THE CASE FOR A SECOND LOOK AT CANADIAN BANK INSOLVENCY LEGISLATION

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ABSTRACT

This thesis is an analysis of the bank insolvency process in Canada. The phenomenon of bank bailouts is examined and three possible rationale for bailouts are put forth. The conclusion is reached that bank bailouts can be justified on the basis of these rationale, and, therefore, that bank insolvency legislation should recognize the bailout process and provide an adequate and appropriate framework for this process. Three recent bank failures, Canadian Commercial Bank, Northland Bank and the Bank of British Columbia, are discussed, with particular emphasis on the different bailout tools used by the government in each case. These case studies are used as a framework within which to assess current Canadian bank insolvency legislation. The conclusion is reached that the legislative framework is inadequate to deal effectively with bank insolvency.

By examining the American approach to bank insolvency and two recent Canadian studies on the subject, a model for reform is proposed. The model contemplates a more highly-structured legislative framework, with broad powers granted to the deposit insurer to implement a bailout in circumstances which justify this form of government intervention. Finally, this model is used as a basis on which to evaluate recent financial sector reform initiatives made by the federal government.

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THE CASE FOR A SECOND LOOK AT CANADIAN BANK INSOLVENCY LEGISLATION

INTRODUCTION

In the fall of 1985, the Canadian financial system was rocked by its first bank failures since the collapse of the Home Bank of Canada in 1923. On September 1, 1985, the Department of Finance announced that curators would be appointed to supervise the business and affairs of the Canadian Commercial Bank and the Northland Bank.[1] Both banks were eventually liquidated. These failures were not isolated events. In the last two years, four other Canadian banks have been forced to merge with more viable institutions in order to survive: Continental Bank merged with a Canadian subsidiary of Lloyds Bank of London; Mercantile Bank of Canada merged with The National Bank of Canada; Morguard Bank was taken over by Security Pacific Bank, a wholly-owned subsidiary of Security Pacific Corp. of California; and the Bank of British Columbia sold substantially all of its assets to the Hongkong Bank of

1 Canada, Estey Commission, Report of the Inquiry into the Collapse of the CCB and Northland Bank (Ottawa: Minister of Supply and Services, August, 1986) at 352 [hereinafter "Estey"].

Canada. For the first time in many decades, the Canadian government has had to exercise its legislative jurisdiction over banks faced with actual or threatened insolvency. It is my thesis that this experience has illustrated the inadequacy of Canadian bank insolvency legislation.

Assuming federal regulatory institutions will face more bank insolvencies in the future, a strong argument can be made that broader and more flexible powers are required to cope with these insolvencies. In particular, the power to arrange and subsidize mergers of troubled banks with viable institutions or to establish government assistance programs which will restore insolvent banks to healthy operation is needed. In arriving at this conclusion, this paper will proceed along the following course:[2]

1. It will be argued that this area of legislation is in immediate need of reform due to the fact that Canada, in all likelihood, can expect more bank failures in the future;

2. Justifications for government regulation of banks and, in particular, for government intervention in cases of distressed or insolvent banks will be examined;

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2 It should be noted that a recent spate of insurance and trust company failures has paralleled those of the banks. See Economic Council of Canada, <u>A Framework for Financial Regulation: A Research Report Prepared for the Economic Council of Canada:1987</u> (Ottawa: Minister of Supply and Services, 1987) at 47 (table 4-1) [hereinafter "Economic Council of Canada, 1987"] for details of these failures. Although the powers needed by regulatory agencies to deal with the failures of these other types of financial institutions are in many ways comparable to the powers needed in the context of bank failures, this paper will be restricted to an examination of bank failures.

3. Canadian bank insolvency legislation as it existed prior to July, 1987, will be outlined and its operation examined in the context of case studies of three banks: Canadian Commercial Bank ("CCB"), Northland Bank ("Northland") and the Bank of British Columbia (Bank of B.C.);

4. The adequacy and appropriateness of Canadian bank insolvency legislation will be evaluated and the conclusion reached that reform is essential;

5. In attempting to develop a model for such reform, the American approach to bank insolvency will be examined and compared to the Canadian approach;

6. The model will be further developed by examining proposals on the Canadian banking sytem put forth in two studies commissioned by the federal government. Conclusions will be reached on the directions which reform should take, and a model for such reform will be proposed;

7. Finally, the conclusions reached in chapter 6 will be used to assess financial sector reforms introduced in two recent pieces of federal legislation: An Act to Amend Certain Acts Relating to Financial Institutions (S.C. 1987, c.26) and the Financial Institutions and Deposit Insurance System Amendment Act (S.C. 1987, c.23).

CHAPTER 1. CAUSE FOR CONCERN?

Unless the Canadian financial system can be expected to suffer more bank failures in the future, an argument in favour of expanded government powers to deal with such failures becomes a moot point. A variety of reasons has been cited for the bank failures which have occurred since 1985, including: inadequate management, lack of diversification in loan portfolios, and the recession which hit Western Canada in 1981.[3] Undoubtedly, each failure, when examined on its facts, can be explained by the interaction of a number of contributing factors. It is submitted, however, that many of these factors are merely symptoms of an underlying causal factor: the federal government's recent policy of increasing competition among Canadian financial institutions. Between 1923 and the mid-1960's, the Canadian banking industry experienced relative stability. The number of banks remained fairly constant (11 at the end of 1925 to a low of 8 in 1961; with the formation of only one new bank-- the Mercantile Bank of Canada in 1953).[4] In the mid-1960's, the federal government embarked on a policy of increasing competition in the financial sector-- a policy which remains a priority of the government's financial sector policy today. The development of this policy is traced below. The approach has been to increase the number of banks in the marketplace (and thereby

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3 Economic Council of Canada, 1987, <u>supra</u>, note 2 at 46-49.
4 Estey, <u>supra</u>, note 1 at 359-363.

increase competition among banks) and to deregulate the financial sector by breaking down the traditional four pillars, thereby increasing competition between banks and other financial institutions. The effect has been an increasing number of bank failures.

It is the small banks which have tended to fail, due to the tendency of small banks to lack adequate loan diversification and a broad base of deposits.[5] These characteristics can be viewed as manifestations of competition rather than the actual cause of failure. For example, reasons cited by the Estey Commission in its report of August, 1986 (the "Estey Report") for the failure of the CCB included poor lending practices,[6] and inadequate loan diversification.[7] It can be argued that these characteristics of the CCB were symptomatic of the competition faced by the bank when it was formed. The bank attempted to occupy a niche which was considered unoccupied by the established banks but, in retrospect, was not.[8] In order to create business and thereby compete with the established banks, the CCB was forced to lend where these banks refused to lend (thereby creating its own market).[9] It is submitted that it was this need to compete and find an unoccupied niche that necessitated the creation of a high-

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5 Coopers and Lybrand, <u>A Study to Assess the Current Mandate and Operations of the Inspector General of Banks</u> (Toronto, 1986) at 29 [hereinafter "Coopers and "Lybrand"].
6 Estey, <u>supra</u>, note 1 at 11.
7 <u>Ibid</u>. at 417.
8 <u>Ibid</u>. at 2.
9 <u>Ibid</u>. at 71.

risk loan portfolio which could not withstand the recession in Western Canada and ultimately led to the CCB's collapse.

The regulatory approach of increasing competition in the financial sector emerged in 1964 with the publication of the Royal Commission on Banking and Finance (the "Porter Commission"). The Porter Commission proposed a comprehensive reform of Canadian financial markets, stressing efficiency and innovation. It recognized that if competition among financial institutions was to be encouraged, the restrictions on the ability of banks to compete would have to be removed.[10]

Many of the Porter Commission's proposals were implemented in the 1967 revisions to the Bank Act. The effect of this Act was to grant banks greater freedom to compete. For example, it permitted banks to make conventional mortgage loans, allowed for the removal of the ceiling on bank loan rates in three stages, limited bank investments in trust companies in order to prevent further concentration in the financial sector, and prevented interlocking directorships and collusive behaviour between banks and other financial institutions.[11]

In 1976, the White Paper on the Revision of Banking Legislation reaffirmed the government's commitment to increase competition in the financial sector:

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10 H.H.Binhammer, Money, Banking & the Canadian Financial System (Toronto: Methuen Publications, 1968) at 137.
11 Canada, Department of Finance, The Regulation of Canadian Financial Institutions: Proposals for Discussion (Ottawa: Minister of Supply and Services, April, 1985) [hereinafter the "Green Paper"] at 22.

> [Competition] remains the basic underlying objective of the government in its approach to banking legislation... An adequate level of competition will help to ensure that banking services are provided, throughout the nation, at the lowest cost to borrowers and the highest return to savers that are consistent with the survival and healthy growth of the country's financial system.[12]

The revisions to the 1980 Bank Act further reflected this policy of increased competition by easing the barriers of entry into the banking system. The new Act encouraged the formation of new banks in several ways. For example, it made it easier for Canadians to start a bank by permitting incorporation by letters patent (no longer requiring a private member's bill). It also permitted wholly-owned foreign bank subsidiaries to operate in Canada as chartered banks and allowed newly-formed domestic banks to be closely-held for ten years in order to give them a chance to grow and become new sources of competition. The effect of the 1980 Bank Act was summed up in the Department of Finance's, The Regulation of Canadian Financial Institutions of April, 1985 (the "Green Paper") as follows:

> All of these measures had the effect of making entry into banking easier and of promoting competition in the financial system.[13]

12 Canada, Department of Finance, White Paper on the Revision of Canadian Banking Legislation (Ottawa: Minister of Supply and Services, August, 1976) at 16.
13 Green Paper, supra, note 11 at 22.

The number of active banks in Canada increased from nine in 1967 to sixty nine by the end of 1985, largely as a result of the 1980 revisions to the Act.[14]

The federal government's intention to pursue this financial sector policy of increasing competition has continued since 1980. For example, in the Green Paper, the Department of Finance listed as one important goal the promotion of competition, innovation and efficiency in the financial sector. It recommended some degree of deregulation, whereby financial institutions would be given greater scope to offer a wider variety of financial services than in the past.[15] The Green Paper did reflect a recognition that the long-term risk of the policy of increased competition would be that some financial institutions would disappear, through failure or merger.

The federal government's commitment to increasing competition among banks was further evidenced by new competition legislation introduced in 1986: the <u>Competition Act</u> (S.C. 1986, c.26). The stated purpose of this new legislation was to "maintain and encourage competition in Canada" (section 19(1)). Of significance is the fact that this Act expanded the scope of pre-existing competition law to include banks-- for example, interbank agreements are now under the authority of the Director of Investigation and

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14 Coopers and Lybrand, <u>supra</u>, note 5 at 22.
15 Green Paper, <u>supra</u>, note 11 at 2.

Research rather than the Office of the Inspector General of Banks.[16]

A recent statement of the government's policy of increasing competition in the financial sector is contained in New Directions for the Financial Sector tabled in the House of Commons on December 18, 1986, in which the Minister of State for Finance stressed the promotion of competition as a major policy goal. One way it proposed to achieve this goal was to increase the powers of trust, loan and insurance companies to compete with banks in commercial lending, a traditional stronghold of the banks.[17] Similarly, portfolio restrictions on trust, loan and insurance companies in the field of consumer loans would be eliminated.[18] The policy paper also recommended that banks, trust, loan and insurance companies be allowed to offer investment advice and portfolio management services and a full range of securities activities through subsidiaries.[19] Full networking powers would be made available to financial institutions as well as an expanded range of fiduciary powers.[20] These proposals were, for the most part, implemented in the Financial Institutions and Deposit Insurance System Amendment Act and An Act to Amend Certain Acts Relating to Financial

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16 Barry R. Campbell, "The Competition Act-- The Special Case of Banks" (1987) 1 Banking and Finance Law Review 225 at 226.
17 Canada, Minister of State for Finance, New Directions for the Financial Sector (tabled in the House of Commons on December 18, 1986) at 12 [hereinafter New Directions].
18 Ibid. at 12.
19 Ibid. at 13.
20 Ibid. at 13.

Institutions, proclaimed on July 2 and July 3, 1987, respectively. This legislation is discussed infra in chapter 7.

At the same time that the government has been implementing a policy of increased competition in the financial sector, it has made some attempts to counter-act the effects of competition by increasing supervision and regulation of financial institutions in order to protect their solvency. The Green Paper recognized solvency, improved consumer protection and control of self-dealing and conflicts of interest as important goals and advocated stricter regulation and supervision of financial institutions to achieve these goals. Similarly, in New Directions for the Financial Sector, the government recommended a strengthening of the directors' role in the regulation of financial institutions, an enhanced role for auditors, and stricter rules with respect to self-dealing and conflicts of interest. It also proposed the creation of a supra-regulatory body, the Office of the Superintendent of Financial Institutions, which would possess more effective supervisory and enforcement powers.[21]

The object of stricter supervision such as that proposed in the Green Paper and in New Directions for the Financial Sector (and implemented in the recent legislative

21 The Office of the Superintendent of Financial Institutions was created by the Financial Institutions and Deposit Insurance System Amendment Act. This new regulatory body is discussed in chapter 7.

reforms), is to give greater capacity to regulators to spot impending crises through greater inspection and supervisory powers and to prevent potential insolvencies through more powerful enforcement techniques. It is submitted, however, that the effects of competition are essentially independent of the regulatory regime. Regulation can control certain excesses which could lead to insolvency, but cannot be relied upon to prevent failures. This is the approach taken by the Canadian Bankers' Association in its Comments on The System of Bank Regulation and Supervision in Canada of January, 1986:

> ...regulatory supervision cannot prevent either human or institutional failure. The market system must be allowed to work through the forces of competition. Failure is an occasional consequence of the competitive adjustment process of the market.[22]

That increased supervision cannot be considered a cure for the effects of competition is illustrated by the American experience. The U.S. system employs an intensive system of bank supervision and inspection but has not had a successful record in preventing bank insolvencies. The three federal regulatory agencies in the United States rely on four supervisory techniques: a wide variety of detailed prudential reports provided by the banks on a regular basis; on-site safety and soundness examinations conducted by agency inspectors resulting in a comprehensive bank report

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22 Canadian Bankers' Association, Comments on the System of Bank Regulation and Supervision in Canada (January, 1986).

and a rating being assiged to the bank; computer-assisted surveillance programs used to discover signs of developing problems; and a variety of enforcement powers to remedy unsafe practices or close problem banks.[23] Despite this comprehensive and onerous supervision, the U.S. financial system suffered 118 bank failures in 1985 and 138 in 1986.[24] Therefore, it is not certain that more intensive supervision will prevent bank failures in the future or counter-act the effects of the government's policy of increasing competition in the financial sector.

Conclusion

Therefore, there has been a distinct trend in financial sector policy toward the promotion of competition among financial institutions. This has been facilitated by easing the restrictions for entry for new banks and breaking down the functional distinctions between various types of financial institutions. As non-bank institutions continue to gain more power to perform traditional banking functions, Canadian banks will experience more competition than they have ever faced. Even if the supervisory process is strengthened, as long as there are increasing numbers of banks which are facing increased competition from each other and from other financial institutions, there will, in all likelihood, be some fallout--particularly of small, new

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23 Estey, supra, note 1 at 391-392. For more details on the American system of regulation, see chapter 5 herein.
24 Gordon F.Boreham, "Banking in Canada and the USA: Some Comparisons" (1987) 94 Canadian Banker 6 at 11.

banks. In fact, the Minister of State for Finance, Thomas Hockin recently indicated that this was the expected result when he stated, in the context of his government's proposed financial sector legislation, that: "No legislation can or should prevent some rotting apples from falling off the tree,...."[25]

This very real possiblity of future bank failures has made it important for the government to have clear, adequate and appropriate powers to deal effectively with a situation of actual or imminent bank insolvency.

25 Bruce Constantineau, "Let 'Rotting Apples' Fall, Hockin Says", The Vancouver Sun (March 5, 1987) at B-1.

CHAPTER 2. RATIONALE FOR BANK BAILOUTS

Before examining the rationale for government intervention in cases of bank insolvency (i.e. a bank "bailout"), it is important to define the types of intervention that will be described in this paper as a "bailout". Essentially, the concept of a bailout will be used to include any situation where: a) government financial resources are used to keep a failing institution afloat or to facilitate its merger with a viable institution or b) clients of institutions that have failed are compensated out of public funds.[1]

Traditionally, the banking industry has been subject to government intervention in the form of regulation and supervision. This has developed out of a perception that banks (and other financial institutions) are somehow different from other businesses and should be treated differently.[2] It is basically this reason that justifies bailing out banks while letting ordinary industrial and

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1 The latter aspect of this definition would include payouts of insured claims under public deposit insurance schemes. Although the deposit insurance fund is funded by premiums assessed against insured institutions, the premium is indirectly paid by the users of financial services (in the form of increased cost for those services). This class is as wide as the taxpayer class and, therefore, the deposit insurance scheme is ultimately funded by public funds.

2 George B. Balamut, "A Morality Tale: Everything's Got a Moral If Only You Can Find It" (1975) 27 Ad L Rev 343 at 345, note 5.

commercial corporations succeed or fail as the market dictates.

Two characteristics of banks distinguish them from non-financial corporations and justify their differential treatment: a) the fact that much of their capital is supplied by depositors and b) their important role in the financial system. Out of these characteristics, it is submitted, flow two fundamental rationale for bailing out banks: 1) consumer protection and 2) maintenance of the stability of the financial system. These two rationale also justify the ongoing regulation and supervision of banks. It is submitted that there is an additional rationale for bailing out banks-- one that includes the type of political, social and economic considerations operating in the government bailouts of any business-- which will be described as "public benefit". Each of these rationale is examined below.

1. Consumer Protection

The ground of consumer protection-- the protection of suppliers of capital to banks-- is often cited as a fundamental justification for bank regulation. A bank's capital suppliers are comprised of three groups: depositors, creditors (secured and unsecured) and equity-holders (i.e. shareholders). Government intervention is aimed at benefitting a bank's depositors as opposed to its shareholders or creditors. Depositors possess special characteristics which justify their protection by the government while industrial and commercial enterprises are allowed to fail. The consumer protection concerns which justify preferential treatment of depositors as compared to suppliers of capital to ordinary commercial and industrial corporations will be examined first. Then, the consumer protection rationale will be applied to the other suppliers of bank capital (i.e. shareholders and creditors) in order to determine whether these same concerns are applicable.

a) Depositors

Depositors, as a class, differ fundamentally from suppliers of debt and share capital to non-financial corporations. As R.C. Clark pointed out in his article, "The Soundness of Financial Institutions", investors in ordinary industrial corporations come "predominantly from an elite group of persons who inhabit the higher brackets of income or wealth".[3] The suppliers of capital to financial intermediaries, on the other hand, come from a broad class which consists of virtually every adult-- rich and poor.[4] Clark contrasts capital suppliers to financial intermediaries--a truly public class of capital suppliers--with the elite class which supplies capital to ordinary industrial corporations.

