



January 1993

Bad Policy as a Recipe for Bad Federalism in the Regulation of Canadian Financial Institutions: The Case of Loan and Trust Companies

Ronald J. Daniels

University of Pennsylvania, president@jhu.edu

Follow this and additional works at: http://repository.upenn.edu/law_series

 Part of the [Law Commons](#)

Recommended Citation

Daniels, R. J. (1993). Bad Policy as a Recipe for Bad Federalism in the Regulation of Canadian Financial Institutions: The Case of Loan and Trust Companies. 543-587. Retrieved from http://repository.upenn.edu/law_series/14

Reprinted from *Osgoode Hall Law Journal*, Volume 31, 1993, pages 543-587.

This paper is posted at ScholarlyCommons. http://repository.upenn.edu/law_series/14
For more information, please contact libraryrepository@pobox.upenn.edu.

Bad Policy as a Recipe for Bad Federalism in the Regulation of Canadian Financial Institutions: The Case of Loan and Trust Companies

Abstract

This article addresses the impact of substantive policy on federal arrangements in the regulation of Canadian loan and trust companies. It is argued that reliance on market-suppressing policies (flat-rate based deposit insurance and selective bail-outs of depositors in the event of institutional failure) has undermined the value of competitive federalism in this area, and has spawned highly contentious policy initiatives such as Ontario's Equals Approach. To redress the federalism problems in the regulation of loan and trusts, a useful starting point would be the enhancement of market forces in substantive policy. Here, it is argued that the commitment to secrecy regulation by financial institution regulators has impeded this enterprise.

Disciplines

Law

Comments

Reprinted from *Osgoode Hall Law Journal*, Volume 31, 1993, pages 543-587.

BAD POLICY AS A RECIPE FOR BAD FEDERALISM IN THE REGULATION OF CANADIAN FINANCIAL INSTITUTIONS: THE CASE OF LOAN AND TRUST COMPANIES[©]

BY RONALD J. DANIELS*

This article addresses the impact of substantive policy on federal arrangements in the regulation of Canadian loan and trust companies. It is argued that reliance on market-suppressing policies (flat-rate based deposit insurance and selective bail-outs of depositors in the event of institutional failure) has undermined the value of competitive federalism in this area, and has spawned highly contentious policy initiatives such as Ontario's Equals Approach. To redress the federalism problems in the regulation of loan and trusts, a useful starting point would be the enhancement of market forces in substantive policy. Here, it is argued that the commitment to secrecy regulation by financial institution regulators has impeded this enterprise.

I. INTRODUCTION	544
II. THE COMPETITIVE MODEL OF FEDERALISM	546
III. LOAN AND TRUST REGULATION AND FEDERALISM	549
A. <i>The Distortional Impact of Government Intervention on Market Conduct</i>	550
1. Introduction	550

© 1994, Ronald J. Daniels.

* Assistant Professor, Faculty of Law, University of Toronto. I would like to express my appreciation to Jim Baillie, Bruce Chapman, Tom Courchene, Robert Howse, Richard Janda, Ralph Simmonds, George Triantis, Michael Trebilcock, and Jacob Ziegel for useful comments on an earlier draft of this article, as well as participants in the 1989 Annual Workshop on Consumer and Commercial Law held at the Faculty of Law, University of Toronto. I would also like to thank Jim Craven, Kelly Friedman, Frank Morrison, and Brian Osler for invaluable research assistance and Pia Bruni for secretarial assistance on various drafts. I am, of course, responsible for all errors and omissions. This article is current as of summer 1992.

2. Flat-rate based deposit insurance	551
3. Protection for uninsured depositors on a failure event through bank closure policies ..	557
a) <i>The contagion rationale</i>	559
b) <i>Protection of the public purse</i>	562
c) <i>Protection of stakeholders</i>	568
4. Summary—compensating for perverse policy and the destructive effect of the regulatory ratchet	570
B. <i>Market Impediments and their Impact on the Competitive Federalism Model</i>	572
 IV. THE EQUALS APPROACH AND THE DEMISE OF COMPETTIVE FEDERALISM	575
 V. A PLAN FOR REVERSING THE EQUALS APPROACH AND FOR REVIVING COMPETTIVE FEDERALISM	581
 VI. CONCLUSION	586

