable on secondary markets of assets, there are potentially very few information problems on this market. asset type that prevents mark-to-market recognition; - high-quality loans with a maturity of less than one year or granted at revisable rates at least annually, on the assumption that they reflect their market value (the interest rate risk on such assets being limited); - loans for which there is a secondary market, such as loans to developing countries for a mark-to-market valuation.

Where there are barriers to mark-to-market:

- loans for which there are no secondary markets, and the estimation of the quality of "tailor-made" loans is often difficult and requires important informational investment because of the diversity and heterogeneity of borrowers. It is possible to many ready to use for estimating the market value, the present value of the stream of advance payments. Thus, by simplifying the assumption that payments are made at the end of each period, the present value of the payment stream at 0 that constitutes an assessment of the market value of the loan can be formulated as follows :

$$VP_0 = C_2 / (1 + r_2) C_n / (1 + r_n) n$$

where C_n represents the expected payment of principal and interest for the period i ($i < n$) r (the discount rate for the period in the number of years between today and the date of the final payment).

This equation shows how the change in credit quality or interest rates affects the market value of the bank's assets. A decline in the quality of the credit, as a result of a reduction in expected cash flows, reduces the market value of the asset. A rescheduling of the loan repayment also affects its market value, the actual duration of the loans is not always independent of market interest rate movements. Thus, an increase in these may induce early repayment behavior on the part of borrowers. The market value of fixed rate loans varies inversely with market rates. This is not the case for variable rate assets because any increase in the interest rate is accompanied by an increase in future remuneration, which is why we have classified this type of loan among those that do not pose a problem of valuation at market value. For some particularly sophisticated loans, even more sophisticated valuation methods will be required. One possible solution is to adjust the carrying value of assets not individual but groups of assets. The experience gained by banks in the securitization field where the setting of the "pool" price of loans converted into securities could be exploited by the agents responsible for the valuation of banks.

- Demand or savings deposits are also potentially difficult items to measure at market value for two main reasons. First of all, most deposits do not have an established deadline; there is no objective method for determining their duration. Any calculation in terms of present value must therefore be based on difficult to verify hypotheses, it is enough to convince oneself to recall that leakage deposits are one of the main sources of potential instability banks. On the other hand, since banks usually pay deposits at a rate lower than the market rate, they are a source of inflation of the market value of their net worth. However, in the event of a rise in market rates, it cannot be concluded that the saving per unit of money will increase accordingly as deposits compete with market instruments and a decrease in the volume of deposits is possible.

- Off-balance sheet activities also present valuation difficulties at market value, insofar as they are contingent liabilities of the bank. For example, NIFs (Note Issuance Facility) are medium-term commitments by which a borrower can issue short-term paper in his own name, while benefiting from the guarantee given by his bank to buy the "notes" in case of difficulty of placing on the market, or to provide a "stand-by" credit. The bank therefore only undertakes to finance the borrower on a conditional basis, ie whether the borrower cannot place his "notes". If well obviously impossible to accurately assess these off-balance sheet activities, it must nevertheless be taken into account in assessing the solvency of banks. To do this, banks should be required to provide relevant information on these activities; while evaluation officers would construct risk classification grids specific to this type of activity based on the borrower categories and the terms of the contract binding the bank. Of course, it is not a question of the accuracy of the evaluation of the risks inherent in the off-balance sheet activity, but simply of approaching the concept of net economic value in what distinguishes it from the concept of value. net book. All of the mark-to-market issues we have just raised point to the extent to which this new accounting policy cannot claim absolute accuracy. Nevertheless, it can be argued that the experiment will stimulate innovations in evaluation methods that lead to improved quality and reduced errors. On the other hand, the question is not whether mark-to-market accounting has absolute accuracy, but whether it represents a significant improvement over the current system. While mark-to-market accounting compared to historical cost accounting can reduce the difference between the economic value and the book value and the variance of this difference, it is undeniably an improvement.

The banking profession is mainly against the adoption of such a reform and this especially because of its cost. It should be noted in this connection that this cost, which is largely comparable to a fixed cost, will be heavier for small banks than for large ones. Furthermore, over the medium term standardization of evaluation methods and the development of specialized software for the calculation market values certainly induce a tendency to reduce these costs. The simple argument in terms of costs cannot be imposed anyway, since the costs must be compared to the benefits and not at the level of the individual banks but of the community as a whole. However, the social benefits of such a reform have become increasingly important in the recent period due to the rise of interest rate risk. In doing so, although for some banks the cost of implementing mark-to-market accounting exceeds the benefits they derive from it; if the net social benefit of such a reform is positive, it should be adopted. Here we find one of the main traditional justifications for the introduction of regulations, namely the difference between net private profit and net social profit. Market-based accounting is, as we have seen, the permissive condition for better moral hazard control, the imposition of risk-taking disincentives and therefore greater stability of the financial system as a whole, its adoption seems justified to us.

Finally, to promote market discipline, a deposit insurance system in Europe that guarantees 100% deposit coverage should not be introduced in Europe. Indeed, while it is unanimously accepted that small applicants do not have access to information and expertise to assess their bank, the same is not true of large depositors whose supervisory capacity could be fueled by incomplete coverage of their deposits. Thus, rather than setting a maximum amount for deposit insurance that can be diverted by the multiplicity of accounts credited, each of sums below this

ceiling in various banks, it is possible to imagine a system where the insured deposit amount would be set for each individual rather than for each account. The insured amount for each individual would be set in such a way as to protect small depositors, whereas the introduction of such a system would push large depositors to control their banks more effectively and, in so doing, punish risky behavior through deposits transfers to healthier banks ("flight to quality"). Such a proposal seems interesting to us in that the banks themselves would become a large category of uninsured depositors, but they are in a very favorable position to exercise such control.

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