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3 R.C.Clark, "The Soundness of Financial Institutions" (1976) 86 Yale Law Journal 1 at 11 [hereinafter "Clark"].
4 Ibid. at 11.

In Canada, Clark's distinction can be usefully applied to bank depositors and investors in ordinary commercial and industrial corporations. In 1984, 85 percent of Canadians had a personal savings account in a chartered bank-- truly a public class.[5] In addition, the vast majority of these accounts were relatively small. For example, in 1984, the composition of personal savings accounts of chartered banks was as follows: 18.1 million accounts of less than $1,000; 9.8 million with amounts between $1,000 and $9,999; 2.7 million totalling between $10,000 and $99,999; and 58,000 with amounts exceeding $100,000.[6] With the average savings account containing $3,429, it can be said that Canadian depositors are, on average, small savers.

In contrast, only 10 percent of Canadians own share equity in corporations.[7] The Economic Council of Canada described this latter class as follows:

> The owners of shares in publicly traded companies...tend to be in higher-income and higher-education groups and reside mostly in larger urban centres.8

Clearly, this can be considered an "elite class" in comparison to the average bank depositor.

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5 Economic Council of Canada, 1987, _supra_, chapter 1, note 2 at 64.

6 Canadian Bankers' Association, _Bank Facts/85: The Chartered Banks of Canada_ (1985).

7 Economic Council of Canada, _supra_, chapter 1, note 2 at 64.

8 _Ibid_. at 64.

Arising out of the different composition of the two classes, are several reasons explaining why depositors require special protection. First, the funds contained in the savings account of the average depositor represent life savings, i.e. non-disposable income. Owners of share and debt capital in non-financial corporations, on the other hand, tend to be investing discretionary income-- income they can more readily afford to lose.[9] As a result, losses caused by bank insolvency will have a greater disutility for depositors than similar losses suffered by ordinary capital investors.[10] To prevent the devastating effects that lost deposits can inflict, depositors are protected through government intervention.

A second justification for protecting depositors arises from this public class's lack of access to financial information about depository institutions. Without exposure to adequate financial information, it is impossible for depositors to assess the riskiness of investment alternatives. This concern was reflected by the Department of Finance in the Green Paper:

> Millions of Canadians have entrusted their savings to financial institutions and a large proportion of them know little, if anything, about the risks those institutions are incurring in the course of their business dealings.[11]

9 Clark, supra, note 3 at 21.
10 Ibid. at 21.
11. Green Paper, supra, chapter 1, note 11 at 12.

Several factors contribute to the informational barrier faced by depositors: i) the cost of obtaining and assessing financial information; ii) depositors' lack of the necessary motivation to make use of financial information; and iii) reluctance on the part of regulatory bodies to compel financial institutions to disclose pertinent information.

i) Cost: For small depositors, the size of their investment does not warrant the costs associated with obtaining and assesssing investment information. As Clark put it:

> ... the costs of obtaining accurate, relevant, intelligible, and personally usable information about the risks of alternative investments in financial intermediaries is excessively high for many public suppliers of capital, in relation to the amounts to be invested.[12]

It is not cost-efficient for the depositor to seek investment advice due to the small size of the average deposit and the tendency of financial advisers to tie the sale of financial products to financial advice. Not only is investment advice expensive, it is probably more difficult for a small saver to obtain than for an investor:

> Financial planners have shown little interest in taking business from persons with an annual gross income of less than $30,000 because of their limited capacity to purchase more sophisticated financial products. Thus persons of more modest means may have more difficulty in obtaining adequate

12. Clark, supra, note 3 at 15.

> information or in gaining access to certain types of financial products. 13

Certainly the average depositor would lack the financial sophistication and/or the time to make an assessment themselves.

In contrast to this are the investors in non-financial corporations-- the elite suppliers of capital-- for whom it is cost-efficient to assess (or to have assessed) the financial information disclosed by corporations before making investment decisions due to the large amounts at risk. These investors either possess the financial sophistication necessary to assess financial information or can justify the cost of financial advice.

ii) Motivation: An additional informational barrier facing depositors is the motivation to make use of financial information. In the case of depositors, the necessary motivation may be lacking because they generally do not perceive themselves as risk-takers-- they consider banks as safe places to keep those funds which they can least afford to lose.[14] Investors in non-financial corporations, on the other hand, are more likely to perceive themselves as risk-takers-- they are investing larger sums at higher risk in order to earn a higher return. These factors instil the

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13 Economic Council of Canada,1987 supra, chapter 1, note 2 at 64.

14 This motivational problem may be on the decline as more depositors have been made aware of risk as a result of recent bank (and other financial institution) failure.

motivation to assess whatever information is available and make investment decisions on the basis of that assessment.

iii) Availability: The third factor contributing to the informational problem faced by depositors is government and institutional reluctance to disclose information-- particularly information relating to distressed institutions.[15] This reluctance is based on fear that the disclosure of damaging information will cause depositors to withdraw their funds, turning a threat of insolvency into a reality. Disclosure of banking problems has traditionally been considered by regulators to be inconsistent with the promotion of a sound and stable banking system.[16] Edward Brainsilver, general counsel to the American Federal Deposit Insurance Corporation in 1975 summed up that regulatory body's policy with respect to disclosure as follows:

> To have continuous disclosure of the bank's deteriorating condition can, in our opinion, result in larger losses to everyone-- the holders of uninsured deposits, FDIC's insurance fund, and ultimately the remaining security holders who must bear the brunt of the loss and obtain their recovery out of the assets left after complete liquidation, and without the benefit of the substantial premium that may be paid for the bank's going concern value. In the long run, we feel that meaningful disclosures of a bank's deteriorating condition would be counter productive to the best interests of most of the concerned persons.[17]

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15 The issue of disclosure is debateable and there are those who argue in favour of increased disclosure: see, for example, John Evans, "Disclosure Through a Glass Darkly" (1975) 27 Ad.L.Rev.357 at 364.
16 John Evans, supra, note 15 at 362.
17 Edward Brainsilver, "Failing Banks: FDIC's Options and Constraints" (1975) 27 Ad.L.Rev. at 340 [hereinafter "Brainsilver"].

Therefore, if relevant information is unavailable, depositors cannot be expected to evaluate the risks of financial institutions accurately and base their investment decisions accordingly. This leaves bank management free to carry on business in a high-risk manner, without the discipline imposed by depositor investment decisions. It is the need to protect depositors from such risk that justifies bailing out depositors who lose their investments due to a risk they could not have anticipated.

The Canadian government has responded to this need for depositor protection by implementing a system of deposit insurance which insures a maximum of $60,000 for each depositor in each insured institution. The $60,000 limit, an arbitrary limit, represents an attempt to protect the small depositor.

The discussion thus far of the consumer protection rationale for government bailouts of banks has concentrated on the needs of average depositors (i.e. small depositors) and the comprehensive protection afforded them by deposit insurance. However, there is a subclass within the depositor class which should be examined separately: the large depositor with funds in excess of $60,000. It is more difficult to justify protecting these depositors on consumer protection grounds. This class consists largely of commercial depositors with diversified investments, and it is submitted, therefore, that it is more comparable to Clark's class of elite suppliers of capital than the public class he describes.[18] They are better able to withstand the financial shock of a bank failure (and the resulting loss of their deposits) than small depositors. Furthermore, they are more likely to possess the financial sophistication necessary to evaluate the relative risks of financial institutions accurately and are investing large enough sums that such evaluation can be performed economically.

Due to these differences between insured and uninsured depositors, the consumer protection concerns which justify deposit insurance as a method of bailing out small depositors, do not justify similar protection for large depositors.

b) Shareholders

Does the consumer protection rationale which justifies protection of small depositors apply to a bank's shareholders? The holders of share capital in a bank differ in fundamental respects from its depositors.

18 When Clark describes his public class of capital suppliers to financial intermediaries, he does not distinguish between insured and uninsured members of this class. He recognizes that the public class does contain some extremely wealthy members (see Clark, supra, note 3 at 11). However, for the purpose of this paper, these large depositors are examined separately. They are identified on the same basis as the government has identified them for deposit insurance purposes. It should be noted that this basis of identification is problematic due to the brokering of deposits, i.e. the breaking of large deposits into parcels of $60,000 and the distribution of them among a number of financial institutions in order to obtain the protection of deposit insurance.

Depositors hold an unsecured claim to their funds and do not share in profits earned by the bank. Their primary motivation for supplying capital to banks is to save their money-- they are not intending to risk it in order to make a profit.[19] Shareholders, on the other hand, do profit from the bank's successes. In the event of extraordinary gain, it is the shareholders who reap extraordinary profit rather than the depositors (who hold fixed claims). On the other hand, any loss incurred by shareholders is limited to their initial investment due to the principle of limited liability. Limited liability plus the high debt to equity ratio which is characteristic of the capital strucuture of banks means that more of the depositors' wealth than that of the shareholders is on the line when banks make risky investments.20 Shareholders, unlike depositors, tend to benefit from excessive risk-taking.[21]

Thus, consumer protection concerns do not justify government compensation of shareholders in the event of bank failure. Like the shareholders of non-financial corporations, they are risk-takers: if the business thrives, their risk pays off; if it fails, their investment is lost.

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19 From an economic point of view, depositors, like shareholders, are risking their funds. Whenever there is a return, there is an associated risk. However, from a psychological point of view, depositors do not perceive themselves as risk-takers.
20 Economic Council of Canada, 1987, supra, chapter 1, note 2 at 57.
21 Charles Freedman, "Comments" in Jacob Ziegel, Leonard Waverman, David Conklin, Canadian Financial Insitutions: Changing the Regulatory Environment (Toronto: Ontario Economic Council, 1985) at 88 [hereinafter "Ziegel"].

c) Bank Creditors

The consumer protection rationale which justifies protection of a bank's small depositors does not apply to its creditors. Clearly, secured creditors are already protected by their security upon which they can realize in the event of default. Unsecured creditors are unprotected but, it is submitted, they tend to resemble Clark's financially-sophisticated and elite class of capital suppliers rather than a public class.[22] As such, they do not need the protection which, it has been argued, is required by small depositors. It is more likely that the funds loaned to a bank by an unsecured creditor represent discretionary income rather than life savings. Furthermore, unsecured creditors tend to diversify their investments and, therefore, the failure of one bank would have less disutility for them than for a small depositor. Therefore, like an uninsured depositor, the consumer protection rationale does not justify the government bailing them out in the event of bank failure.

Conclusion

Therefore, there are consumer protection rationale for compensating some suppliers of capital in the event of a bank failure or for preventing the failure from occurring in

22 It should be noted that the statements made vis a vis unsecured creditors are not evidenced by empirical data--more empirical study is required on this class of capital suppliers.

the first place. On the basis of consumer protection, reformed bank insolvency legislation should aim at protection of insured depositors in all situations of bank failure. This is effectively achieved through deposit insurance. The consumer protection rationale, however, cannot justify the bailing out of an insolvent bank's uninsured depositors, shareholders or creditors.

2. Stability of the Financial System

The second basic justification for bailing out distressed banks lies in the importance of maintaining the stability of the financial system. This stability is essential in order for financial institutions to effectively carry out their functions as integral parts of the payments system, (thereby facilitating expeditious transactions between parties), as financial intermediaries (i.e. transferring funds from savers to borrowers) and as safekeepers of funds and suppliers of financial information and advice.[23] The fear is that the failure of one bank will create a domino effect: depositors will lose confidence in banks leading to the failures of other banks and thereby destabilizing the financial system.[24] Banks are more susceptible to failure than non-financial operations because of their highly leveraged capital structure.[25] The

23 Economic Council of Canada, 1987, supra, chapter 1, note 2 at 1.
24 Green Paper, supra, chapter 1, note 11 at 11.
25 Economic Council of Canada, 1987, supra, chapter 1, note 2 at 50.

comparatively small equity portion of this capitalization is threatened by any significant loss.[26] Furthermore, a large percentage of a bank's assets are illiquid while most of its liabilities are payable on demand or within a short time.[27] Thus, in the event of a run on deposits, a bank may be unable to meet depositor demands quickly enough, resulting in the forced sale of assets at "fire sale" prices. This can result in insolvency.[28]

Deposit insurance is of great assistance in maintaining stability of the financial system by preventing bank runs.[29] Because insured depositors know that their claims will be settled promptly in the event of failure, they have little incentive to withdraw their funds on the strength of rumour or the collapse of other institutions. However, bank runs still occur-- due in large part to the actions of uninsured depositors. Two recent examples are provided by the Bank of B.C. and Continental Bank ("Continental"). Both banks suffered from contagion arising out of the failures of the CCB and Northland in September, 1985. For example, in the four months following the declaration of their insolvency, Continental lost $2.6 billion (representing almost one half

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26 Ontario Task Force on Financial Institutions, Final Report (Toronto: November, 1985) [hereinafter "Dupre"] at 30.
27 Ibid. at 30.
28 Economic Council of Canada, supra, chapter 1, note 2 at 46.
29 Laurence S.Goodman, Sherrill Shaffer, "The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reforms" (1984) 2 Y.J.Reg.145 at 148 [hereinafter "Goodman"].

of its deposits) in a bank run.[30] A large majority of these withdrawals were made by the bank's uninsured depositors:

> Unlike some runs, where depositors line up at the door, this one was invisible. Money managers were leaving in what's known as a 'flight to quality'. They wanted their money in larger, safer institutions and they moved it in large chunks. In the end, the $2.6 billion in losses came from only 3000 of the bank's 150,000 accounts-- an average pullout in excess of $85,000.[31]

Similarily, the Bank of B.C.'s deposits plunged $355.6 million in fiscal year 1984-85, ending October 31.[32] Once again the withdrawals were made almost entirely by commercial depositors; in fact deposits held by small depositors increased throughout the Bank of B.C. crisis.[33]

Therefore, the potential for banks runs caused by loss of depositor confidence is very real. On the basis of the Continental and Bank of B.C. experience, it would appear that deposit insurance is not sufficient to prevent bank runs. This observation is made by the Economic Council of Canada in its 1987 Report:

> In the recent insolvencies in Canada, deposit insurance has limited the loss of confidence. But it has been unable to prevent it completely, as witnessed by the shift in deposits from smaller, regional institutions to larger, national firms.[34]

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30 Rod McQueen, "Showing the Colours" Canadian Business (April, 1986) 16 at 16.
31 Ibid. at 81.
32 John Schreiner, "Is Edgar on a Kaiser Roll?" Financial Post Magazine (March 1, 1986) 22 at 26.
33 Ibid. at 26.
34 Economic Council of Canada,1987, supra, chapter 1, note 2 at 51.

It is submitted that in circumstances where a destabilizing bank run is a real risk, the government is justified in bailing out a bank in order to maintain stability. The banking community is closely linked and failure of one bank may well affect all. Banks, as central players in the financial system, perform important functions and, therefore, there is value in maintaining confidence in them. Maintaining the stability of the financial system should be a primary goal of the government when resolving bank failures-- conflicting interests have to be subordinated when the risk of systemic failure is high. This is not to say that banks should never be allowed to fail or that uninsured depositors should always be bailed out, but there is good reason for avoiding the kind of instability which would weaken depositor confidence in the system.

3. Political Benefit

In a study entitled, The Political Economy of Business Bailouts, Michael Trebilcock et al. examine a number of business bailouts by the Canadian government in an effort to explain government decisions to bail out some failing firms and not others. The study examines economic and political rationale for bailouts, on a theoretical level. It is argued that the economic rationale for bailouts justifies government intervention in situations where the operation of the market without such intervention would lead to a socially undesirable outcome.[35] The object of a bailout is to improve economic efficiency by correcting market imperfections.[36] The political rationale is based on the pursuit of self-interest by politicians-- decisions to intervene are motivated by the desire to increase electoral support through granting benefits to groups of marginal voters.[37]

When these theoretical propositions are applied to case studies of business bailouts, the conclusion is reached that bailouts in recent Canadian history are more consistent with the political rationale than the economic[38]-- i.e. that bailouts are the result of a strategy on the part of political actors to seek net political benefit rather than to maximize social benefits.[39] This conclusion was summarized as follows:

> In summary, arguments supporting government intervention that were based on political expedience applied in virtually all of the bailout cases. Self-interested utility maximization was more evident on the part of political actors than was any desire to increase economic efficiency. Thus, bailouts can best be understood as part of politicians' basic strategies to enhance their prospects for staying in power by 'magnifying the gain and depreciating the pain' of income redistribution.[40]

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35 Michael Trebilcock, et al., The Political Economy of Business Bailouts: Volume 1 (Toronto: Ontario Economic Council, 1985) at 270 [hereinafter "Trebilcock et al."].
36 Ibid. at 276
37 Ibid. at 348.
38 Ibid. at 354.
39 Ibid. at 353.
40 Ibid. at 21.

Political gain is achieved by recognizing specific interests (for example, the interest of organized labour in retaining jobs) and providing benefits to specific groups.

Evidence of the strong incentives created by the political system to intervene in banks facing potential or actual insolvency is provided by case studies of recent bank bailouts. For example, political benefit can be used to explain, at least in part, the government's decision to bail out uninsured depositors of CCB and Northland. In testimony given before the Standing Senate Committee, the Minister of State (Finance), justified her government's departure from the general rule of market discipline as follows:

> We cannot ignore the reality of circumstances that, in this case, were not without significance. The government recognized that there were valid reasons for departing from the general rule. These depositors joined with the government in demonstrating support and confidence in our banking system in general and in regional banks in particular. We were concerned, as well, about the impact in western Canada if holders of deposits over the $60,000 insured limit had to absorb those losses. Those depositors included many individuals and small businesses, charitable organizations, religious organizations, credit unions, municipalities and school boards, as well as other groups.[41]

Thus, there were a number of interests which influenced the government's decision to bail out CCB and Northland, in addition to the interests of consumer protection and financial stability. First, was the interest of regional

41 Proceedings of the Standing Senate Committee on Banking, Trade and Commerce (Ottawa: November 19, 1985) at 31:7 [hereinafter "Proceedings"].

economic development-- in particular, the interest in developing regional banks in western Canada. This interest in province-building and regional development explains a large percentage of the Canadian government's decisions to bail out businesses between the late 1950's and the late 1970's.[42] Secondly, the government reacted to a moral and, essentially political, commitment to uninsured depositors who demonstrated their support in the banks by maintaining their deposits. Clearly, it would have been politically detrimental for the government to let these depositors lose, in the face of government assurances as to the viability of the banks. A third incentive for bailing out the banks arose from the composition of the uninsured depositor class, which included a large number of voters and politically-influential institutions, concentrated in one region. In The Political Economy of Business Bailouts, the co-authors determined that government assistance in the form of bailouts is generally granted to marginal districts (i.e. any riding in which a significant number of voters will be adversely affected by the business failure) which have effective political representation (for ex., the support of a Cabinet minister).[43] A strong argument can be made that the region which benefitted from the CCB and Northland bailouts was a marginal district and, therefore, a candidate for a bailout.