I. INTRODUCTION

In a country where interminable federal-provincial power squabbling is virtually a national pastime, the observation that alternative distribution of power arrangements can shape, sometimes even determine, substantive policy outcomes is commonplace. What is generally less appreciated, however, is that this causal relationship can work in reverse—*i.e.*, certain substantive policy commitments can affect the workability of various distribution of power arrangements. One of the starkest examples of this reciprocal relationship can be found in the regulation of Canadian loan and trust corporations.¹ Because loan and

¹ Like other financial intermediaries, the traditional role of loan and trust corporations has been to reconcile the conflicting needs of savers for relatively passive, low-risk, liquid investments with the needs of borrowers for long term, illiquid debt that requires close monitoring. Historically, loan and trust corporations have differed from other financial intermediaries in terms of the concentration of their lending activities in residential mortgages and small consumer loans and in their ability to engage in fee-based fiduciary activities (The historical evolution of trust companies is described in E.P. Neufeld, *The Financial System of Canada* (Toronto: Macmillan, 1972) at 9). However, as a number of commentators have noted, for all intents and purposes, the substantive differences between the activities of loan and trust corporations and those of other financial intermediaries, particularly the chartered banks, have been dulled considerably by regulatory and market innovations, which have occurred over the past several decades. (P.N. McDonald, "The B.N.A. Act and the Near Banks: A Case Study in Federalism" (1972) 10 Alta. L.Rev. 155 at 166: "If banking is synonymous with financial intermediation, then the trust companies ... are banks notwithstanding the statutory declaration of trust in respect of their liabilities to

trust corporations are subject to both federal and provincial jurisdiction, the industry is faced with regulations that overlap—often even contradict—one another, generating a patchwork-quilt regulatory regime that is distinguished mainly by its lack of underlying coherence.² But just as federalism arrangements in loan and trust regulation have impacted on policy, so too have policy commitments impacted negatively on federalism. Of these policies, perhaps the most destructive has been the long-standing and widely shared commitment of financial regulators to policies that, whether intentionally or not, suppress the disciplinary force of external markets. An even greater concern is that these policies not only distort optimal incentives for industry members, but they also affect provincial governments. These actions have, in turn, provoked a regulatory counter-reaction, which further strains the federal dynamic.

Despite the intricate and interdependent relationship that exists between federalism and policy, it is striking that the corrosive role of market-suppressing policies has been all but ignored in the contemporary debate over the efficacy of federal arrangements in the loan and trust area.³ Instead of addressing the question of *what* the ideal content of financial institution regulation should be, participants in the debate have remained fixated on the the second order question of *who* gets to regulate financial institutions. It is, however, a central theme of this article that unless regulators turn their attention to questions of substance—namely, the appropriateness of continued devotion to market-suppressing policies—many of the most dysfunctional features of federalism will remain in force.

customers”). The rationale for financial intermediation is explored in: H. Leland & D. Pyle, “Informational Asymmetries, Financial Structure and Financial Intermediation” (1977) 32 J. Fin. 371; D.W. Diamond, “Financial Intermediation and Delegated Monitoring” (1984) 51 Rev. Econ. Stud. 393; R.T.S. Ramakrishnan & A.V. Thakor, “Information Reliability and a Theory of Financial Intermediation” (1984) Rev. Econ. Stud. 415; M. Millon & A. Thakor, “Moral Hazard and Information Sharing: A Model of Financial Information Gathering Agencies” (1985) 40 J. Fin. 1403; and J.H. Boyd & E.C. Prescott, “Financial Intermediary Coalitions” (1986) 38 J. Econ. Theory 211.

² Both the federal and provincial governments claim jurisdiction under the *Constitution Act, 1867* (U.K.), 30 & 31 Vict., c. 3, to charter loan and trust corporations. Federal jurisdiction emanates from the federal incorporation power (s. 91(15)), while provincial jurisdiction derives from authority over property and civil rights in the province (s. 92(13)) and over the incorporation of companies with provincial objectives (s. 92(11)).