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42 Trebilcock, et al., supra, note 34 at 72.
43 Ibid. at 349.

Therefore, the rationale of political benefit can be used to explain government decisions to bail out banks (as well as non-financial corporations). Whether it is a justification for such intervention is arguable-- because it is based on a self-serving and short-sighted premise, it is harder to justify than the motivations of consumer protection and financial stability. For the purposes of this paper, it is assumed that government decisions to bail out some banks and not others will continue to be influenced by considerations of political benefit. Furthermore, it is submitted that this influence of the political benefit rationale is a valuable aspect of the bailout decision-- to the extent that it acts as a vehicle for the recognition, promotion and protection of important local, regional and national interests (other than the interests of consumer protection and financial stability). In order to control the public benefit rationale and justify its role in the bailout process, it is submitted that its influence on the decision to bail out a bank should be recognized in bank insolvency legislation-- but confined to circumstances in which the national interest calls for the protection of a right or interest which would be jeopardized by allowing a bank to fail.

Conclusion

Therefore, three rationale explain government decisions to bail out banks: consumer protection, financial stability and political benefit. Each of these rationale justify bailing out banks or their clients in some circumstances. It is submitted that bank insolvency legislation should reflect these rationale and provide techniques for resolving bank failures which are consistent with these rationale.

4. Additional Factors in the Bailout Decision

It has been argued that government decisions to bail out banks can be explained by the presence of one or more of the following rationale: consumer protection, maintenance of the stability of the financial system and political benefit. However, it is submitted that there are other interests/concerns which should be addressed in the bailout decision. These concerns, if recognized by government, would tend to affect its choice of bailout instrument rather than the underlying decision of whether or not to bail out a bank. The two concerns which are discussed below are: market discipline and cost-efficiency.[44]

a) Market Discipline

Under the discussion on consumer protection, it was argued that the government is justified in compensating small depositors on consumer protection grounds, but not

44 There are other concerns and issues which, it may be argued, should influence the bailout decision. For example, it is argued in Trebilcock, et.al. at 354, that decision makers should be made more sensitive to the economic, long-term consequences of bailout policies. This economic rationale for bailouts is not developed in this paper but is discussed, on a theoretical level by Trebilcock et al. in chapters 3, 4, 5 and 6.

large depositors. The government has attempted to distinguish the two classes and afford protection to small depositors by the implementation of a deposit insurance scheme with an insurance ceiling of $60,000. This legislative response to the consumer protection concern[45] also reflects the government's interest in market discipline-- large depositors are excluded from insurance protection in the expectation that they will maintain some degree of discipline in the market. A good definition of market discipline is found in Robert O. Edminster's article, "Bank Regulation and Deposit Reform: Some Hard Questions for Congress":

> [Market discipline] means that investors evaluate financial institutions on the basis of available information, decide which ones are operating in their (the investors') interest, then move funds in appropriate directions depending on risk and return expectations. If an institution fails to meet external expectations, it is 'disciplined' by investors who withdraw their funds.[46]

The problem with deposit insurance and government bailouts aimed at protecting uninsured as well as small depositors is that all depositors would lose their incentive to assess risk and move their funds according to that assessment. When market discipline is eliminated, the risks of institutional failure are shifted to the deposit insurance

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45 Deposit insurance is also a response to the need to maintain financial stability by preventing bank runs.

46 Robert O. Edminster, "Bank Regulation and Deposit Reform-- Some Hard Questions for Congress" (1987) 104 The Banking L.J. 42 at 43 [hereinafter "Edminster"].

fund and the taxpayer. This argument was made in the Final Report of the Ontario Task Force on Financial Institutions which stated that acts of bailing out uninsured depositors:

> ...effectively remove the influence of the market to enforce the prudent management of deposit-taking institutions. They encourage persons making deposits which may be worth millions of dollars to do so with little care, perceiving that governments will save them from the consequences of their own imprudence. [47]

Market discipline becomes a compelling reason for denying uninsured depositors the protection of a bailout afforded to smaller depositors. The expectation is that the investment decisions of uninsured depositors will maintain an effective degree of market discipline.[48]

Unsecured creditors are another source of market discipline. Like uninsured depositors, creditors do not benefit from bank management assuming increased risk due to the fixed rate of return earned on debt securities.49 Furthermore, creditors' funds are locked in and cannot be withdrawn upon demand (unless the debt security can be

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47 Dupre, <u>supra</u>, note 26 at 48.
48 The use of brokered deposits decreases the potential influence of uninsured depositors on market discipline. In 1984, Canada's 6 largest chartered banks had 74% of their Canadian dollar deposits insured. However, in smaller banks, especially banks relying on wholesale deposits, the proportion of uninsured deposits is higher: in 1984, other Canadian banks averaged only 31.1% insured deposits (see: Economic Council of Canada, 1987 at 50). Proposals have been made to control brokered deposits and the adverse effect they have on market discipline (see: <u>Final Report of the Working Committee on the Canada Deposit Insurance Corporation</u> (Ottawa: Minister of Supply and Services, April, 1985) at 30-32 [hereinafter "Wyman"].
49 Goodman, <u>supra</u>, note 29 at 161.

sold). Therefore, unsecured creditors have a strong incentive to assess the riskiness of alternative institutions before investing [50] -- an incentive that would disappear if they expected to be bailed out.

It is submitted, therefore, that market discipline is an important consideration which should be reflected in the bailout decision. It is not an interest which should override more fundamental interests of consumer protection and financial stability. However, once the decision is made to provide government assistance to a distressed bank, market discipline should affect the way the decision is implemented (i.e. which of the bank's capital suppliers should be bailed out).

b) Cost-Efficiency

A second factor which should influence the implementation of the bailout decision is cost-efficiency. Bailouts are funded by the deposit insurance scheme and/or government revenues. The interest of cost-efficiency dictates that governments resolve bank failures in a way that involves the least drain on public funds. This is an especially important consideration in the case of a large bank, the bailout of whose insured depositors could completely exhaust the deposit insurance fund. At present, the Canadian deposit insurance fund is a subject of concern for government officials and is in need of replenishment.

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50 Ibid. at 161.

For example, at the end of 1985, the fund had a deficit of $1.2 billion.[51] Therefore, cost-efficiency should be a concern of decision-makers when implementing a decision to bail out a bank.

Conclusion

Therefore, in addition to the three rationale for government bailouts of banks, it is submitted that there are two additional interests which should be reflected in the bailout decision and, therefore, in bank insolvency legislation: market discipline and cost-efficiency.

The following two chapters of this paper consist of an evaluation of Canadian bank insolvency legislation in light of the rationale for bank bailouts and the interests of market discipline and cost-efficiency.

51 The Canadian Bankers' Association, Response to Bill C-42: An Act Respecting Financial Institutions and the Deposit Insurance System (Toronto: April, 1987) at Appendix C.

CHAPTER 3. CANADIAN BANK INSOLVENCY LEGISLATION

On July 2 and 3, 1987, legislation reforming the regulation of financial institutions and the deposit insurance system was proclaimed by the federal government. The changes which this new legislation have made to the legislative framework preceding it will be examined in chapter 7. However, it is the pre-existing legislation which controlled the government's responses to the bank failures experienced in Canada to date. Therefore, it is the pre-July, 1987 legislative framework which is the subject of the following analysis.

Before examining the sources of the federal government's legislative authority over bank insolvency, a brief outline of the regulatory framework and the institutions responsible for bank regulation in Canada will be provided. Although the focus of this paper is government power to respond to actual or threatened bank insolvency, some understanding of its underlying powers to prevent insolvency through regulation and supervision is important.

1. Regulatory Framework

The Canadian banking system is governed by the terms and provisions of the Bank Act (S.C. 1980, c.40). The Act establishes two classes of banks: Schedule A and Schedule B. Schedule A banks are widely-held by the public with no individual or corporation holding in excess of 10% of the shares of any class and not more than 25% of the shares of any class being held by a Canadian or foreign individual or corporation.

Part V of the Bank Act sets out the authorized business and powers of banks, which include accepting deposits, borrowing money, acting as financial agents, guaranteeing payment or repayment of funds, lending money (which includes making mortgages), and investing in securities. Section 174 sets out the limitations on the powers of banks. Generally, banks are prohibited from dealing in goods, wares or merchandise or engaging in any trade or business except as authorized by the Act. Under Part V, each bank is required to maintain adequate capital and adequate and appropriate forms of liquidity in relation to its operations. Banks are required by section 208 to maintain primary reserves and, if required by the Bank of Canada, secondary reserves.

The regulation of banks is based on a tripartite system consisting of internal regulation, external auditing and inspection by federal authorities. Internal regulation is conducted in several ways. The bank's directors are given the responsibility of managing the business and affairs of the bank, subject to the provisions of the Act (section 34). Section 54 imposes a statutory duty of care, owed by directors and officers to the bank. Section 243 imposes an obligation on the directors to appoint an audit committee, comprised of at least three independent directors. The purpose of the audit committee is to examine the work of the bank's internal and external auditors, before the financial statements are approved by the directors (section 243(3)). When informed by the external auditors of an error or misstatement in a financial statement, the directors are obligated to prepare revised financial statements or otherwise inform the shareholders and the Inspector General of the error (section 243(8)). Banks also use internal inspection departments which test the bank's internal control systems and the quality of its loans.[1]

The second aspect of bank regulation is performed by the shareholders' auditors. At least two external auditors must be appointed annually by the shareholders of the bank (section 237). These auditors report to the shareholders on the financial statements at each year end and to the chief executive officer and chief general manager on matters which may affect the well-being of the bank.

The third branch of the tripartite regulatory structure, inspection by federal authorities, will be discussed below, under the heading, "Office of the Inspector General of Banks".

The four governmental institutions relevant to bank supervision and regulation: the Bank of Canada, the Department of Finance, the Office of the Inspector General of Banks and the Canada Deposit Insurance Corporation, are discussed briefly below.

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1 Estey, supra, chapter 1, note 1 at 38.

a) The Bank of Canada

The Bank of Canada is governed by the Bank of Canada Act. Canada's central bank, this institution is responsible for monetary policy and acts as the Canadian government's fiscal agent (i.e. it manages the public debt) and as a lender of last resort to banks. In its role as the regulator of liquidity, the Bank of Canada provides ordinary advances (usually one day) to banks experiencing shortfalls in their reserve balances or in the reserves required by section 208 of the Bank Act.[2] Under section 18(1)(h), the Bank of Canada is empowered to make extraordinary (maximum of six months) liquidity payments to banks unable to meet depositor withdrawals due to a run on deposits. It is obligated to report all liquidity advances made to banks to the Minister of Finance, which information is published in the Canada Gazette (section 25(1)). The Bank of Canada does not possess supervisory powers over the banks.

b) Department of Finance

The Minister of Finance is granted supervisory powers under the Bank Act. For example, under section 246(4), the Minister can authorize an examination of a bank when it is believed that an offence has been committed under the Bank Act. Under section 239(1), the Minister has the power to revoke the appointment of auditors and under section 229 can require a bank to furnish such other information as he may

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2 Estey, supra, chapter 1, note 1 at 57.

require in addition to the returns required by Part VII. Under section 175(1), a bank shall comply with any rules in the form of written directives from the Minister with respect to capital adequacy and liquidity. It is the Minister who appoints a curator to supervise the business and affairs of an insolvent bank. In practice, the Minister of Finance relies heavily on the Office of the Inspector General of Banks for daily administration of the Act, while restricting its attention to policy matters.[3]

c) <u>Office of the Inspector General of Banks</u>

Created in the aftermath of the 1923 failure of the Home Bank of Canada, the Office of the Inspector General of Banks (the "OIGB") is a branch of the Department of Finance and possesses the primary supervisory responsibility over banks.[4] Under section 245 of the <u>Bank Act</u>, an Inspector General of Banks is appointed by the Governor General in Council on the recommendation of the Minister of Finance. The Inspector is responsible for the administration of the Act (section 246(1)). In fulfilling his supervisory functions, the Inspector is required by section 246(2) to make or cause to be made, at least once a year, such examination or inquiry into the business and affairs of each

3 Estey, <u>supra</u>, chapter 1, note 1 at 56.
4 It should be noted that the <u>Financial Institutions and Deposit Insurance System Amendment Act</u> replaced the OIGB with a new body: the Office of the Superintendent of Financial Institutions. It retains much of the powers and duties with respect to banks as held by the OIGB but is given several new powers which are discussed in chapter 7.

bank as the Inspector deems necessary. He is to satisfy himself that the provisions of the Bank Act are being observed (for example, capital adequacy and liquidity) and that the bank is in sound financial condition. The results of such examination are to be reported to the Minister.

According to section 246(4), the Minister, when he has reason to believe that an offence under the Act has been or is about to be committed, shall direct the Inspector to make such inquiry as is necessary to determine the facts and report the results to the Minister. The Inspector is given the right to access the bank's books, documents, cash etc. and the right to require the directors, officers and auditors of the bank to provide such information as he may require (section 246(5)). In reality, although the Inspector has full powers to inspect the banks, he relies heavily on the shareholders' auditors and the internal bank inspection system.[5]

d) Canada Deposit Insurance Corporation

The Canada Deposit Insurance Corporation (the "CDIC") is a Crown corporation and is governed by the Canada Deposit Insurance Corporation Act (R.S.C. 1970, c.C-3). It is responsible for insuring deposits at banks and other deposit-taking institutions to a maximum of $60,000. The CDIC's insurance fund is provided for by the assessment of premiums on member institutions at the rate of one-tenth of

5 Coopers and Lybrand, supra, chapter 1, note 5 at 21.

one percent of insured deposits.[6] The Board of Directors of the CDIC is comprised of a Chairman selected by the Governor General in Council, the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Insurance and the Inspector General of Banks.

Despite its obvious interest as insurer in avoiding bank failures, the CDIC has very limited supervisory powers. It is entitled to have the affairs of chartered banks examined on its behalf by the OIGB but is not entitled to conduct its own inspection. After an examination is made on its behalf, the examiner is to report to the Corporation as to whether or not any changes have occurred in the circumstances of the bank that might materially affect the Corporation's position as insurer (section 23). It has the authority to prescribe standards of sound business and financial practices when concerned about a bank's practices but has no corresponding enforcement powers. When the Corporation is of the view that a member institution is following unsound business or financial practices, it is required by section 24 to report the facts to the president or chairman of such institution, who shall cause the report to be presented to a directors' meeting. Although the CDIC's powers to regulate and supervise banks before they reach insolvency are limited, once insolvency is threatened, its powers to act are slightly broader. The specific

6 The Financial Institutions and Deposit Insurance Amendment Act allows the premium levels to be set by regulation, subject to a statutory ceiling of one-sixth of one percent of insured deposits.

provisions of the Canada Deposit Insurance Corporation Act which grant authority to the Corporation to deal with insolvency or threatened insolvency are discussed below under the heading "Legislative Framework".

2. Legislative Framework

The power of federal institutions to act in a bank insolvency situation is derived from three sources: the Bank Act, the Canada Deposit Insurance Corporation Act, and the Winding-up Act.

a) Bank Act

Under section 276 of the Bank Act, a bank is consituted insolvent if it suspends payment for ninety consecutive days of any liability as it accrues. Once insolvent, the bank may exercise the powers conferred upon it by the Act only for the purpose of winding up the business of the bank under the Winding-up Act (section 276(2)). When a bank suspends payment of its liabilities, the Minister shall, under section 278, appoint a curator to supervise the business and affairs of the bank. Similarly, if the Inspector reports that in his opinion a bank will be unable to pay its liabilities as they accrue, the Minister may appoint a curator (section 278(2)). Once appointed, the curator is responsible for supervising the business and affairs of the bank and has all powers and shall take all steps necessary to protect the interests of creditors and shareholders of the bank and to conserve its assets and ensure their proper disposition (section 279). For such purposes, the curator is entitled to free access to the bank's accounts, records, cash, securities, etc. The curator retains its powers of supervision over the busines and affairs of the bank until he is removed from office by the Minister or until a liquidator is appointed to wind up the business of the bank (section 279(2)).

Upon insolvency, the priorities of creditors' claims are determined according to section 277. Claims of the governments of Canada and of any province (except debts evidenced by bank debentures) are the first and second charges, respectively, on the bank's assets. Next, deposit liabilities are to be paid in full, then all other liabilities of the bank, followed by debentures and those liabilities ranking equally with debentures. Finally, fines or penalties constitute the last charge on the bank's assets.

b) Winding-up Act (R.S.C.1970, c.W-10)

An application for a winding-up order of an insolvent bank is to be made by the bank (section 11) or by a creditor of the bank having a claim in excess of $1000 (section 153). Upon application for a winding-up order, the court may make the order requested, dismiss it, adjourn it, or make any interim or other order it deems just (section 13). If the bank opposes the application on the ground that it has not become insolvent, the court may in its discretion adjourn the application for a maximum of six months and order a person to inquire into the affairs of the bank and report to the court (section 14).