³ The impact of federalism on the regulation of financial institutions has been discussed in a number of different articles. See, for instance W.D. Moull, E.J. Waitzer & J. Ziegel, “The Changing Regulatory Environment for Canadian Financial Institutions: Constitutional Aspects and Federal-Provincial Relations” in J. Ziegel, L. Waverman & D.W. Conklin, eds., *Canadian Financial Institutions: Changing the Regulatory Environment* (Toronto: Ontario Economic Council, 1985) at 101. See also McDonald, *supra* note 1; and J.F. Chant & J.W. Dean, “An Approach to the Regulation of Banking Institutions in a Federal State” (1982) 20 Osgoode Hall L.J. 721.

The corrosive effect that market-suppressing policies have had on the federal dynamic in the loan and trust area can be best illustrated by reference to the theory of competitive federalism. An identification of the prerequisites for an effective decentralized federalism can facilitate an understanding of the distortionary impact of certain regulatory policies on federal arrangements. Once the corrosive effect of these policies is understood, policy makers can then turn their attention to substantive policy reform. To assist in this exercise, I consider a range of different policy modifications designed to enhance the vigour of market oversight. Ultimately, I conclude that, until regulators substantially revise their commitment to secrecy based regulation, the suitability of reliance on enhanced depositor vigilance is questionable. A preferable way of augmenting market oversight would be to modify the incentives facing shareholders and regulators.

II. THE COMPETITIVE MODEL OF FEDERALISM

The competitive model of federalism is based on the idea that a political system comprised of multiple competing providers of regulatory product is most conducive to the realization of certain vaunted political and economic goals.⁴ This model is rooted in Schumpeterian notions of entrepreneurial efficiency⁵ and Madisonian⁶ visions of democracy. Specifically, the model envisages numerous state or provincial governments endowed with jurisdiction over the same subject area so that citizens can migrate to whichever jurisdiction offers the most attractive policy mix.⁷ From a political perspective, the competitive model

⁴ For a brilliant synthesis of the arguments in favour of competitive federalism, see A. Breton, "Supplementary Statements" in *Report of the Royal Commission on the Economic Union and Development Prospects for Canada*, vol. 3 (Ottawa: Supply and Services Canada, 1985) 483. See also D.A. Kenyon & J. Kincaid, "Introduction" in D.A. Kenyon & J. Kincaid, eds., *Competition Among States and Local Governments* (Washington, D.C.: Urban Institute Press, 1991) 1; A. Breton, "The Existence and Stability of Interjurisdictional Competition" in Kenyon & Kincaid, *ibid.* at 37; and J. Kincaid, "The Competitive Challenge to Cooperative Federalism: A Theory of Federal Democracy" in Kenyon & Kincaid, *ibid.* at 87. The actual operation of the competitive federalism model is explored at great length in R. Daniels, "Should Provinces Compete? The Case for a Competitive Corporate Law Market" (1991) 36 McGill L.J. 130.

⁵ J.A. Schumpeter, *Capitalism, Socialism and Democracy*, 4th ed. (New York: Harper & Row, 1975) at 84-85.

⁶ James Madison, *The Federalist* (Middletown, Conn.: Wesleyan University Press, 1961).

⁷ Not unlike the allocation of resources in private economic markets, the production of laws in the decentralized model is seen to be guided by the "invisible hand" of consumer demand. In this model of law production, local governmental units are believed to compete against one another in the provision

of federalism is prized for several properties, including: hostility towards concentrated governmental power, congeniality to highly participatory forms of government decision making, and dedication to citizen sovereignty. From an economic perspective, the model is valued for its ability to force governments to produce regulatory products that are responsive to consumers' (more appropriately, citizens') preferences.