Before making a winding-up order, the court must direct that both the shareholders and the creditors of the bank hold meetings in order to ascertain their wishes as to the appointment of a liquidator (section 153(2)). The chairman of each meeting is to report the results of the proceeding to the court and if a winding-up order is made, the court will appoint a maximum of three liquidators from among those nominated by the shareholders and creditors. The liquidator(s), once appointed, is to take into his control all property of the bank, prepare a statement of the bank's assets, debts and liabilities and generally do all things necessary for winding up the affairs of the bank and distributing its assets (sections 33-35). The court may appoint inspectors to assist and advise the liquidator in the liquidation of the bank. Once a winding-up order is made, the bank shall cease to carry on business except as required for its beneficial winding-up (section 19).

c) <u>Canada Deposit Insurance Corporation Act</u>

The fundamental responsibilities of the CDIC under the <u>Canada Deposit Insurance Corporation Act</u> are to insure deposits and to compensate depositors when their insured deposits are lost as a result of the failure of a member institution. Section 11 of the Act sets out the powers of the CDIC. Generally, the Corporation is authorized to do all things necessary or incidental to the pursuit of its objects. The Corporation's objects are set out in section 8 and are as follows: to provide, for the benefit of persons having deposits with member institutions, against the loss of deposits; to provide the deposit insurance required by the Act for federal institutions; to examine into the affairs of member institutions for the purpose of obtaining information relative to deposit insurance; and to accumulate, manage and invest a deposit insurance fund. Section 11 goes on to provide a non-exhaustive list of the Corporation's powers, which includes the following powers:

> i) to acquire assets from a member institution and make, or guaranteee loans, advances or deposits with a member institution for the purpose of reducing a risk or threatened loss to the Corporation;
>
> ii) to borrow money from the Government of Canada and issue bonds and debentures therefor;
>
> iii) to act as a curator of a bank or liquidator or receiver of a member institution when duly appointed as such;
>
> iv) to assume the costs of winding up a member institution;
>
> v) to guarantee the payment of the fees of and the costs incurred by a liquidator or receiver of a member institution;
>
> vi) to acquire assets of a member institution from a liquidator or receiver thereof;
>
> vii) to make an advance for the purpose of paying a claim against a member institution for which the Corporation is acting as receiver or liquidator in respect of any insured deposit and becoming

subrogated as an unsecured creditor for the amount of such advance; and

viii) to make or cause to be made such inspection of member institutions as is authorized under the Act or the policy of insurance.

Under section 13(4), the Corporation is required to pay any claim in respect of an insured deposit as soon as possible after the obligation arises. The Corporation is entitled to make such payment where a winding-up order has been made or the member institution is unable to make any payment in respect of the deposit by reason of an order of a court or where the Corporation is satisfied that the member institution is unable to pay immediately and in full any insured deposits (section 13(4.1)).

The CDIC has the authority to initiate the winding-up of a bank if the Corporation is of the view that the bank is or is about to become insolvent (section 29). When a bank ceases to take deposits, or is, in the opinion of the CDIC, insolvent, the CDIC may cancel its insurance under section 27 of the Act. When its deposit insurance is cancelled, the member instituion is obligated to notify its depositors of that fact. Furthermore, the Corporation may give public notice of such cancellation if it is of the opinion that such notice would serve the public interest.

Therefore, the CDIC has some powers to act in the event of the threatened or actual insolvency of a chartered bank. However, it will be argued that these powers are inadequate if the CDIC is to be able to fully protect its interest as insurer.

3. Case Studies

As a framework in which to analyze the federal government's legislative authority to deal with bank insolvency, case studies of CCB, Northland and the Bank of B.C. will be employed, with particular emphasis on the government's response to the actual or threatened insolvencies of these three banks. The case studies will be used to examine and assess the adequacy of the legislation under which government agencies have been empowered to deal with bank failure.

a) Canadian Commercial Bank

Originally incorporated in 1975 as the Canadian Commercial and Industrial Bank, the CCB operated predominantly in Alberta and British Columbia, concentrating on real estate and energy loans.[7] From its inception, in order to compete with the big six banks, the CCB attempted to fill what it perceived to be an unoccupied niche, by making higher risk loans to the commercial middle market.[8] The bank was designed as a business bank rather than as a consumer bank and until 1983 relied on funding from the wholesale money market rather than retail deposits, thereby avoiding the expense of establishing a chain of retail

7 Estey, supra, chapter 1, note 1 at 72.
8 Ibid. at 405.

branches.[9] In the Estey Report, the Commission observed that: "The bank was seen in the West as well as by the federal government as being one which would 'lend money where the established banks refused to lend'".[10]

In its early years, the bank grew quickly, as did the Western economy. In order to finance this growth, rapid expansion of its loan portfolio was necessary, which increased the risk of making unsatisfactory loans.[11] The bank's troubles, which became evident in 1982, were triggered by the recession which hit Western Canada in 1981. The effect of this economic downturn was that a high percentage of the loans in the CCB's excessively concentrated portfolio became non-performing.[12] By 1983, it was clear that the CCB's deposit base, dependent as it was on the unstable, volatile and cyclical wholesale market was dangerous and management attempted to shift to the more stable retail market.[13] By the fiscal year end of 1984, retail deposits had risen from a negligible percentage to 20% of total deposits.[14] However, the number of bad loans in CCB's portfolio continued to rise between 1984 and 1985.[15] Adding to its difficulties, was the costly attempt to diversify its investments by the acquisition of an

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9 Ibid. at 426.
10 Estey, supra, chapter 1, note 1 at 71.
11 Ibid. at 74.
12 Ibid. at 11.
13 Ibid. at 71-72.
14 Ibid. at 81.
15 Ibid. at 83.

interest in Westlands Bank--a problem-ridden California bank.[16]

Management, recognizing that the bank was in serious trouble, resorted to several survival tactics, in an attempt to tide the bank over until the economy improved. Management placed unsatisfactory loans into a workout arrangement which entailed the adoption of a valuation standard referred to by management as "baseline value".[17] Baseline value was the anticipated value of the loan, based on an assumption that the economy would recover.[18] Based on this valuation, management recognized questionable accrued interest as income although it had not in fact been received, failed to make specific provisions in its financial statements for bad loans and established security values on the basis of future (i.e. higher) values rather than present (i.e. depressed) values.[19] These accounting techniques had the effect of shoring up the bank's financial statements.[20] By the end of fiscal year 1984, the financial statements no longer revealed the bank's true status, which delayed the ultimate insolvency.[21]

Meanwhile, neither the bank's external auditors nor the OIGB put a stop to management's questionable practices. The Estey Report concluded that the CCB's external auditors were aware of these management practices and accepted them

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16 Ibid. at 81.
17 Ibid. at 86.
18 Ibid. at 91.
19 Ibid. at 91.
20 Ibid. at 83-93.
21 Ibid. at 100.

although by 1983 they were expressing concern that the accounting practices were not as conservative as they might wish.[22] Despite their concern, they continued to certify the bank's financial statements, feeling their professional duty had been discharged by communicating their concerns to the bank's Audit Committee.[23] The Estey Report concluded that the auditors did not apply standard principles of bank auditing to the financial statements.[24] Furthermore, they failed to report unsatisfactory conditions affecting the well-being of the bank to the chief executive officer and chief general manager as required by section 242 of the Bank Act.[25]

The Estey Report also concluded that the OIGB knew of the bank's deteriorating condition between 1982 and 1983 and of the unconservative practices adopted by management, but ignored all warning signals.[26] It relied on the fact that the external auditors continued to certify the bank's financial statements as well as statements of management for its lack of action.[27]

On March 14, 1985, representatives of the CCB informed the OIGB and the Bank of Canada that the CCB could no longer operate without financial assistance.[28] In response, the Bank of Canada made substantial liquidity advances to the

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22 Ibid. at 137-149.
23 Ibid. at 151.
24 Ibid. at 153.
25 Ibid. at 151.
26 Ibid. at 164.
27 Ibid. at 158.
28 Ibid. at 105.

CCB in March and early April. At the same time, negotiations began, the object of which was to instate a support program to restore the CCB to solvency and, ultimately, healthy operation. In the course of these negotiations, the president of the CCB indicated that loan loss provisions totalling $244 million were necessary.[29] This assessment was confirmed by the OIGB, on the basis of an incomplete inspection of the bank's loan portfolio.[30] A support package in the amount of $255 million was ultimately agreed upon, with the participants consisting of the CDIC (contributing $75 million), the federal government ($60 million), the Province of Alberta ($60 million) and a banking group comprised of the big six banks (contributing a total of $60 million).[31] The government of Canada was authorized to participate in the rescue plan by the passage of the Canadian Commercial Bank Assistance Act (R.S.1984-1985, c.9). The banking group had insisted during negotiations of the rescue plan that CCB debenture holders waive their right to principal or interest until the support plan participants recovered their contributions.[32] When the debenture holders refused to so agree, the Governments of Canada, Alberta and British Columbia purchased $39 million in debentures. Thus, CCB debenture holders were paid off before the rescue program was implemented. The members of the banking group received warrants to acquire shares of the

29 Ibid. at 110-111.
30 Ibid. at 110.
31 Ibid. at 499.
32 Ibid. at 111.

CCB in the future, in exchange for their financial contribution. The effect of these warrants when exercised would have been to virtually eliminate the interests of the existing shareholders.[33] In addition, the CCB was obliged to pay one half of the bank's pre-tax income to the participants in the rescue plan and suspend all dividends on CCB shares until the $255 million contribution was repaid.[34]

After the rescue plan was instituted, further and more comprehensive portfolio examinations were conducted by the OIGB. As a result, it became clear that many of the CCB's loans were overvalued on the balance sheet and that the support group had devised their rescue plan with inadequate and inaccurate information.[35] It quickly became obvious that the $255 million infused into the CCB was grossly inadequate and the CCB's financial outlook appeared dim.[36]

In July and August of 1985, the possibility of a merger was considered but no party could be found who was willing to merge with the CCB without a substantial government subsidy.[37] On September 1, 1985, the OIGB informed the Minister of Finance that a curator should be appointed as the CCB was no longer able to pay its liabilities as they came due. The bank was ultimately liquidated, with insured and uninsured depositors receiving full compensation and the

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33 Ibid. at 116-118.
34 Ibid. at 499.
35 Ibid. at 121.
36 Ibid. at 126.
37 Proceedings of the Standing Senate Committee on Banking, Trade and Commerce (Ottawa: November 19, 1985) at 31:7 [hereinafter "Proceedings"].

members of the support group (who were not classified as depositors) losing their contributions.[38]

b) Northland Bank

Incorporated in 1975, Northland was, like the CCB, a Western-based bank designed to lend to higher-risk mid-market commercial borrowers and to rely essentially on funding from wholesale money markets.[39] Although the bank grew steadily from 1975 until 1982, it suffered from geographic concentration, a lack of experienced management, and a non-diversified loan portfolio which concentrated on the cyclical energy and real estate industries.[40] Due to its lending practices and reliance on the wholesale money markets, Northland was vulnerable to the recession which hit Alberta in 1981.[41] By 1983, it was clear to management that it was facing a large number of nonperforming loans.[42] In response, management adopted survival tactics (much like those used by CCB's management) in an attempt to maintain a healthy appearance until the Western economy recovered.

One tactic adopted by management was to turn to the retail market for a more stable core of deposits.[43] Another stategy was to place unsatisfactory loans into a workout which management felt justified inflating the value of the loan or its collateral, capitalizing interest and

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38 Estey, supra, chapter 1, note 1 at 530.
39 Ibid. at 2.
40 Ibid. at 181.
41 Ibid. at 186.
42 Ibid. at 187.
43 Ibid. at 189.

taking accrued but unreceived interest into income.[44] The effect of these tactics was summarized in the Estey Report:

> The Financial Statements became gold fillings covering cavities in the assets and in the earnings of the bank. By conventional standards of banking and bank accounting the bank would have been shown as short on assets and earnings. The confidence of the money market would have been lost and deposits withdrawn. The bank, without outside assistance, would have had to close its doors as early as 1983.[45]

As in the case of the CCB, Northland's external auditors accepted managements's practice of taking into account their expectations of future improved economic conditions when valuing assets.[46] They were not conservative when reviewing management workouts of unsatisfactory loans.[47] The Estey Report concluded that the auditors expressed concern to the Audit Committee only occasionally and ineffectually.[48] In 1982-1983, the OIGB became aware of the discrepancy between present day values of Northland's loans and those future values ascertained by management.[49] However, it relied on the external auditors and management and did not direct its powers to deal with the bank's problems until 1985.[50]

Northland's problems were compounded by the highly publicized bailout of the CCB in March, 1985. The two banks

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44 Ibid. at 4.
45 Ibid. at 5-6.
46 Ibid. at 242.
47 Ibid. at 248.
48 Ibid. at 244.
49 Ibid. at 253.
50 Ibid. at 262.

were seen by depositors as belonging to the same category and as a result, Northland suffered a loss of deposits and a fall in share prices.[51] Liquidity advances which ultimately totalled $500 million were made by the Bank of Canada to replace these lost deposits.[52] On September 1, 1985, the OIGB informed the Bank of Canada that Northland was unable to meet its liabilities as they came due and recommended to the Minister of Finance that a curator be appointed.

The liquidation process was delayed due to management's belief that Northland could be rehabilitated or merged with a viable institution. Four proposals were put forth but each involved substantial open-ended indemnities from government and were, therefore, rejected by government officials.[53] The bank was liquidated in early 1986 with insured and uninsured depositors having received full compensation.

c) Bank of British Columbia

Formed in 1967 and promoting itself as "Canada's Western Bank", the Bank of B.C. was successful in the retail market, building forty one retail branches in British Columbia and Alberta. However, like the CCB and Northland, it suffered from the economic downturn which hit the Western economy in 1982. In 1983, it posted loan losses of $51 million and in 1984 had $122 million worth of outstanding

51 Ibid. at 6.
52 Ibid. at 6.
53 Proceedings, supra, note 37 at 31:9.

loans on which interest payments had ceased to be made.[54] Despite an infusion of new capital in 1985, its deposits dropped dramatically in that year due to confidence lost as a result of the collapses of CCB and Northland.[55] By April, 1986, liquidity advances from the Bank of Canada had reached a maximum height of $975 million.[56]

Following the failures of the CCB and Northland, Bank of B.C. management conducted an unsuccessful search for a potential purchaser or merger partner. In the second quarter of the financial year ending October 31, 1986, management decided to consolidate its operations by closing some Western branches and reducing foreign operations.[57] In November, 1986, the Bank of B.C.'s external auditors informed management that they would be unable to provide an unqualified audit opinion on the financial statements due to concern over the bank's future viability.[58] The OIGB conducted four reviews of the bank's loan portfolio between September, 1985 and September, 1986, concluding that the bank was in a precarious position.[59]

Management conducted a renewed search for prospective purchasers in the fourth quarter of 1986. The CDIC offered to contribute financial support to a proposed transaction

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54 John Shreiner, "Is Edgar on a Kaiser Roll?", Financial Post Magazine (March 1, 1986) at 22.
55 Ibid. at 22.
56 Bank of British Columbia, Management Information Circular (December 12, 1986) at 8 [hereinafter "Information Circular"].
57 Ibid. at 8.
58 Ibid. at 10.
59 Ibid. at 10.

after calculating that liquidation of the Bank of B.C. would result in an immediate payment of $1.3 billion to insured depositors.[60] The Hongkong Bank of Canada (a subsidiary of the Hongkong and Shanghai Banking Corporation) was the only party willing to conclude a transaction with the amount of subsidy being offered by the CDIC.[61] It agreed to purchase 98.6% of the Bank of B.C.'s total assets (including the majority of its domestic and international loan portfolio) for $63.5 million and assumed substantially all of its liabilities (including a $400 million debt to the Bank of Canada and all of its deposit liabilities).[62] The CDIC contributed $200 million to cover any possible future losses associated with the Bank of B.C.'s loan portfolio.[63] As a result of this purchase assumption arrangement, all of the bank's depositors were protected from potential losses. In the course of winding up its business, the Bank of B.C. will realize upon the remaining assets and satisfy the retained liabilities. The amount which shareholders will receive upon liquidation will depend upon the realization of the remaining assets, the progress of litigation involving the Bank of B.C., the settlement of the retained liabilities and whether or not the Bank of B.C. is entitled to an existing pension fund surplus.[64] It is likely that shareholders will suffer a substantial but not complete loss-- Bank of B.C.'s

60 Ibid. at 11.
61 Ibid. at 15.
62 Ibid. at 5.
63 Ibid. at 5.
64 Ibid. at 7.

management expects preference shareholders to be paid out fully and common shareholders to receive between \$0.55 and \$1.20 per share (which would increase to between \$1.20 and \$1.85 per share if the bank is entitled to withdraw the pension surplus).[65]

The preceeding three examples of bank failures/mergers are useful because although the factual situations of the banks involved are roughly comparable, in each case the government responded differently to the threatened or actual insolvency. The government's responses in these cases provide insight into the operation of Canadian bank insolvency legislation and assist in the following evaluation of that legislation.

65 Ibid. at 7.

CHAPTER 4. EVALUATION OF BANK INSOLVENCY LEGISLATION

The legislative approach to bank insolvency embodied in the three Acts outlined in chapter 3 concentrates on one course of action in the face of an insolvency: liquidation and payoff of insured depositors. The effect of this response is to bail out insured depositors, a form of government intervention which is justified on the grounds of consumer protection. However, this may not always be the most appropriate solution depending on what other interests are in need of protection.[1] The case studies show that other options have been considered and in some circumstances, implemented--regardless of the limited options open to the government under the Bank Act, the Canada Deposit Insurance Corporation Act, and the Winding-up Act. Special legislation was passed when necessary to empower the government to take the action it deemed appropriate. The case studies point to the need for reform of the overly restrictive bank insolvency legislation in force at the time of the failures. By examining the alternative responses to bank insolvencies which the government and the CDIC have made in the context of the CCB,

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1 Clearly, a private sector solution would be more desirable than any form of government intervention. However, this paper assumes that such a solution would be unobtainable--which is generally the case due to deterioration of the bank's loan portfolio. See Richard M. Rosenberg, Donald B. Given, "Financially Troubled Banks: Private Solutions and Regulatory Alternatives" (1987) The Banking Law Journal 284 at 285 {hereinafter "Rosenberg"].

Northland and Bank of B.C., the specific disabilities and limitations of the legislative framework become evident. These alternate courses of action included: a) paying off uninsured depositors; b) subsidizing mergers with viable institutions; and c) arranging and contributing to rescue packages designed to restore insolvent banks to healthy operation.

a) Payoff of Uninsured Depositors

Although the CDIC is obligated to pay claims of only insured depositors in the event of liquidation, in some circumstances the government has decided that the claims of uninsured depositors should be paid as well. The justifications for the government's decision to bail out uninsured depositors of CCB and Northland were discussed *supra* (chapter2). Because no legislative authority existed for this type of complete payout, the *Financial Institutions Depositors Compensation Act* (R.S.C. 1985 c. 51) was passed, authorizing the government to pay the claims, including interest, of the uninsured depositors of the two banks. This highlights a deficiency in the legislative structure in place at the time of the failure of these banks: it did not contemplate this form of government response to bank failure yet the government was compelled by the interests of financial stability and regional economic development to make such a response. Although there are circumstances in which the bail out of uninsured depositors and creditors is justified, it will be argued that there are more cost-efficient and beneficial techniques for achieving this result than the liquidation and payoff approach taken by the government in the CCB and Northland cases. These alternate techniques and the criteria for their implementation should be clearly set forth in revised bank insolvency legislation.