At the core of the model is the claim that politicians and bureaucrats will be devoted to citizens' preferences because of the fear that sub-optimal regulation will precipitate a flight of citizens to jurisdictions offering more favourable legislative product.⁸ Migration, or the threat thereof, is seen to be an effective way of ensuring governmental fidelity to citizens' preferences because it directly impacts on the welfare of bureaucrats and politicians. The welfare of public officials is threatened by migration because it typically reduces the amount of revenue, and hence, power that is at their disposal.⁹ Of course, to the extent that the welfare functions of bureaucrats and politicians are driven by goals unrelated to personal aggrandizement, or if internal government structures confer wide scope on bureaucrats

of legislative products. Those governmental units providing superior products will, like "winners" in economic markets, enjoy benefits from increased consumer patronage. In this framework, the fact that gains in market share may accrue to one province at the expense of another is both predictable and uncontroversial. Moreover, diversity in government output indicates either specialization of provincial activity or legal innovations introduced by competitive governments in an effort to gain market share. In any event, in this model, shifting market share, diversity of outcome, and competitive behaviour are indicators of optimal processes of law production.

⁸ The claim that competitive interaction among governments is capable of producing superior laws owes much to Tiebout's model of local government. See C.M. Tiebout, "A Pure Theory of Public Expenditures" (1956) 64 J. Pol. Econ. 416. Tiebout designs his model of local government in an effort to show that the interaction of local governments and "consumer-voters" could overcome daunting revealed preference problems in the provision of public goods. Specifically, Tiebout posits that, under certain simplifying assumptions (*i.e.*, perfect information, negligible mobility costs, trivial external economies and diseconomies, and a large set of available destination jurisdictions), the migratory decisions of "consumer-voters" can reveal individual preferences (at 420). The greater the number of choices (*i.e.*, local governmental units) that a "consumer-voter" can select from, the more likely that optimal matches between "consumer-voters" and local governments will result. If there is a hint of unreality about Tiebout's model, it is his assumption that local governments do not "adopt" the preferences of "consumer-voters," rather, local governments are only "adopted" by "consumer-voters." The model of federalism developed in this article corrects for this deficiency and anticipates that provinces will consciously modify their policy "bundles" so as to enhance the appeal of residency in their jurisdiction to mobile constituents.

⁹ This feature is, of course, especially salient in the realm of corporate and commercial regulation, where, in the absence of such mechanisms, politicians perceive relatively minuscule gains (in terms of conventional votes) from the provision of innovative legislation. Consequently, they allow priorities in these areas to fall to the bottom of the legislature's agenda. To some extent, the problems of political neglect of corporate and commercial legislative priorities can be redressed through the use of, among other devices, sunset laws.

and politicians to escape responsibility for poor decisions,¹⁰ then many of the predictions generated by the model will be undermined.¹¹

For the competitive model to operate effectively, four general conditions must be satisfied: (i) a high degree of mobility of people and resources; (ii) a large number of destination jurisdictions; (iii) jurisdictional latitude in selection of laws; and (iv) full internalization of policy effects.¹² For most corporate and commercial policies, the greatest difficulties for the decentralized model derive from a failure to satisfy the first and fourth conditions. The first condition is difficult to realize

¹⁰ For instance, responsibility may be avoided through widespread use of compensation systems that are based on tenure of service rather than actual productivity.

¹¹ One of the earliest scholars to consider the nature of incentives operating on public officials was Anthony Downs. See A. Downs, *Inside Bureaucracy* (Boston: Little Brown, 1967) at 84-85. Downs argued that public officials are motivated by a range of goals, including increased power, money, prestige, convenience, pride in proficient performance of work, personal loyalty, desire to serve the public interest, and a commitment to a specific programme of action. See also W.A. Niskanen, Jr., *Bureaucracy and Representative Government* (Chicago: Aldine Atherton, 1971); J. Donahue, *The Privatization Decision: Public Ends, Private Means* (New York: Basic Books, 1989) at 87; and M.J. Trebilcock, L. Waverman & J.R.S. Prichard, "Markets for Regulation: Implications for Performance Standards and Institutional Design" in *Government Regulation: Issues and Alternatives* (Toronto: Ontario Economic Council, 1978) 11, for support for the multi-goal conception of the public official welfare function. More recently, Steven Kelman has argued that government officials are motivated by a commitment to civic virtue. See Public Policy Workshop, *What's Wrong with the Revolving Door?* by S. Kelman (Toronto: Faculty of Law, University of Toronto, 1991). Other scholars, however, emphasize the overriding desire of public officials to increase the size of their budget, and the inextricable dependence of other goals upon this principal goal. See, for instance, D.C. Mueller, *Public Choice* (Cambridge: Cambridge University Press, 1979). For a discussion of the role of bureaucratic behaviour in shaping federalist institutions, see A.C. Cairns, "The Government and Societies of Canadian Federalism" (1977) 10 Can J. Pol. Sci. 695.

The issue of whether public officials are able to respond effectively to financial incentives has been canvassed by D. Cohen. See D.S. Cohen, "Regulating Regulators: The Legal Environment of the State" (1990) 40 U.T.L.J. 213 and "Suing the State" *ibid.* at 630. Cohen argues that "[w]hatever incentives financial risk have in the private sector, they are unlikely to operate in the same fashion in public institutions" (at 646). Cohen asserts that the weak response of governments to financial incentives is due to the lack of external constraint imposed by competitive markets, which enables governments to reflect any costs imposed on them back onto the taxpayer or onto different institutions or individuals within government. See also Donahue, *ibid.* at 47-48, who argues that financial incentives do not work in the government context because of the lack of meaningful standards of evaluation. However, for a contrary view, see H. Kee, "Incentives and Rewards in the Public Sector" (1986) 29 Can. Public Adm. 545. Kee argues that there is no *a priori* reason that financial incentives could not work in the public sector, especially for senior managers, given ample data on macro-level performance. Kee claims that rejection of financial incentives in the public sector is based on philosophical and political objections.

¹² See Tiebout, *supra* note 8, and F.H. Easterbrook, "Antitrust and the Economics of Federalism" (1983) 26 J.L. & Econ. 23 at 34.

because of product bundling.¹³ Because residence is often a prerequisite for the consumption of policy and laws, citizen-consumers are precluded from selecting the policies that they believe are best from each jurisdiction. Instead, they will end up having to choose among competing baskets of policies, some of which are desirable, some of which are not. The fourth condition—full internalization of the costs and benefits of laws onto their suppliers and consumers—is compromised by sundry policy spillovers. In the corporate law case, for instance, the integrity of a given jurisdiction's corporate law can be subverted by aggressive assertion of jurisdiction by securities regulators located in other provinces.¹⁴ These spillover effects will perversely distort optimal production and allocation decisions, causing competing jurisdictions to produce too much or too little innovative policy.

III. LOAN AND TRUST REGULATION AND FEDERALISM

Although there is no *a priori* reason why the competitive federalism model could not yield optimal policy in the regulation of loan and trust companies, close examination of the institutional framework for loan and trust regulation reveals the presence of debilitating externalities which violate the fourth pre-condition for the competitive model and thereby impair the effectiveness of the model.¹⁵ Because of

¹³ In antitrust parlance, this bundling is referred to as a "tied sale" or a "tying arrangement." The presumption underlying the prohibition of such arrangements is that consumers are prevented from making optimal consumption choices. It should be noted, however, that a vociferous group of antitrust scholars suggest that the prohibition on tying arrangements—and the "leverage theory" which is invoked to justify the prohibition—cannot be supported on logical, principled grounds. See R.H. Bork, *The Antitrust Paradox: A Policy at War With Itself* (New York: Basic Books, 1978) at 365-81; R.A. Posner, *Economic Analysis of Law*, 2d ed. (Boston: Little, Brown, 1977) at 226-27; and W.S. Bowman, Jr., "Tying Arrangements and the Leverage Problem" (1957/58) 67 *Yale L.J.* 19. For an article supporting leverage theory, see L. Kaplow, "Extension of Monopoly Power Through Leverage" (1985) 85 *Col. L. Rev.* 515. A critical discussion of this issue in a Canadian context is in B. Dunlop, D. McQueen & M. Trebilcock, *Canadian Competition Policy: A Legal and Economic Analysis* (Toronto: Canada Law Book, 1987) at 253-57.

¹⁴ Daniels, *supra* note 4 at 182-84.