2. Merger

Merger is a second response to bank failure which is not contemplated by Canadian bank insolvency legislation. If a troubled bank can arrange a merger privately, there is no need for government intervention and therefore, no need for authorizing legislation. However, it is often the case that a distressed bank cannot find a willing merger partner without the contribution of a government subsidy or indemnity. The merger approach was used in the Bank of B.C. case and was contemplated in both the CCB and Northland situations.

The purchase of substantially all of the assets and the assumption of substantially all of the liabilities of the Bank of B.C. by the Hongkong Bank of Canada was facilitated by a subsidy from the CDIC. When the Inspector General's team reviewed the Bank of B.C.'s loan portfolio in September, 1986, it concluded that the bank's position was precarious and encouraged the bank to arrange a sale to a viable financial institution.[2] It was clear that the CDIC

2 Information Circular, supra, chapter 3, note 56 at 10.

would incur a substantial loss if the Bank of B.C. were forced to liquidate. Therefore, in order to avoid the looming prospect of liquidation and payoff (and an immediate estimated payout of $1.3 billion),[3] the CDIC agreed to provide significant financial support if a transaction could be arranged which would avoid involuntary liquidation of the Bank of B.C. The purchase assumption transaction which was entered into by the Hongkong Bank of Canada was subsidzed by the CDIC in the amount of $200 million. There does not appear to exist any legislative authority for the CDIC to have made such financial assistance. Under section 11 of the Canada Deposit Insurance Corporation Act, the Corporation is authorized to do all things necessary or incidental to its objects. Its objects are to provide deposit insurance and make payments to insured depositors in accordance with the Act; examine into the affairs of member insitutions for the purpose of obtaining information relative to despoit insurance; and to accumulate, manage and invest a deposit insurance fund (section 8). It would be stretching the language of section 8 to fit the CDIC's actions in the Bank of B.C. case within one of these subsections. The Act goes on in section 11 to provide a non-exhaustive list of the Corporation's powers (see chapter 3 supra) but none appear to encompass the payment of a subsidy to an acquiring institution.

3 Ibid. at 10.

Therefore, the CDIC's solution to the threatened insolvency of the Bank of B.C. was beyond the scope of its authorizing legislation. However, it was arguably a more appropriate solution than the liquidation approach contemplated by that legislation. For example, by subsidizing the purchase of the Bank of B.C. in the amount of $200 million, the CDIC avoided the almost inevitable payment of approximately $1.3 billion to the bank's insured depositors. The bank was able to remain in operation, thereby maintaining its going concern value. Furthermore, the bank's uninsured depositors and creditors did not lose any portion of their investment and were saved the hardship of waiting until the bank was liqudated for the satisfaction (and possibly only partial satisfaction) of their claims.[4] The bank's shareholders suffered a significant loss, but avoided loss of their entire investment which would have been the likely outcome of involuntary liquidation.[5] Therefore, the Bank of B.C. is a clear example of the inadequacy of the present legislative structure and the inappropriateness of the liquidation and payoff approach in some situations.

4 It will be argued that this effect of a purchase and assumption (i.e. of bailing out uninsured depositors and creditors) is not desirable in all circumstances due to its adverse effect on market discipline (see chapter 5, section 2). However, if the circumstances are such that the government is justified in paying out the claims of uninsured depositors in any event, a purchase and assumption has many advantages over a liquidation and payoff.

5 Information Circular, supra, chapter 3, note 56 at 22.

The merger option was contemplated by the government in the CCB case as a method of dealing with the bank's looming insolvency. The OIGB investigated the potential of a merger in August of 1985 and reported to the Minister of State as follows:

> No bank would be willing to amalgamate with them unless some third party (i.e., the CDIC or the government in some form or other) pays the larger bank. Payment could be by purchasing bad and nonearning loans at face value or by funding the nonearning loans and providing an indemnity against losses...Obviously, there is little to distinguish this from a liquidation approach...6

The merger option was ultimately abandoned.

The possibility of a merger was also considered in the Northland case. However, like the CCB, the bank's assets had deteriorated to such an extent that government subsidies required to amke the bank acceptable to proposed partners were unacceptably large. For example, the OIGB asked the National Bank to consider a merger with Northland. National refused after examining the bank's loan portfolio.[7] When the government failed to find a willing merger partner, it had no alternative but to use its power under section 278 of the Bank Act to appoint a curator to oversee the bank's operations. Further merger efforts were made after the appointment of the curator: the liquidation process was delayed and the government retained a consultant who worked with Northland management to come up with a viable

6 Estey, supra, chapter 1, note 1 at 521.
7 Proceedings, supra, chapter 3, note 37 at 31:9.

reorganization or merger.[8] Merger partners were sought among major international banks but all required federal commitment to cover losses on the bank's loan portfolio.[9] The government refused to make such a commitment and on September 30, announced its decision to seek approval to have Northland wound up.

Therefore, the merger option was contemplated in the CCB and Northland cases but rejected because the banks' assets had deteriorated to an extent that made the necessary government subsidy prohibitively large. However, if such a solution had been attempted earlier, it may have met with the success achieved in the Bank of B.C. case and avoided the costly payoff of the insured and uninsured depositors of both banks.

3. Rescue Packages

A third course of action which the government has taken in the face of bank failure is the arrangement of a rescue program (i.e. the infusion of government funds into a failing bank with the aim of restoring it to healthy operation). There is no legislative framework in existence which provides criteria for deciding when a Canadian bank should be rescued by the government. Nor is there legislation giving government agencies the authority to institute a rescue program or the flexible powers needed to implement it. However, in the spring and summer of 1985,

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8 Ibid. at 31:9.
9 Estey, supra, chapter 1, note 1 at 598-599.

when faced with the financial difficulties of the CCB and Northland, the government contemplated and, in the case of CCB, attempted a rescue through direct financial assistance.

In the Northland case, the government considered a rescue package as an alternative to the liquidation and payoff approach.[10] In July, 1985, the bank's management proposed a major restructuring arrangement to government officials in the hopes of restoring depositor confidence in the bank.[11] The proposal involved the purchase by the Government of Canada of $250 million worth of the bank's loans. However, officials from the Bank of Canada, the Department of Finance and the OIGB rejected the proposal on the basis that it was premature:

> ...the proposal, which would be viewed as a government bail-out operation, would heighten the perception that the true situation of the Northland, and of other small banks, was much worse than the public has been led to believe and could further undermine confidence in the Northland and possibly, in other small banks.12

In August of 1985, a further proposal involving interest-free loans from the CDIC or the federal government to Northland was rejected by government officials for much the same reasons. In September, after a curator was appointed, a government-appointed consultant received four further proposals to rescue the bank through restructuring. However, these were rejected by the government on two

10 Proceedings, <u>supra</u>, chapter 3, note 37 at 31:9.
11 Estey, <u>supra</u>, chapter 1, note 1 at 578.
12 <u>Ibid</u>. at 579.

grounds: 1) each involved "large and open-ended subsidies" from the government and 2) none would guarantee a "viable ongoing banking operation that would not be dependent on continuing government support".[13] Although the possibility of a rescue program was ultimately rejected by the government in the context of the Northland insolvency, the significant point is that the government did in fact consider this approach before resorting to the statutory procedure of liquidation and payoff and the compensation of uninsured depositors.

In the CCB case, the government actually made a rescue attempt (for details of the program see chapter 3 _supra_). In making the decision to implement and contribute public funds to the rescue operation, government officials had to balance the desire to avoid government investment in a private business against the potential negative effects of failure. These included: possible repercussions for small, Western-based financial institutions and the Western Canadian economy; possible international implications; disruption to the busineses of CCB borrowers; and adverse effects on the viability of the regional bank concept.[14]

Lacking the legislative authority to make direct financial contributions to a distressed bank, the federal government passed special enabling legislation: the _Canadian Commercial Bank Assistance Act_. Under the terms of that Act, $75 million was authorized to be paid from the

13 Proceedings, _supra_, chapter 3, note 37 at 31:9.
14 Estey, _supra_, chapter 1, note 1 at 478-479.

Consolidated Revenue Fund for the purposes of the federal government's participation in the CCB rescue. In addition, the Act gave the Minister of State (Finance) the power to enter into any agreements necessary to provide financial support to the CCB under the terms of the proposed support package.

The CDIC also participated in the rescue program in the amount of $75 million. Presumably, the Corporation's power to make this contribution derived from section 11(a) of the Canada Deposit Insurance Corporation Act. Under the terms of that section, the Corporation is entitled to acquire assets from or make loans to a bank for the purpose of reducing a risk or reducing or averting a threatened loss to the Corporation. The capital infused into the CCB by the support group was described in the joint agreement as a purchase of a package of nonperforming loans and could, therefore, be considered a purchase of assets within the meaning of section 11. Alternatively, the transaction could be described as a loan by virtue of its repayment provision (which is more characteristic of a loan than of a purchase and sale). Clearly, the CDIC's participation-- whether an asset purchase or a loan-- was made in an attempt to avert a threatened loss to the Corporation, as required by section 11.

From its inception, the support package was almost certain to fail and within several months had done so. The

Estey Report cited several reasons for the failure of the rescue plan, including the following:

i) miscalculation of the amount of assistance and the type of assistance required-- the funds were inadequate and did not provide the CCB with an immediate flow of income. The rescue funds were paid directly to the Bank of Canada to reduce liquidity advances--they became a further debt obligation of the CCB and did not alleviate the insolvency of the CCB;

ii) lack of direct involvement by the one federal agency experienced in liquidation--the CDIC;

iii) inadequate inspection of the loan portfolio by the OIGB and inadequate communication of the results of examinations to the participants in the support program. Due to the lack of accurate and adequate information regarding the bank's financial status, an insufficient and inappropriate plan was put into place to save a bank which may well have been beyond the point of rescue;

iv) lack of a method for dealing with the interests of CCB shareholders. The only method used to deal with their interests was the granting of warrants to the banking group in exchange for its advancement of funds under risky circumstances. The warrants would have virtually eliminated the sharholders' interests at some future time. Estey argued that it was inappropriate to grant equity in the CCB to competitor banks--recovery of their advances and maintenance of the stability of the financial system would have been sufficient consideration for their financial assistance;

v) failure to replace the bank's management (and thereby help to restore confidence in the bank);

vi) lack of an authorized leader to direct the design and execution of the plan; and

vii) lack of a mechanism to monitor the operation of the program.[15]

The fact that the CCB rescue program failed does not demand the conclusion that such an approach to threatened insolvency is always inappropriate. Estey's retrospective analysis of this attempt indicates that there were specific and identifiable reasons for its failure and a future attempt may be more successful if these pitfalls can be

15 For a complete discussion of these reasons for the failure of the CCB rescue plan, see Estey, <u>supra</u>, chapter 1, note 1 at 114-121.

avoided. On the basis of Estey's evaluation of the rescue attempt, it is concluded that a more structured legislative framework is needed to guide regulatory agencies in the initial decision to implement a rescue program and in the structuring and monitoring of it thereafter. Statutory authority should be vested in one agency to assume leadership over and control of the process. In addition, a statutory mechanism is required to deal with the interests of the shareholders of an insolvent bank in order to avoid their unjust enrichment when direct government assistance is provided to an insolvent bank. The CCB experience is helpful in that it provides this type of insight into the search for reformed legislation in the area of bank insolvency.

Conclusion

The case studies show, therefore, that the basic response to bank insolvency contemplated by the present legislation--liquidation and payoff--has been considered by government to be inapproporiate or undesirable in dealing with recent bank failures. It is submitted that, in these cases, the government's decision to resolve the insolvencies through methods other than liquidation and payoff, can be explained by the operation of the rationale of financial stability and/or the political benefit rationale. If consumer protection had been the government's sole objective in these cases, liquidation and payoff would have been an appropriate and adequate response-- due to the protection afforded by deposit insurance. Deposit insurance is an effective method of protecting small depositors. In addition to providing this protection, liquidation and payoff has the added advantage of maintaining some measure of market discipline through the insurance ceiling of $60,000 (which encourages uninsured depositors to investigate the riskiness of alternative investments). It also maintains financial stability to the extent of preventing bank runs on insured deposits (although, as discussed in chapter 2, it does not prevent runs on uninsured deposits). In circumstances of relative financial stability where consumer protection is the government's major concern, therefore, deposit insurance is an appropriate response to bank failure.[16]

It is in circumstances where there exists, or the government perceives there to exist, one of the other rationale for bailouts, that the liquidation and payoff approach proves inadequate. In the case studies, the government perceived a risk of a destabilizing bank run or was motivated by the rationale of political benefit to go beyond the protection of small depositors-- by implementing other forms of bailout assistance. In the CCB and Northland cases, for example, the government was concerned about

16 The whole issue of deposit insurance is a complex one. A variety of proposals has been made on reform of the deposit insurance system which includes recommendations to change the insurance ceiling, co-insurance, and risk-related premiums. Reform of the deposit insurance system is relevant to the topic of this paper, but beyond its scope.

financial instability and perceived a risk of a destabilizing bank run.[17] Furthermore, the bailout decision in these cases can be explained by the government's interest in protecting regional economic development.[18] These rationale motivated the government's actions in implementing a rescue program in the CCB case and, ultimately, in bailing out the uninsured depositors of CCB and Northland. These forms of government intervention were not provided for in the government's authorizing legislation, necessitating the implementation of special enabling legislation. It is submitted, therefore, that in the face of one or more of the rationale for bailouts which justify saving a bank or compensating its uninsured depositors and creditors, the legislative structure under which the government has been authorized to resolve bank insolvencies has proven inadequate and is in need of reform.[19] The challenging aspect of this conclusion lies in developing broader and more flexible powers to deal with insolvency and an institutuional structure for carrying out such powers. The process of identifying the rationale for bailouts and the Canadian government's attempts at implementing broader solutions in three recent case studies, has highlighted some of the criteria which reformed legislation should meet. The following is a list of functions which, on the basis of

17 Proceedings, supra, chapter 3, note 37 at 31:46.
18 Ibid. at 31:7.
19 The reforms which the government has already implemented in this area are discussed in chapter 7 infra.

the preceding analysis, reformed bank insolvency legislation should fulfil:

i) maintain the stability of the financial system;

ii) protect small depositors;

iii) protect those local, regional and national interests the protection of which is in the national interest;

iv) maintain a degree of market discipline sufficient to control excessive risk-taking by bank management;[20]

v) promote economic efficiency (i.e. protect the deposit insurance fund);

vi) establish an authorized leader with: control over the making and implementation of decisions; access to adequate information for the fulfillment of such responsibilities; and broad and flexible powers to resolve actual or threatened bank insolvencies;

vii) create a mechanism whereby equity interests are dealt with in cases of direct government assistance to avoid bailing out shareholders; and

viii) provide some measure of certainty for persons and institutions affected by bank failure.

Having identified these criteria for reformed legislation, the next step is to develop a model embodying as many of the criteria as possible. Two sources of ideas have been particularly significant in the search for such a model and are discussed below: the American approach to bank insolvency and recent public studies of the Canadian system.

20 Note that a corollary of this criteria is the need for increased disclosure. If large depositors and creditors are to be expected to exercise market discipline, adequate financial information must be made available to them. The form which such disclosure should take is an important issue, but one that is beyond the scope of this paper.

CHAPTER 5. AMERICAN APPROACH TO BANK INSOLVENCY: THE FDIC MODEL

The American banking system is dual in nature. In every state, two sets of commercial banks co-exist: national banks chartered by the Comptroller of the Currency and state banks chartered by state regulatory officials. The chartering agencies, in addition to their control over charter applications, have regulatory control over the banks established under them. For example, the agencies issue rules regulating capital requirements, lending practices, powers, investments, etc. with respect to these banks and examine their records and operations to ensure legal and sound operation.[1] Every national bank is required to be a member of the Federal Reserve system, which is governed by the Federal Reserve Act. The Act creates a Federal Reserve Board which acts as the nation's central bank and establishes a Federal Reserve Bank in each of 12 districts in the United States. State-chartered banks may apply for Federal Reserve membership and for such banks, the Federal Reserve Bank is the primary regulator. As such, it regulates reserve and capital requirements and carries out inspections of state member banks.

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1 Kenneth E.Scott, "The Dual Banking System: A Model of Competition in Regulation" (1977) 30 Stan L. Rev.1 at 3.

All national and state banks which are members of the Federal Reserve must be insured by the Federal Deposit Insurance Corporation (the "FDIC").[2] State banks which are not Federal Reserve members may apply for coverage by the FDIC. The function of the FDIC, like the CDIC, is to insure depositors against losses arising from bank insolvency. To facilitate its insurance function, the FDIC is given direct supervisory and regulatory powers over insured state banks which are not members of the Federal Reserve. Although the FDIC does not directly supervise federally-chartered banks and state-chartered member banks, it has access to the reports of inspections made to the Comptroller of the Currency and to the Federal Reserve Bank and is advised by these agencies as to any changes in deposit liabilities.[3]

The Comptroller, the Federal Reserve and the FDIC use four basic methods in exercising their supervisory responsibilities. First, banks are required to provide a number of regular Reports of Condition, the most important of which indicate financial condition.[4] Secondly, the regulators conduct on-site examinations to determine safety and soundness, compliance with laws, etc. and employ a grading system to indicate loan quality.[5] A safety and soundness examination produces a bank report to be analyzed by regulators and a bank rating which indicates the bank's

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2 Estey, <u>supra</u>, chapter 1, note 1 at 386.
3 <u>Ibid</u>. at 387.
4 <u>Ibid</u>. at 390.
5 <u>Ibid</u>. at 390-391.

level of safety and soundness.[6] Thirdly, computer-assisted surveillance systems are used to monitor financial condition of banks and provide early warning of potential problems.[7] Finally, these regulatory agencies have enforcement powers, including powers to issue cease and desist orders, suspend or remove directors and officers, terminate insurance, impose civil monetary penalties, and revoke a bank charter.[8]

The chartering agency of a bank has the sole authority to determine its insolvency. The FDIC can petition the chartering agency to declare an insured bank insolvent.[9] When the Comptroller becomes satisfied of the insolvency of a national bank, it has the power under the Federal Deposit Insurance Act (12 U.S.C. s.191), after due examination of the bank's affairs, to appoint a receiver who is to proceed to close up the bank. The statute does not provide a definition of insolvency and the Comptroller is given the sole discretion to make such a determination. This determination is final and not subject to judicial review (except if made arbitrarily or in bad faith).[10] The receiver functions under the direction of and reports to the Comptroller.[11] In the case of nationally-chartered banks, the FDIC is automatically appointed by the Comptroller to

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6 Ibid. at 391.
7 Ibid. at 392.
8 Ibid. at 392.
9 Edward J. Kane, "Correcting Incentive Problems in Deposit Insurance: The Range of Alternative Solutions" in Ziegel, supra, chapter 2, note 21 at 421.
10 Re American City Bank & Trust Co., N.A. 1975, D.C.Wisc.
11 89 Pine In. v. European American Bank, (1976, DC NY) 424 F.Supp.908.

act as receiver (12 U.S.C. s.1821(c)). State bank regulators are not obliged to appoint the FDIC as receiver of insolvent state banks but, in practice, usually do so.[12] As receiver, the FDIC pursues one of three basic courses of action under 12 U.S.C. s.1821 et.seq.: 1) liquidation and payoff; 2) a purchase and assumption transaction; or 3) direct financial assistance.