¹⁵ The role for inter-jurisdictional competition in shaping policy outcomes in the financial institutions area has been given some recognition by Canadian scholars. See, for instance, Royal Commission on the Economic Union and Development Prospects for Canada, *Economic Management and the Division of Powers* (Background Papers vol. 67) by T. Courchene (Toronto: University of Toronto Press, 1985) at 198 (endorsing the value of decentralized competition in the securities area); and Canada, *16th Report of the Standing Senate Committee on Banking, Trade and Commerce: Toward a More Competitive Financial Environment* (Ottawa: Queen's Printer, May 1986) (Chairman: L. Murray) [hereinafter *Towards a More Competitive Financial Environment*] at 63: "multiple jurisdictions may be conducive to greater experimentation and innovation. The costs of an inappropriate expansion of

the federal government's commitment to flat-rate based deposit insurance and, frequently, to *de facto* full protection for uninsured depositors upon institutional failure, shareholders and managers of loan and trust companies, as well as provinces, are able to externalize most of the costs of an institution's investment activities onto the federal government, which leads to predictable increases in institutional risk-taking. This increase, however, has forced both the federal and, surprisingly, the Ontario governments to introduce a variety of measures that, by attempting to compensate for some of the perverse incentives introduced by earlier policies, further impair the operation of the competitive model.¹⁶

A. *The Distortionary Impact of Government Intervention on Market Conduct*

1. Introduction

In this section, the impact of several of the key components of financial institution regulation on the behaviour of various market actors, namely the shareholders and depositors of loan and trust corporations, will be assessed.¹⁷ As this discussion shows, a range of government policies has enabled shareholders—particularly those whose human capital is not concentrated in the companies in which they have invested financial capital—to run companies in a riskier fashion than would be observed if their behaviour were regulated by a different, more rational, set of rules.¹⁸ This propensity impacts directly

powers may still be serious, but these costs would be localized and thus minimized in comparison to a situation where such an experiment were conducted nation wide"; and Law and Economics Workshop Series, *Regulation of Financial Institutions: Some Notes on Regulatory Competition* (Working Paper No. WS 1989-90-(5)) by N. Roy (Toronto: Faculty of Law, 1989) (decentralized competition led by Quebec responsible for modernization of financial institution regulation).

¹⁶ This compensatory reaction is discussed below in Part V, and undercuts the first and third conditions (jurisdictional mobility and jurisdictional latitude in the selection of laws, respectively) that are necessary for the model to operate effectively.

¹⁷ A lucid introduction to the structure of financial institution regulation can be found in R.C. Clark, "The Soundness of Financial Intermediaries" (1976) 86 Yale L.J. 1. For a Canadian perspective, see R.A. Schearer, J.F. Chant & D.E. Bond, *The Economics of the Canadian Financial System*, 2d ed. (Toronto: Prentice Hall, 1984).

¹⁸ Managers whose human and financial capital is heavily invested in the companies in which they are employed will be less likely to exploit some of the gains that may be obtained from risky investment activity than those whose capital is well diversified. See H. Garten, "What Price Bank Failure?" (1990) 50 Ohio State L.J. 1059 at 1182; and A. Saunders, E. Strock, & M. Travlos, "Ownership Structure, Deregulation, and Bank Risk Taking" (1990) 45 J. Fin. 643 (stockholder controlled banks exhibited

on the operation of competitive federalism because it encourages shareholders to migrate to jurisdictions having excessively lenient (or sub-optimal) regulatory standards. Unless constrained, unfettered migration forces other jurisdictions to match the laws offered in the most lenient jurisdiction, thereby producing a race to the bottom.

2. Flat-rate based deposit insurance

As a succession of governmental and quasi-governmental task forces, commissions, and special committees have noted over the past decade, the provision of flat-rate based deposit insurance by the Canadian Deposit Insurance Corporation (CDIC) is inimical to the efficient operation of market forces in the financial institutions area.¹⁹ In Canada, deposit insurance was introduced by the federal government in 1967 in the wake of a series of highly publicized financial institution failures in Ontario.²⁰ Fearing the outflow of investor funds from

significantly higher risk-taking behaviour than managerially controlled banks during the 1979-1982 period of relative deregulation). For a general discussion of the agency costs emanating from managerial risk aversion, see M. Jensen & W. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305 ("managers of large, publicly held corporations seem to behave in a risk averse way to the detriment of the equity holders" (at 353)). See also B. Holmstrom, "Moral Hazard and Observability" (1979) 10 Bell J. Econ. 74; and Y. Amihud & B. Lev, "Risk Reduction as a Managerial Motive for Conglomerate Mergers" (1981) 12 Bell J. Econ. 605 ("mergers ... viewed as a managerial perquisite intended to decrease the risk associated with managerial human capital. Accordingly, the consequences of such mergers may be regarded as an agency cost" (at 606)); and A. Marcus, "Risk Sharing and the Theory of the Firm" (1982) 13 Bell J. Econ. 369 ("constrained managers overspend on variance reducing activities, thereby imposing a welfare loss on the other owners, and by this definition, exhibit excessive risk aversion" (at 375)).

¹⁹ See, for instance, Canada, *Final Report of the Working Group on the Canada Deposit Insurance Corporation* (Ottawa: Supply and Services Canada, June 1985) (Chairman: W.R. Wyman) [hereinafter the Wyman Report] at 25-37. The Wyman Report is discussed at length in a symposium issue of the Can. Bus. L.J. See: (1985/86) 11 Can. Bus. L.J. 97-256; Ontario, *Report of the Task Force on Financial Institutions* (Toronto: Queen's Printer, December 1985) (Chairman: J.S. Dupre) at 45-50; Canada, *Report of the Standing Committee on Finance, Trade and Economic Affairs: Canadian Financial Institutions* (Ottawa: Queen's Printer, November 1985) (Chairman: D. Blenkarn); Canada, *Tenth Report of the Standing Senate Committee on Banking, Trade and Commerce: Deposit Insurance* (Ottawa: Supply and Services Canada, December 1985); Canada, *Towards a More Competitive Financial Environment*, *supra* note 15 at 2; and Canada, *Report of the Inquiry into the Collapse of the CCB and Northland Bank* (Ottawa: Supply and Services Canada, August 1986) (Commissioner: W.Z. Estey) [hereinafter the Estey Report] at 343-344. Many of these reports are discussed in R. Granatstein, "Deposit Insurance Reform in Canada" (1986/87) 16 Man. L.R. 45. See also K.P. McGuinness & L. Abrams, "Deposit Protection: Lessons Learned From Recent Experiences—Part I" (1986/87) 12 Can. Bus. L.J. 185; and "Deposit Protection: Lessons Learned From Recent Experiences—Part II" (1986/87) 12 Can. Bus. L.J. 312.

²⁰ The failures involved Atlantic Acceptance Corp. Ltd. and Prudential Finance Corp. Ltd. of Toronto.

Ontario based institutions to federally chartered banks, Ontario initially proposed the adoption of a provincial deposit insurance scheme modelled after the Federal Deposit Insurance Corporation (FDIC) in the United States.²¹ However, the federal government, perhaps motivated by a desire to skim rents (in the form of annual insurance fees collected from guaranteed institutions)²² or to shore up the sagging reputation of federally chartered banks that had extended loans to the failed provincial institutions,²³ occupied the field by establishing CDIC.²⁴

The mechanics of the scheme are relatively straightforward. As in the United States, deposits made by individuals to CDIC-member institutions are insured to a ceiling prescribed by law, currently \$60,000.²⁵

²¹ The FDIC was introduced by Roosevelt in 1933 in an effort raise the level of confidence in the soundness of the American banking system. The genesis of the FDIC is discussed in G. Emerson, "Guaranty of Deposits Under the Banking Act of 1933" (1933/34) 48 Q.J. of Econ. 229 (reprinted in G. Kaufman, ed., *Restructuring the American Financial System* (Boston: Kluwer Academic Publishers, 1990) c. 2).

²² Carr and Mathewson argue that the federal government's foray into deposit insurance was motivated by a desire to earn rents from the administration of the scheme. See Working Paper Series, *The Effect of Deposit Insurance on Financial Institutions* (Working Paper No. 8903) by J. Carr & F. Mathewson (Toronto: Department of Economics and Institute for Policy Analysis, University of Toronto, 1989). Ironically, however, as recent experience shows, deposit insurance does not constitute a captive source of income for sponsoring governments. Invariably the right to collect yearly annual insurance fees is accompanied by the obligation to assist ailing institutions at the time of collapse, which can generate considerable cost for the sponsoring government. In the end of fiscal year 1990, for instance, CDIC's deficit (which is financed by borrowings from the federal government) stood at \$643 million, down from \$1,245 million in 1986 (Canada Deposit Insurance Corporation Annual Report 1990 at 21).