1. Liquidation and Payoff

This procedure involves closure of the insolvent bank, payoff of insured depositors (i.e. deposits to a maximum of $100,000) and liquidation of the bank's assets by the appointed receiver. Under section 1821(f) of the Federal Deposit Insurance Corporation Act, whenever an insured bank is closed for reason of the bank's inability to meet the demands of its depositors, the FDIC is obliged to pay off insured depositors as soon as possible by cash or by making a transferred deposit in another bank available to each depositor. If determined to be advisable, the FDIC may organize a new national bank to assume the insured deposits of a closed bank. The FDIC makes available to the new bank an amount equal to the insured deposits of the closed bank plus operating expenses. The Corporation may decide to offer capital stock of the new bank for sale which shareholders of the closed bank will be given a first option

12 Willis R.Buck, "Comments, Bank Insolvency and Depositor Setoff" (1984) 51 U. of Chicago L.R.188 at 201 [hereinafter "Buck"].

to purchase. If an adequate amount of stock is purchased, the new bank may be conformed into a national bank (s.1821(g)).

Upon payment to a depositor, the FDIC is subrogated to all rights of the depositor against the closed bank to the extent of such payment. The FDIC is then entitled to share pro rata with uninsured depositors in the bank's assets upon liquidation. If the assets are insufficient to meet these claims, the FDIC and uninsured creditors will lose a portion of their investments. Even in the event of full recovery, they lose post-failure interest and the use of their funds throughout the liquidation process. Other losses resulting from the closure of the bank include disruption to its creditors, borrowers, employees, the community and loss of the bank's going concern value.

An example of the FDIC's use of the liquidation and payoff approach is provided by Penn Square National Bank which failed in 1982. In this case, the FDIC paid only insured amounts in full. It represents the only large bank (i.e. with assets in excess of $100 million) to have been liquidated in American history.[13]

A review of the FDIC's approach to bank failure between 1973 and 1982 shows that out of 124 failures (or threatened failures), only 25 were resolved by liquidation and payoff

13 Helen A.Garten, "Banking on the Market: Relying on Depositors to Control Bank Risks" (1986) 4 Yale J.Reg.129 at 146.

while 99 were handled by purchase and assumption.[14] Furthermore, since 1960, all failures of big banks (except Penn Square), have been resolved through purchase and assumption.[15] The FDIC has opted against the liquidation and payoff approach in favour of the purchase and assumption method in so many cases in order to avoid the cost to the insurance fund of paying the claims of insured depositors, to prevent bank runs and to maintain the stability of the financial system, and due to the political consequences of allowing large numbers of uninsured depositors to bear substantial losses.[16] The purchase and asumption method and its advantages and disadvantages relative to liquidation and payoff, are discussed below.

2. Purchase and Assumption Transaction

Frequently employed by the FDIC, the purchase and assumption technique involves the purchase of a failed bank's assets and the assumption of its liabilities by a healthy institution. Upon merger, the acquired bank is liquidated. Once the FDIC decides that a purchase and assumption is feasible, it canvasses the market by inviting bids from potential purchasers. Through the bidding process, the FDIC seeks the purchaser willing to offer the

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14 Harry Waddell, "FDIC's First 50 Years" A.B.A. Banking Journal, (October, 1983) at 52.

15 Steve Cocheo, "How Four Large Depositors Rate Market Discipline" A.B.A. Banking Journal (July, 1983)at 64.

16 G.J.Benston, P.A.Eisenbeis, P.M.Horvitz, E.J.Kane, G.G.Kaufman, ed., Perspectives on Safe and Sound Banking: Past, Present and Future (Cambridge: The MIT Press, 1986) at 101 [hereinafter "Benston"].

highest premium for the failing bank's assets, the premium representing the value of the bank as a going concern. The premium is paid by the acquiring bank accepting assets worth less than the value of liabilities assumed.[17] If the value of the assets transferred is less than the value of the liabilities minus the premium, the FDIC must make up the difference by way of subsidy. Typically, there are nonperforming assets which the acquiring institution is unwilling to accept. These assets are sold by the FDIC (as receiver) to the FDIC in its corporate capacity. The purchase price is the amount of the subsidy which the FDIC is required to pay to the acquiror. These assets are then liquidated by the FDIC (in corporate capacity), with proceeds being used to reimburse the FDIC (receiver) for the costs of liquidation and the remainder divided among the failed bank's remaining creditors.[18] The FDIC has the authority to arrange the sale of a distressed bank's assets to the acquiring institution and to the FDIC (corporate capacity) on an overnight basis, to enable the bank to provide uninterrupted services.[19]

Valuation of a failing bank's assets by interested parties (which is necessary in order for them to tender a bid), is a time-consuming process. It is sometimes avoided by the FDIC having the acquiring institution assume all the

17 Ibid. at 95.
18 Michael A.Burgee, "Purchase and Assumption Transactions Under the Federal Deposit Insurance Act" (1979) 14 Forum 1146 at 1155 [hereinafter "Burgee"].
19 Rosenberg, supra, chapter 3, note 1 at 296.

liabilities of the failed bank in exchange for a cash settlement from the FDIC equal to these liabilities less the premium agreed upon.[20] Although simplifying and shortening the bidding process, this approach does require a greater cash outlay by the FDIC and leaves it with the task of disposing of the failed bank's assets.

In some cases, an acquiring institution will demand an indemnity from the FDIC, due to concern about the contingent liabilities which it may be assuming. The indemnity protects the acquiror from liabilities unknown at the time of the acquisition and shifts the burden of these potential liabilities to the FDIC.[21] In the Penn Square case, one reason for the FDIC's decision to pay off the claims of insured depositors and liquidate rather than attempt a purchase and assumption was the existence of a large number of contingent liabilities.[22] When arranging a purchase and assumption, it is essential for the FDIC to accurately appraise expected losses, but in Penn Square the size of the contingent liabilities made such an appraisal infeasible.[23]

An example of the FDIC's use of purchase and assumption to resolve a bank insolvency is provided by Franklin National Bank. Franklin, the twentieth largest bank in the U.S.A., was declared insolvent by the Comptroller in 1974, resulting in the appointment of the FDIC as receiver. After canvassing the market, the FDIC determined that sale of a

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20 Benston, <u>supra</u>, note 16 at 95-96.
21 <u>Ibid</u>. at 97.
22 Buck, <u>supra</u>, note 12 at 207.
23 <u>Ibid</u>. at 207.

substantial portion of the bank's assets was the best method of resolving its financial difficulties.[24] While a transaction was being negotiated, the bank's solvency was maintained by loans from the Federal Reserve Bank.[25] Franklin was eventually sold to European-American Bank and Trust Company. The assets were sold for an amount equal to the bank's deposit liabilities at the time of the receivership less the premium paid by European-American. The remaining assets were used by the FDIC to repay the Federal Reserve.[26]

The FDIC's legislative authority to arrange and financially assist purchase and assumptions is found in U.S.C. s.1823(c)(2):

> In order to facilitate a merger or consolidation of an insured bank...with an insured institution or the sale of assets of such insured bank and the assumption of such insured bank's liabilities by an insured institution, or the acquisition of the stock of such insured bank, the Corporation is authorized, in its sole discretion and upon such terms and conditions as the Board of Directors may prescribe:
> i) to purchase any such assets or assume any such liabilities;
> ii) to make loans or contributions to, or deposits in, or purchase the securities of, such insured institution or the company which controls or will acquire control of such insured institution;
> iii) to guarantee such insured institution ...against loss by reason of such insured institution merging or consolidating with or assuming the liabilities and purchasing the assets of such insured bank...[27]

24 In Re Franklin National Bank, 381 F.Supp. 1390 (E.D.N.Y.1974)
25 Garten, supra, note 13 at 147.
26 In Re Franklin National Bank, supra, note 23.
27 Note that s.1823(c)(2) authorizes the FDIC to assist mergers and consolidations as well as purchase and assumptions. In practice, however, it has only assisted

Under s.1823(c)(4(A)), the FDIC is prohibited from providing such assistance to insured banks unless (a) it is determined by the Corporation to be less costly than the liquidation alternative, or (b) the Corporation determines the continued operation of the distressed bank to be "essential to provide adequate banking services in its community".

Thus, before opting for the purchase and assumption option, the FDIC must determine that this approach will minimize costs. The lower the quality of the failed bank's assets and the lower its going concern value, the more federal assistance will be required by the acquiring institution before it will agree to assume the liabilities. The required federal assistance must be less than the value of the failed bank's insured deposits, otherwise, liquidation and payoff would be the cheaper alternative.[28] In determining cost, the FDIC examines the failed bank's contingent liabilities, the amount of deposits exceeding the insurance limit and the size of the premium offered.[29]

In most cases, the purchase and assumption works out to be the least costly approach, due to the premium paid by the acquiring bank and the fact that the FDIC avoids the direct costs associated with a payoff, liquidation expenses and

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in the latter type of transaction, perhaps because in a purchase and assumption, the acquiror assumes only specified liabilities; while in a statutory consolidation or merger, it is deemed to have assumed all liabilities of the closed bank. See: Brainsilver, supra, chapter 2, note 17 at 331.

28 Garten, supra, note 13 at 149.

29 Rosenberg, supra, chapter 3, note 1 at 297.

potential losses.[30] The purchase and assumption has several additional advantages over the payoff approach. First, it provides protection for uninsured depositors and other creditors of the failed bank (they become creditors of the acquiring institution). This in turn helps to preserve stability and confidence in the banking market. Secondly, the bank in question stays open, hence, credit arrangements remain intact, customers are not inconvenienced, employees' jobs are not disrupted and the bank's going concern value is preserved.[31] Thirdly, the FDIC avoids the obligation of making a large and immediate payout to insured depositors and the tying up of its funds for long periods of time. These advantages are summed up by Michael B.Burgee, senior counsel to the FDIC in 1979:

> The chief advantage of the Purchase and Assumption transaction is that, with FDIC's financial assistance, a sound, insured bank provides uninterrupted banking services to the community previously served by the failed bank. FDIC's ability to structure and to effect Purchase and Assumption transactions quickly and smoothly provides the greatest protection to our monetary system and to individual depositors.32

Despite its advantages, the purchase and assumption is open to the criticism that it does not encourage market discipline. When employed, a purchase and assumption has the effect of providing 100 percent insurance to all depositors and unsecured creditors. The FDIC is entitled

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30 Benston, <u>supra</u>, note 16 at 95.
31 Buck, <u>supra</u>, note 12 at 202.
32 Burgee, <u>supra</u>, note 18 at 1160.

under section 1823(c)(2) to arrange a purchase and assumption whenever it is the least costly resolution to a failure. Extensive use of purchase and assumptions by the FDIC in recent years has created the public expectation that all depositors and creditors will be fully protected in the event of bank failure. This is especially true in the case of a large bank-- the public perception being that the FDIC cannot afford to let a large bank fail.[33] If large depositors feel that their funds are not at risk, they will base investment decisions on yield alone.[34] In order to offer high yields, and thereby attract large depositors, bank management must accept higher risk.[35] It is excessive risk-taking which increases the risk of bank failure-- the loss from which is borne by the FDIC (and, therefore, the users of financial services) rather than the uninsured depositor. Thus, depositors have no incentive to discipline banks for excessive risk-taking.[36]

In recent years, the FDIC has been calling for increased market discipline in order to make large depositors perceive that their funds are at risk and thereby force them to examine banks more carefully with the aim of avoiding high risks.[37] This was one reason for the FDIC's decision to opt for payoff and liquidation of Penn Square,

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33 Benston, supra, note 16 at 102.
34 Robert W.Norcross, Jr.,"The Bank Insolvency Game: FDIC Superpowers, The D'Oench Doctrine, and Federal Common Law" (1986) 103 The Banking Law Journal 316 at 320 [hereinafter "Norcross"].
35 Ibid. at 320.
36 Benston, supra, note 16 at 175.
37 Rosenberg, supra, chapter 3, note 1 at 299.

rather than a purchase and assumption. As William Isaac, Chairman of the FDIC at that time, put it: "If we had bailed everyone out, we would have been abandoning any hope of a more disciplined banking system."[38]

Another approach which the FDIC has adopted is the modified purchase and assumption (or modified payout), one variation of which was implemented for the first time in 1984 on the Seminole State National Bank.[39] This technique involves closure of an insolvent bank, payment of insured claims immediately by the FDIC but only partial advances to unsecured creditors and uninsured depositors.[40] The payment made to uninsured depositors is based upon the FDIC's estimate as to the value of assets to be recovered upon liquidation.[41] Receivership certificates are issued to the holders of any remaining claims and all amounts realized in excess of the FDIC's estimate are distributed pro rata to the holders of such certificates.[42] The funds advanced by the FDIC are raised by a transfer of some of the failed bank's assets to another institution.[43] The benefit of the modified payout is its effect on market discipline:

> By introducing an element of loss-sharing into a bank failure, the modified P & A should make large creditors and investors more risk-sensitive and more

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38 Peter W. Bernstein, "Turnabout at the FDIC" (1984) 110 Fortune at 178 [hereinafter "Bernstein"].
39 Norcross, supra, note 34 at 348.
40 Ibid. at 349.
41 Ibid. at 349.
42 Ibid. at 349.
43 Ibid. at 349.

> selective in their choice of banks and, therefore, should increase market discipline significantly.[44]

The modified purchase and assumption can be viewed as a compromise between the payoff and purchase and assumption approaches. While it instils a greater degree of market discipline than a purchase and assumption, it provides uninsured depositors and unsecured creditors with an immediate payout (based on the FDIC's estimate) which they would not have received in a liquidation and payoff situation.[45]

Therefore, in the American experience, the purchase and assumption has proven to be an extremely useful technique for resolving bank insolvency-- with many advantages over the liquidation and payoff method. However, because it has the effect of bailing out all depositors and creditors, indiscriminate use of this approach could seriously impair market discipline. In an effort to restore market discipline, the FDIC has developed a modified purchase and assumption which has great potential as a tool which alleviates some of the disadvantages of the payoff and liquidation method but at the same time imposes discipline on the market.

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44 Ibid. at 322.

45 There are potential problems with the FDIC's use of the modified purchase and assumption, in the context of U.S. laws. For example, it might prevent the use of the FDIC's "superpowers" as debtor defences. See Norcross at 349-350.

3. Direct Financial Assistance

A third alternative open to the FDIC is that of direct financial assistance to banks which remain a going concern. This can be provided by the FDIC in the form of loans to, deposits in, assumption of liabilities of, purchase of the assets or securities of, or contributions to any insured bank (s.1823(c)(1)). This assistance can be made provided that it is necessary to: 1) prevent the closing of an insured bank or 2) to restore a closed bank to normal operation or 3) to prevent extraordinary risk to the deposit insurance fund under a threat of instability. A further prerequisite is that it be the least expensive alternative open to the FDIC unless it is determined by the FDIC that the continued operation of the insured bank is "essential to provide adequate banking services in the community" (s.1823(c)(4). There are no criteria stipulated in the Act according to which the FDIC is to make a determination of essentiality.

The FDIC used its direct assistance power in 1984 in the case of Continental Illinois National Bank and Trust Company of Chicago ("Continental Illinois"). This represents the largest bank rescue in American history. The size of the bank limited the FDIC's options in handling it--no banks were both large enough and sufficiently interested in acquiring it.[46] Thus, the FDIC was unable to arrange a

46 Benston, supra, note 16 at 97.

purchase and assumption. Furthermore, the bank was experiencing a run on deposits which the government wanted to stop.[47] Feeling that use of a modified purchase and assumption would further unnerve uninsured depositors and intensify the run, the FDIC temporarily abandoned this technique and in May, 1984, guaranteed that all depositors and creditors would be made whole.[48] The direct government assistance provided to Continental Illinois consisted of a $7.5 billion loan to the bank from the Federal Reserve and the FDIC, the assumption by the FDIC of $3.5 billion of the bank's troubled loans and the contribution of $1 billion of capital to the bank.[49] The effect of the assistance was that all depositors and creditors of Continental Illinois were bailed out and its shareholders suffered a significant, but not total loss.[50] The FDIC justified the assistance on the basis that Continental Illinois was an "essential" bank.[51]

A criticism of the direct financial assistance method is that it has the effect of bailing out shareholders as well as uninsured depositors and creditors. As discussed in chapter 2 <u>supra</u>, it is conceptually defensible to bail out small bank depositors and, in some circumstances, large depositors and creditors, but never shareholders. When a bank is returned to or kept in operation by direct

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47 <u>Ibid</u>. at 98.
48 Estey, <u>supra</u>, chapter 1, note 1 at 395.
49 <u>Ibid</u>. at 395-396.
50 Benston, <u>supra</u>, note 16 at 101.
51 Estey, <u>supra</u>, chapter 1, note 1 at 395.

assistance, shareholders benefit as directly as do depositors. The FDIC has devised ways to prevent this enrichment of shareholders in cases of direct financial assistance. For example, in the case of Continental Illinois, the FDIC received non-voting preference shares in exchange for its investment.[52] These preference shares were convertible into voting shares which would amount to 80% of the company's outstanding shares.[53] In addition, the FDIC was granted an option to acquire the remaining shares at a nominal cost in the event the FDIC suffered a loss on its purchase of Continental's problem loans.[54] In the result, Continental's shareholders suffered a significant (albeit not total) loss and the FDIC was given the right to participate in any future profits made as a result of its assistance.

Therefore, direct financial assistance can be a useful tool to prevent large losses from being incurred by the FDIC or to avoid disruption of the financial system. In circumstances where a purchase and assumption is infeasible and it is considered important to keep a bank operating or to reopen a closed bank, direct financial assistance is useful. However, the use of direct financial assistance has the effect of bailing out all depositors and creditors of an

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52 John D.Hawke, Jr., Commentaries on Banking Regulation (Washington, D.C.: Law & Business Inc./Harcourt Brace Jovanovich, 1985) at 77.
53 Ibid. at 77.
54 Ibid. at 77.

insolvent bank (as well as shareholders unless the FDIC devises a method for "penalizing" them). The only legislative condition for its use is a determination by the FDIC that it is the least costly alternative or that the subject bank is "essential". Indiscriminate use of such an approach could seriously impair market discipline and may have the effect of unjustly enriching shareholders.

Conclusion

Clearly, the American approach to bank insolvency is a more highly structured, comprehensive and flexible approach than that currently in force in Canada. When measured against the reform criteria set out in chapter 4, it fairs well. Through deposit insurance, the interest of consumer protection is protected (provided, of course, that small depositors place their funds in insured institutions). The Federal Deposit Insurance Act provides the FDIC with the authority to take control of a situation of potential failure, thereby eliminating the type of problem encountered in the CCB rescue attempt where no agency had the authority to implement and monitor the rescue program. The FDIC has the discretion to take into consideration and protect important interests such as the stability of the financial system through the flexible "essential bank" doctrine. When the decision is made to bail out a bank, the FDIC has the flexibility to choose among a number of alternative approaches and has made effective use of purchase and assumption transactions and direct financial assistance.

However, there are several aspects of the American system which fail to meet the specified criteria. First, the fact that the FDIC does not directly supervise the banks that it insures (other than insured state member banks which it supervises directly) means that it has only indirect access to the financial information upon which it must base its decisions. The FDIC is entitled to be advised by the Comptroller of the Currency and the Federal Reserve as to any changes made in respect of deposit liabilities, but it is arguable that the FDIC would be better able to make informed and timely decisions if directly responsible for supervision. Combination of the two functions within one agency would also give the regulator greater incentive to take more immediate action vis a vis a distressed bank, since faster action would minimize losses suffered by the agency in its capacity as insurer.

A second aspect of U.S. bank insolvency legislation which has proven problematic is the bailout technique of direct financial assistance. The lack of a statutory mechanism for dealing with the interests of equity holders has created uncertainty and criticism with respect to the FDIC's handling of shareholders in direct financial assistance cases.[55]

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55 See, for example, John D. Hawke's criticism of the way the FDIC handled the Continental crisis, <u>supra</u>, note 52 at 77-81.

A third criticism of the American system arises from the FDIC's prediliction for the purchase and assumption transaction. The frequent use of this technique for resolving bank insolvencies has created an expectation in depositors (especially of large banks) that they will be bailed out.[56] The legislation authorizes the FDIC to arrange a purchase and assumption in any situation where a purchase and assumption is more cost-efficient than payoff and liquidation (or if a bank is deemed "essential"). The effect of this provision is to encourage purchase and assumptions-- at the expense of market discipline.

A final comment with respect to the American system involves the broad discretion granted to the FDIC in the bank insolvency process-- not only is the Corporation responsible for devising and implementing resolutions to bank failure, but it is given the sole authority to make the underlying decision to rescue a bank or to let it fail. To make this fundamental decision requires that a number of conflicting interests be balanced. On the one hand, is the goal of cost-minimization, which is often (but not always) best served by a purchase and assumption. On the other hand, is the importance of maintaining market discipline, which is best achieved through liquidation and payoff. An overriding factor that must be considered by the FDIC is essentiality-- a vague term which allows the FDIC to take into account a variety of interests, including consumer

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56 Norcross, <u>supra</u>, note 34 at 319.

protection, financial stability and the dependence of a community on a bank. These concerns would be best served, in many circumstances, by direct financial assistance or a purchase and assumption. The broad language of the Act provides little guidance for the FDIC's decision which results in unpredictable decisions and, therefore, uncertainty. In addition, the legislative structure creates a situation where an essentially political decision (i.e. whether or not to bail out a bank) is being made by an administrative body. It is submitted that in the Canadian political environment, it would be more appropriate for a politically-accountable body to make this fundamental decision.

Out of this discussion on the American approach to bank insolvency, several conclusions can be made with respect to the model for reform of the Canadian system:

i) The creation of a strong, centralized agency like the FDIC, with the authority and the broad powers to arrange and oversee resolutions to bank insolvencies is desirable. However, the fact that the FDIC lacks direct and on-going access to the information on which it must act is inefficient.

ii) In the Canadian context, it would be inappropriate for an adminstrative agency such as the FDIC to possess the power to decide whether or not to bail out a bank--this decision should be the responsibility of an elected official who is accountable to the public. However, the expertise of the administrative agency should be recognized by giving it the responsibility of recommending a course of action to an elected body.

iii) The FDIC has made significant use of three techniques for resolving bank failures which would be useful in the Canadian context: the purchase and assumption transaction, the modified purchase and assumption and direct financial assistance. However, due to the deleterious effect of purchase and assumptions and direct financial assistance on market discipline, their use should be legislatively controlled.

iv) A statutory mechanism for dealing with equity interests in direct financial assistance cases is required.

This model for reform is further developed by examining recent proposals for reform made in the Canadian context.

CHAPTER 6. CANADIAN PROPOSALS FOR REFORM

Two recent public studies have recommended significant reforms to the bank insolvency process in Canada and, in particular, the CDIC's role in this process: the Estey Report and the Final Report of the Working Committee on the Canada Deposit Insurance Corporation submitted to the Minister of State (Finance) on April 24, 1985 (the "Wyman Report"). Both reports recommended structural as well as functional reforms to bank insolvency legislation. Their proposals will be discussed and evaluated below in light of the reform criteria set out in chapter 4.

1. Wyman Report

The Wyman Committee examined the operation and structure of the CDIC and made recommendations regarding the objects of the Corporation; the supervisory, enforcement and examination powers it should possess; funding, organization and staffing of the Corporation; and possible methods to improve market discipline. Of significance here are the Committee's proposals regarding the CDIC's role in the bank insolvency process.

a) Proposals re: Structural Reform

The Wyman Report accepted the current structure of the bank regulatory system, including the basic division between the OIGB as the primary regulator and the CDIC as insurer.

However, it did recommend an enhanced supervisory and regulatory role for the CDIC. In the event of failure, Wyman recommended that the CDIC be granted broad powers to cope with the insolvency in a cost-efficient manner. To facilitate the fulfillment of its broader responsibilities, the Committee recognized the CDIC's need for greater access to information, to be provided by: i) the CDIC maintaining its own data base of current information about insured banks and ii) the CDIC receiving copies of all reports and correspondence made for or by the OIGB with respect to problem banks. Furthermore, it proposed that the CDIC conduct its own inspection of problem banks.

Wyman's proposal for strucutural reform represents a partial step toward the creation of a powerful agency to cope with bank failure. However, it has the drawback of involving a duplication of information-gathering efforts (by the OIGB and the CDIC), an inefficiency which could be eliminated by the combination of regulatory and insurance functions in one agency. This issue is addressed in the Estey Report and is discussed in greater detail below.

b) <u>Proposals re: Functional Reform</u>

Wyman's proposal for functional reform of the bank insolvency process is based on an expanded role for the CDIC. For example, the Report recommends that the CDIC be given the power to initiate liquidation proceedings. Currently, the CDIC is granted this power by virtue of section 29 of the Canada Deposit Insurance Corporation Act: where the CDIC is of the view that a bank is or is about to become insolvent, it can take any proceeding which a creditor can take, including having the bank wound up. The problem with the CDIC having the authority to initiate winding-up proceedings is that this decision is a complex one which is closely linked to the bailout decision. If the bank is not wound up, will it be rescued through government funds? If it is wound up, will it be wound up in such a way that uninsured depositors are compensated? As discussed in the American context, these decisions involve the balancing of a number of interests such as consumer protection, financial stability, regional economic development, market discipline, cost-efficiency, etc. The Wyman Report recognized that broad policy factors must be considered when an insured institution is facing insolvency. As examples of such factors the Report cited: confidence in the financial system and the effect of failure on the national or regional economy or on the international perception of Canada's financial institutions.[1] Although the Report recommended that the consideration of these factors remain outside the mandate of the CDIC,[2] it did not suggest how these factors should come to play a role in the regulatory process. It would seem, however, that if political and social factors are to influence the decision to wind up or bail out a bank,

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1 Wyman, supra, chapter 2, note 48 at 14.
2 Ibid. at 15.

then an elected official should have the ultimate authority to make this decision, rather than an administrative body such as the CDIC. On the basis of this reasoning, section 29 of the Canada Deposit Insurance Corporation Act should be amended to give the Minister of Finance the ultimate decision-making power to wind up a bank.[3] Similarly, the power to decide whether a bank should be bailed out should be vested in the Minister of Finance. The CDIC's interest and expertise in this area should be recognized by giving it the power to recommend a course of action to the Minister when faced with an insolvent or potentially insolvent bank.[4]

Wyman also recommended that the CDIC be given the right to become, if it so elects, the liquidator of an insolvent bank. Presently, the liquidator is court-appointed and is subject to the approval of the bank's shareholders and creditors. However, the CDIC is authorized to act as the curator or liquidator if it is duly appointed to act as such. In the USA, the Comptroller of the Currency is obliged to appoint the FDIC to act as the receiver of nationally-chartered banks. It is arguable that a conflict of interest could arise when the deposit insurance agency acts as insurer (and, therefore, creditor) and liquidator

3 The Estey Report makes this argument at 326.

4 Wyman dealt in some detail with a related issue-- the need to clarify the test of insolvency and to specify which authorities have the power to determine insolvency. This issue has important ramifications for a bank (upon a declaration of insolvency, the Minister shall appoint a curator) and for the CDIC (insolvency is the point at which ultimate insurance claims against the Corporation are measured). While important, the issue of a revised insolvency test is beyond the scope of this paper.

simultaneously.[5] However, it is submitted that this concern is overridden by the advantages to such an approach. For example, it is desirable to develop the expertise to conduct bank liquidations within one agency. Furthermore, as argued by Wyman, the deposit insurance corporation has a special and substantial financial interest in the insolvency proceeding which should be recognized. Also, there are costly delays associated with the court-appointed process which could be avoided by automatic appointment of the CDIC. For these reasons, Wyman's proposal to grant the CDIC the right to become liquidator of an insolvent bank would be a desirable feature in revised bank insolvency legislation.

As a further component of its proposal to create a stronger role for the CDIC, the Wyman Committee examined the purchase and assumption transaction. It recognized the considerable advantages to this technique, which include avoiding the costs of liquidation, preventing the disruption of on-going credit relationships and maintaining the going concern value of the bank. The Wyman Report recognized the CDIC's present lack of legislative authority to arrange a purchase and assumption transaction and recommended that the Canada Deposit Insurance Corporation Act be amended to remedy this omission.

The American experience has illustrated the utility of and the benefits to be derived from the purchase and assumption transaction. It was concluded in that context

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5 Estey, supra, chapter 1, note 1 at 339.

that the CDIC should have the legislative authority to arrange such a transaction. However, the use of this technique should be consistent with the rationale for bailing out banks discussed in chapter 2: because it has the effect of bailing out uninsured depositors and unsecured creditors, it should not be used in the absence of one of the rationale for this type of government intervention. This is especially important in light of the potential effect which frequent use of the purchase and assumption may have in breaking down market discipline.[6] Therefore, legislation providing for the implementation of a purchase and assumption transaction by the CDIC should clearly stipulate the conditions for its use. It should be available as an alternative to liquidation and payoff when there exists an interest in bailing out uninsured depositors and creditors which overrides the interest of market discipline. In chapter 2, two circumstances which justified such a bailout were identified: 1) the existence of a clear risk of a destabilizing bank run which could not be controlled by deposit insurance alone and 2) the existence of an interest, the protection of which is in the national interest. An additional criterion for the use of a purchase and assumption should be cost-efficiency-- if there is a less expensive way to achieve the same result, then the interest of cost-efficiency would dictate that the less expensive approach be taken.

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6 Goodman, <u>supra</u>, chapter 2, note 29 at 160.

It is submitted, therefore, that the CDIC be granted the legislative authority to implement a purchase and assumption. However, the agency's power to implement such a course of action to the Minister and the Minister's discretion to decide upon such an approach, should be limited by express legislative criteria in order to provide some measure of certainty to those affected by the decision, to maintain market discipline and to ensure cost-efficiency.

The Wyman Committee summarized its proposals aimed at strenthening the CDIC's power to act in a situation of bank insolvency, with a broad recommendation that the Corporation be given broad and flexible powers to protect small depositors and administer the insurance fund in the most economically-efficient way. The powers to be granted the CDIC would include the power to make direct financial assistance to a distressed insititution:

> Contributions to the rehabilitation of an institution in difficulty, designed to avoid a greater loss at a later date, are only one example of the types of action that should be permissible, if CDIC's Board concludes they will contribute to its object.7

As concluded in the discussion on the U.S. system, direct financial assistance is an important tool to be possessed by the CDIC. However, because it has the effect of rescuing a bank (and bailing out its capital suppliers), its use should

7 Wyman, supra, chapter 2, note 48 at 23.

be structured and controlled. This issue is examined in detail by the Estey Report and is discussed below.

2. Estey Report

a) Structural Recommendations

The Estey Commission recommended broader structural reforms than those proposed in the Wyman Report. Estey concluded that the most logical approach would be a consolidation of the OIGB and the CDIC into a new body, to be named the Canadian Deposit Insurance Commission (the "Commission"). The Commission would be managed and directed by three full-time appointees: one from the auditing profession with five years' experience in bank auditing; one with senior banking experience; and the third with senior management experience in the insurance industry with general business, professional or senior public service experience. It is submitted that the creation of a small, highly-experienced, full-time group to carry out the essentially administrative tasks of the Commission would be much more effective than the present approach of a Crown corporation administered by a part-time board. The private sector composition of such a Commission would bring to it an understanding of the banking and insurance industries, and the experience necessary to identify and solve potential problems.

The Commission would have deposit insurance responsibiities similar to those possessed by the CDIC as well as regulatory and supervisory powers broader than those currently possessed by the OIGB. The Estey Report discussed the advantages of this approach to reform of the present bank regulatory structure, as follows:

> ...by putting the insurer in a position to protect itself effectively through confidential supervision of the insured banks, this alternative recognizes and appeals to natural human instincts. It recognizes that the insurer has the incentive to act on information received to reduce to a minimum the risks it faces in any failure. It is precisely this incentive or will to act which was so graphically illustrated to be lacking in the institutional forms of the existing regulatory scheme.[8]

Furthermore, consolidation of the regulatory and insurance functions in one body would overcome the informational barrier currently faced by the CDIC when attempting to perform its insurance function. As regulator, the Commission would have first-hand and on-going access to the information needed to make recommendations to the Minister and implement solutions expeditiously and efficiently. Combining the two functions would have the additional advantage of avoiding the duplication of information-gathering and regulatory efforts which would be a result of the Wyman Committee's structural proposal.

For these reasons, the creation of a centralized agency possessing both supervisory and insurance responsibilities

8 Estey, supra, chapter 1, note 1 at 277.

would appear to be a logical and efficient structure to carry out the broader powers which such an agency must possess in order to cope with bank insolvency.

b) Functional Recommendations

The Estey Report recommended that the Commission be given the power to recommend to the Minister one of three course of action when faced with a financially-troubled bank: liquidation, merger with a healthy institution or the implementation of a bank assistance plan. Extensive proposals were made with respect to bank assistance plans and these are examined below.

The object of a bank assistance program would be to keep an insolvent bank in operation while reorganizing it with a view to returning it to private ownership or merging it with a viable bank. The program would be designed, implemented and monitored by the Commission. Funding would be provided through private and/or public sources (for example, through the purchase of unsatisfactory loans by the Commission). The Report recommended that directors and management of the bank be at least partially replaced, as a confidence-restoring measure.

A significant feature of the Estey Commission's proposal for bank assistance programs is its mechanism to deal with the problem of existing investors in the bank's capital. As discussed in chapter 5, the problem with the FDIC's *ad hoc* system of dealing with shareholders is the potential for criticism from the public (when it is perceived that shareholders are being unjustly enriched by the government aid) and from the bank's shareholders (when the FDIC attempts to "penalize" them). The Estey Commission proposed a statutory mechanism which would allow these issues to be judicially determined. It recommended that in cases where a bank is insolvent or where insolvency is imminent or inevitable, the bank assistance program contain a term cancelling the interests of the capital investors (which would include debt and share components of the bank's capital).[9] This is justified on the basis that, once insolvent, a bank's capital has been exhausted and, therefore, the investors in that capital have ceased to have any interest in the bank. To preserve the bank's continuity, a nominal number of Treasury shares would be issued to the Commission, which would be sold back to the public once the bank had recovered. Estey anticipated the possibility of a claim by investors that the bank was not in fact insolvent at the time the assistance program was instituted (meaning that the investors' interest had not been extinguished). In that event, Estey proposed a statutory mechanism whereby investors whose interests had been cancelled could apply to a court to determine whether

9 Note that Estey uses the term "capital" as it is defined in the Bank Act , i.e., to include common shares, preference shares and long-term, subordinated, unsecured debt in the nature of a simple bond. Estey's concern in treating all capital alike is to prevent one class from blocking the rescue of a bank, and thereby forcing its liquidation. See Estey at 329.

or not the bank was insolvent at the critical time. If it is determined that it was not, the value of their interests in the capital would be estimated and the Commission ordered to compensate them for their loss. If, on the other hand, insolvency is established, the investors would not and should not be compensated. They took a risk and they lost. This judicial mechanism represents an effective and just way to deal with the interests of capital investors in the event of bank failure. It is submitted that it is an essential feature of the regulator's power to implement a bank assistance program.

Estey's proposal also dealt with the potential failure of a bank assistance program. In this situation, the Report recommended that all depositors and debt-holders (other than capital-investors) be fully compensated. The policy reason behind this recommendation is that the success of a rescue plan depends on the maintenance of depositor confidence in the distressed bank. In order to induce depositors and private sources to lend funds to the bank, the government must stand behind the assistance program and virtually guarantee its success. To turn around in the face of failure and allow those who have relied on government assurances to lose their funds would be politically inconceivable.

The Estey Commission recommended that the ultimate decision to implement a bank assistance program be the responsibility of the Minister of Finance. However, the decision would be based on the CDIC's recommendation. The Report concluded that in making its recommendation, the CDIC should consider:

> "a wide range of factors, including the national interest in the stability of the banking system as well as the likelihood of loss to itself. This would formally recognize in the system the so-called 'essential bank concept' as a conscious step in the administrative process of serious liquidity and solvency problems in a bank.

The Estey Report did not propose any more specific criteria for the CDIC's recommendation, or the Minister's decision, to implement a bank assistance program. It is submitted that in the interest of certainty and in order to ensure that the conflicting interests which operate in a situation of bank failure are expressly considered, the power to implement a bank assistance program be limited by express legislative criteria. Because a bank assistance plan (as proposed by Estey) and a purchase and assumption have essentially the same bailout effects (i.e. the compensation of uninsured depositors and creditors), they should be based on similar legislative criteria (see criteria proposed in the discussion on the purchase and assumption, <u>supra</u>). In most situations, the purchase and assumption would be the more cost-efficient solution (due to the premium paid by the acquiring institution). However, the CDIC's power to implement a bank assistance program should reflect the fact that in some circumstances, a purchase and assumption will be unavailable or inappropriate (for example, if the

Minister deems it to be in the national interest to rescue a bank in order to protect the regional bank concept, but the only merger candidates for the bank are large, national banks or foreign banks). In these circumstances, the Minister should have the authority to direct the CDIC to implement a bank assistance program-- regardless of the cost saving which could have been achieved by a purchase and assumption.

Therefore, two aspects of the Estey Commission's recommendations on Canadian bank regualation are of particular significance to the development of a model for reform. The first is the Commission's recommendation to combine the OIGB and the CDIC to create a centralized agency with direct access to the information needed to carry out its responsibilities in the event of bank failure. The second is the detailed proposal for bank assistance programs, which deals with the problems which have been experienced by both the Canadian government (in the CCB rescue attempt) and by the FDIC.

Conclusion: A Model for Reform

On the basis of the rationale for bank bailouts discussed in chapter 2, the criteria for reform established in chapter 4, and using aspects of the American approach as well as the proposals contained in the Wyman and Estey Reports, it is now possible to outline a model for reform of Canadian bank insolvency legislation. It is proposed:

i) that a new administrative agency (the "Agency") be created which would act as deposit insurer and as the primary regulator of banks. The Agency would be managed by a Committee of full-time appointees, with experience in or related to the fields of banking, auditing and insurance.

ii) that in a situation of actual or potential insolvency, the Minister of Finance possess the ultimate decision-making authority as to an appropriate course of action. The Agency would be responsible for canvassing the available options, conducting cost-analyses and recommending a course of action to the Minister.

iii) that the Minister's discretion in deciding the fate of a bank and the CDIC's power to recommend a course of action be limited by legislative criteria (set out in paragraphs iv, v and vi below) which will reflect the interests of consumer protection, financial stability, market discipline, cost-efficiency and local, regional and national interests of national concern.

iv) that liquidation and payoff be the general rule in the event of insolvency. Deposit insurance would be retained in order that small consumers are protected and some measure of financial stability is ensured. A modified purchase and assumption (which has the same effect as liquidation and payoff, i.e., of bailing out insured depositors only) would be an acceptable alternative, providing it is feasible and less costly than liquidation and payoff.

v) that a second option be available in an insolvency situation: purchase and assumption. The use of this technique would be limited by the following legislative criteria: a) the existence of a clear risk of a destabilizing bank run which could not be controlled by deposit insurance alone; or b) the existence of an interest, the protection of which is in the national interest and which would be best served by a purchase an assumption.

vi) that a third option be available in an insolvency situation: direct financial assistance in the form of a bank assistance program. The legislative conditions for its use would be as follows: a) the existence of a clear risk of a destabilizing bank run which could not be controlled by deposit insurance alone; or b) the existence of an interest, the protection of which is in the national interest and which would be best served by a bank assistance program. The legislation would provide a statutory mechanism for the resolution of the interests of the bank's capital investors in the event a bank assistance program is implemented.

This model for reform is not aimed at preventing future bank insolvencies, but rather, at providing a more comprehensive statutory mechanism for dealing with such failures when they occur. Based on the American model, it creates an agency with direct and on-going access to the information needed to recommend a course of action to the Minister and the broad powers to implement the Minister's decision. The statutory scheme provides as a general rule that only insured depositors will be bailed out in the event of failure but allows for wider compensation in circumstances which justify greater government intervention. The model is also designed to promote the interests of cost-efficiency and market discipline.

As a final step, the reforms to the Canadian bank insolvency legislative framework which the federal government recently enacted, will be examined in light of the model for reform which has been proposed herein.

CHAPTER 7. RECENT FEDERAL REFORM OF CANADIAN FINANCIAL MARKET REGULATION

On July 2 and 3, 1987, the federal government proclaimed the _Financial Institutions and Deposit Insurance System Amendment Act_ and _An Act to Amend Certain Acts Relating to Financial Institutions_. The two Acts introduced a number of changes to the system of supervising financial institutions and to the deposit insurance system with the goals of increasing competition and stability in the financial sector. In the following discussion, the relevant provisions of this legislation are examined and then evaluated in light of the model for reform proposed in chapter 6.

1. _Legislative Framework_

The effect of the _Financial Institutions and Deposit Insurance System Amendment Act_ was to repeal the _Department of Insurance Act_, to establish a new regulatory body and to change the powers and operations of the CDIC. _An Act to Amend Certain Acts Relating to Financial Institutions_ contains provisions which allow federally-regulated financial institutions to own securities dealers, requires that certain share transactions have the approval of the Minister of Finance, specifies circumstances under which the Superintendent of Financial Institutions can obtain an independent appraisal of real estate assets held by any trust, loan or insurance company, and grants the Superintendent of Financial Institutions the power to make cease and desist orders.

Three aspects of this new financial sector legislation have particular impact on the issue of bank insolvency and are examined below: a) the creation of the Superintendent of Financial Institutions; b) the provisions which amend the Canada Deposit Insurance Corporation Act and create new objects and powers for the CDIC; and c) the provisions which amend the Bank Act.

a) The Office of the Superintendent of Financial Institutions

Part I of The Financial Institutions and Deposit Insurance System Amendment Act creates the Office of the Superintendent of Financial Institutions, a consolidation of the pre-existing Superintendent of Insurance (which regulated insurance, trust and loan companies) and the OIGB. A Superintendent of Financial Institutions ("Superintendent") is appointed by cabinet to administer the Act and report to the Minister on matters connected with such administration. In addition, the Act creates a Committee designed to facilitate consultations and exchanges of information between government regulatory agencies. The Committee consists of the Superintendent, the Deputy Minister of Finance, the Governor of the Bank of Canada and the Chairman of the CDIC. Each member of the Committee has the right to any information respecting the supervision of financial institutions within the possession or control of any other member. The Superintendent is given greater regulatory and enforcement powers than those possessed by the OIGB and Superintendent of Insurance. These increased powers are provided by way of amendments to the specific Acts governing individual sectors of the financial system.

b) Canada Deposit Insurance Corporation Act

Part II of The Financial Institutions and Deposit Insurance System Amendment Act contains provisions amending the Canada Deposit Insurance Corporation Act. The new legislation does not alter the basic structure of the CDIC which remains independent from the agency primarily responsible for regulation and supervision of banks (now the Office of the Superintendent of Financial Institutions). The CDIC's role continues to be limited to that of deposit insurer. As deposit insurer, however, its powers are somewhat expanded. For example, in section 57, the Act prescribes broader objects for the CDIC which read as follows:

> "a) to provide insurance...against the loss of part or all of deposits;
> b) to be instrumental in the promotion of standards of sound business and financial practice for member institutions and to promote and otherwise contribute

to the stability and competitiveness of the financial system in Canada; and

c) to pursue the objects set out in paragraphs (a) and (b) above for the benefit of persons having deposits with member institutions and in such manner as will minimize the exposure of the Corporation to loss.

This amendment has broadened the CDIC's objects which were previously restricted to providing deposit insurance.

The new Act goes on to add several specific powers to the illustrative list of the Corporation's powers provided in section 11. These include the power to manage and invest any funds accumulated as a result of its operations; the power to incorporate or acquire a company for the purpose of facilitating the acquisition, management or disposal of the assets of a member institution that the Corporation may acquire; and the power to act as inspector of a member institution when duly appointed to act as such.

The CDIC's powers in the area of supervision are expanded by the new legislation. Although inspections of member institutions will continue to be performed on behalf of the CDIC by the Superintendent, the CDIC is provided with a new power to make preparatory examinations where the Corporation believes that the obligation to pay an insured claim is imminent. With the approval of the Superintendent, the CDIC may examine books, records and accounts of a member institution relating to its deposit liabilities and is entitled to require any official of the insured institution to furnish such information as required (section 60). In addition, the CDIC is given the power to make discretionary payments to insured depositors prior to winding up a member institution where such institution is unable by reason of court order or an action taken by a regulatory body to make any payment in respect of the deposit, or the policy of deposit insurance is cancelled or terminated.

Another aspect of the Canada Deposit Insurance Corporation Act which is amended by the Financial Institutions and Deposit Insurance System Amendment Act is enforcement. The Corporation is now authorized to assess and collect a premium surcharge from any member institution which is violating the Corporation's by-laws (section 65). Furthermore, the CDIC's power to terminate the insurance of provincial institutions is extended to include federal institutions. Thus, when a bank or other member institution is not following safe and sound practices as prescribed by the Corporation's by-laws, the CDIC may send a report of such violation to the member institution. If it fails to remedy the complaint to the Corporation's satisfaction, it may terminate the institution's insurance, upon the lapse of a prescribed time period and subject to ministerial approval.

The CDIC's power to initiate the winding-up of a bank is retained by the new legislation, but amended to provide that such a measure requires the prior approval of the Minister.

c) Bank Act

The Financial Institutions and Deposit Insurance System Amendment Act and An Act to Amend Certain Acts Relating to Financial Institutuions amend the Bank Act to give stronger supervisory and enforcement powers to the Superintendent vis a vis banks. For example, the latter Act entitles the Superintendent to issue directions of compliance (cease and desist orders) to banks conducting or about to conduct unsafe or unsound practices. The Financial Institutions and Deposit Insurance System Amendment Act outlines two processes which can be used by the Superintendent to assume control of a bank in specified circumstances. The first is intended for emergency situations, where the Superintendent believes that the assets appearing on a bank's books are not satisfactorily accounted for, a bank has failed to pay any liabilities that have come due or there exists a situation that is prejudicial to creditors or depositors. In such a case, the Superintendent is entitled to take control of the bank's assets for seven days (or longer if necessary). While in control, the Superintendent is authorized to take all steps necessary to protect the bank's depositors and creditors and has a veto power over the bank's actions in order to preserve its assets. If the Superintendent's office is not convinced that a bank is solvent or will remain so, it has the power to invoke a procedure which leads to more extensive control over the bank. The procedure is commenced by the Superintendent reporting to the Minister in any case where: a bank's assets are insufficient; a report has been sent to a bank's board of directors under the <u>Canada Deposit Insurance Corporation Act</u>; or there exists a state of affairs which may be prejudicial to the interests of the depositors or creditors of a bank. Upon holding a hearing, the Minister has a number of options: restrict the bank's licence, prescribe a time within which the bank must remedy its deficiency or practices and/or direct the Superintendent to take control of the bank. When the Superintendent takes control of a bank by Ministerial order, the powers and duties of the bank's directors are suspended and the Superintendent becomes responsible for the management of the bank's business and affairs. If the institution fails to respond satisfactorily, the Minister may request the Attorney-General to apply for a winding-up order. On the other hand, if the Minister believes that a bank under the Superintendent's control has met all the requirements of the <u>Bank Act</u>, the Minister may direct the Superintendent to relinquish control. Through these mechanisms, the Superintendent is given legal rights of control over banks which go beyond the previous powers of the OIGB or the CDIC.

2. <u>Evaluation of Federal Reforms</u>

The federal government's amendments to the framework for regulation of the financial sector take some significant steps in the direction of increasing stability and competition in the financial market and harmonizing the regulation of federal and provincial institutions. With respect to the more specific issue of the power of government institutions to deal with insolvent banks, the amendments reflect a broader approach than that which existed under previous legislation, but one which is significantly limited.

a) Structural Aspects of Reform

The creation of a new regulatory body by the Financial Institutions and Deposit Insurance System Amendment Act, which is a consolidation of the OIGB and the Department of Insurance, is consistent with the federal government's objective of removing the distinctions between the traditional four financial pillars.[1] From the perspective of the banking sector, however, it can be argued that the supra-regulatory approach taken by the new Act is problematic. This concern was expressed in a recent statement by the Canadian Bankers' Association:

> It has been and continues to be the CBA's belief that an individual charged with exclusive responsibility for one particular sector would be

1 An analysis of the methods by which the government proposes to achieve this objective is beyond the scope of this paper.

> more likely to develop the kind of expertise and detailed knowledge necessary for dealing with the issues and problems unique to that sector than would a "super-regulator" charged with the much broader mandate of overseeing the regulation of all financial institutions.2

This concern is alleviated to some extent by the provision in the Act for the appointment of a Deputy Superintendent who would have expertise in and responsibility over the banking sector. Whether or not this approach will prove adequate or appropriate cannot be fully assessed until the government has completed the process of integrating the four pillars.

A second problematic aspect of the structural reforms introduced by the Financial Institutions and Deposit Insurance System Amendment Act involves the retention of the functional distinction between the primary regulator of banks and the deposit insurer. It has been argued that in order to instil a will to act in the regulator and to provide direct access to information about insured banks, the functions of insurance and regulation of banks should be combined in one agency. Although the new legislation gives the CDIC the power to make preparatory examinations in situations of imminent insolvency, it is argued that it would be more cost-efficient and effective if this information were available to the deposit insurer on an on-going basis.

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2 Canadian Bankers' Association, Response to Bill C-42: An Act Respecting Financial Institutions and the Deposit Insurance System (Toronto: April, 1987) at 2.

A final aspect of the structural amendments introduced by the new legislation that is noteworthy is the creation of the Committee linking officials of the various federal authorities. The object of this Committee, which is comprised of the Superintendent, the Governor of the Bank of Canada, the Chairman of the CDIC and the Deputy Minister of Finance, is to provide on-going consultation and communication. It is submitted that this is an improvement over previous financial sector legislation, which lacked this form of institutionalized co-ordinating mechanism.

b) Functional Aspects of Reform

The federal government's new financial sector legislation grants broader powers to both the CDIC and the Superintendent to supervise banks and to enforce compliance with the Bank Act and the Canada Deposit Insurance Corporation Act. However, the expansion of the powers of these institutions to deal with actual or potential bank insolvency is minimal-- especially when compared to the powers proposed in the model for reform set out in chapter 6.

The amendments to the Canada Deposit Insurance Corporation Act expand the CDIC's objects beyond the provision of deposit insurance. By specifying that an objective of the CDIC is to promote sound business and financial practices, the Act reflects the government's concern in protecting financial stability and the interests of depositors and of the CDIC and recognizes the Corporation's role in this process. Furthermore, the interest of cost-efficiency is recognized by the requirement that the CDIC minimize its exposure to loss. Although these expanded objects provide the CDIC with a broader frame of reference, they will not have a significant effect on the CDIC's ability to resolve bank failure, unless backed up by wider powers to act in an insolvency situation. The amendments to the Canada Deposit Insurance Corporation Act do provide the CDIC with strengthened supervision and enforcement powers aimed at preventing insolvency. However, they fall short insofar as providing for new and flexible powers to resolve bank insolvency.

One significant new power which is introduced by the Financial Institutions and Deposit Insurance System Amendment Act is the Superintendent's legal right to take control of a bank or its assets in certain circumstances. This is an important provision in that it grants the Superintendent the power to take temporary control of a troubled bank and, therefore, the opportunity to investigate the source of the trouble and to prevent further prejudice to the interests of depositors or creditors. The result of this temporary right of control is either a correction of the situation and the return of control over the bank's assets to bank management or a more complete taking of control over the bank's affairs until the unsound practice or state of affairs is remedied or the bank is wound up.

The new Act sets out specific criteria for the taking of such action by the Superintendent and gives the ultimate authority to invoke such a procedure to the Minister.

This procedure will be useful in circumstances where the regulator is concerned about a member institution's solvency and wants to prevent further loss to the bank's depositors, creditors and to the CDIC before the bank is wound up or in circumstances where the interests of depositors and creditors are threatened by an unsound practice or state of affairs which can be remedied. The procedure does not contemplate nor in any way provide a mechanism whereby an insolvent bank can be bailed out.

Conclusion

When measured against the criteria for reform set out in chapter 6, the federal government's legislative initiative falls short. Like the bank insolvency legislation preceding it, the new legislation contemplates one ultimate course of action in the event of bank failure: liquidation and payoff. It does not address the issue of government bailouts of insolvent banks (other than providing deposit insurance for small depositors). Therefore, the present situation will continue-- with the government continuing to bail out insolvent banks without the benefit of the structure, control and predictability provided by a legislative framework.

CONCLUSION

The experience of the Canadian government in attempting to resolve recent bank insolvencies has illustrated the inadequacy of the legislative framework under which it was authorized to act. That legislation did not recognize nor provide a mechanism for the bailing out of distressed banks. Because bank bailouts can be justified in specific circumstances, bank insolvency legislation should recognize this form of government intervention and provide an adequate and appropriate framework for this process.

American bank insolvency legislation reflects a highly-structured approach to the problem of actual or potential insolvency and provides the deposit insurer with broad powers to decide whether a bank should be bailed out or allowed to fail. If the decision is made to bail out, the deposit insurer possesses the authority to choose among a number of alternative approaches, in particular, the purchase and assumption transaction and direct financial assistance.

The model for reform of Canadian bank insolvency legislation which is proposed in this thesis is based on the American approach. It creates an agency with direct and on-going access to the information needed to recommend a course of action to the Minister with respect to a distressed bank, and the broad powers to implement the Minister's decision.

The model proposes a legislative scheme which would provide as a general rule that only insured depositors would be bailed out in the event of failure but would allow wider compensation in circumstances which justify greater government intervention. The model is designed to promote the interests of cost-efficiency and market discipline.

When this model for reform is applied to recent federal initiatives to amend financial sector legislation, the conclusion is reached that the new legislation, while a step in the right direction, does not go far enough. Further and more meaningful legislative reforms are needed if government agencies are to resolve future bank insolvencies in a more consistent and effective way than recent failures have been resolved.

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