²³ A. Emid, "Quiet Watchdog CDIC Seeks a Higher Profile" *The [Toronto] Globe and Mail* (11 September 1989) C4: "Nationally, the new agency reassured Canadian financial institutions of the stability of their own system: the Royal Bank of Canada, the Toronto Dominion Bank, British Mortgage and Trust Co. and (then) Canada Permanent Trust Co. had lent heavily to Atlantic Acceptance."

²⁴ Consequently, Ontario decided not to institute a separate scheme.

²⁵ *Canada Deposit Insurance Corporation Act*, R.S.C. 1985, c. C-3, s.12 [hereinafter the *Act*]. The coverage restriction constitutes an attempt by the architects of the scheme to marry two different, somewhat competing, objectives: (i) extending protection against the risk of institutional failure to only those investors who, because of their lack of expertise or market power, are unable to make informed investment choices; and (ii) ensuring that those investors who have the requisite sophistication and size are motivated to exercise their judgment and skill in their investment activities in order to bring some market pressure to bear on managers and owners of financial institutions. In this respect, the \$60,000 cap is a somewhat arbitrary and coarse threshold that is designed to delineate between these two investor classes. Nevertheless, as will be discussed below in the context of bank closure policies, the \$60,000 cap has not always bound the federal government, and depositors have often received protection for their entire deposit in the event of a failure. In addition to the *ex post* protection conferred by closure policies, depositors have also been able to stretch the boundaries of formal coverage beyond the \$60,000 ceiling through careful investment. The most frequently used device is that of the beneficial trust: by setting up multiple accounts at a single institution, each of which is held for a different named

Consequently, in the event of the failure of an insured financial institution, the capital and accrued interest of depositors is guaranteed by the government. The insurance cannot, however, be “purchased” independently by depositors, and is only available by depositing in an institution that is a “member” of the CDIC. Deposit insurance coverage is obtained by way of application by the federally or provincially chartered institution to, and approval by, the CDIC.²⁶ Once an institution becomes a member of the CDIC it is required to pay an annual flat-rate levy that does not exceed the amount of one-sixth of 1 per cent of their deposit base.²⁷ And, although there is provision in the CDIC’s chartering legislation for the imposition of a premium surcharge upon an institution engaging in certain defined practices, the relatively low ceiling on the amount of the surcharge has all but eviscerated its disciplinary force.²⁸

The perverse incentive effects (moral hazard problems) occasioned by flat-rate based deposit insurance have been known to academics and policy makers for several decades.²⁹ Because, under a system of flat-rate based insurance, the insurer is unable to charge a variable premium—one that is commensurate with the actual risk that the institution brings to the insured pool³⁰—the shareholders and managers of that institution will, assuming no other countervailing pressures, operate the institution in a riskier fashion than if the institution were uninsured.

beneficiary, a single investor can invest considerable sums of money in the same institution. Indeed, use of the trust contrivance has received not merely the tacit approval of CDIC, but its explicit endorsement (see brochure prepared by CDIC: “CDIC Information,” Revised December, 1990. The brochure actually demonstrates how two related depositors could secure formal insurance coverage for more than \$540,000 at the same financial institution).

²⁶ Section 17 of the *Act*, *supra* note 25.

²⁷ These requirements are set out in s. 21(1) of the *Act*, *ibid.*

²⁸ Section 24(2) of the *Act*, *ibid.* restricts the size of the surcharge in any premium year to an amount not to exceed the difference between one-third of 1 per cent of the insured deposits and the regular premium.

²⁹ The leading and most persistent critics of flat-rate based deposit insurance are E. Kane and K. Scott. See, for instance: E. Kane, “The Role of Government in the Thrift Industry’s Net Worth Crisis” in G.J. Benston, ed., *Financial Services: The Changing Institutions and Government Policy* (Englewood Cliffs, N.J.: Prentice Hall, 1983) c. 3; E.J. Kane, *The Gathering Crisis in Federal Deposit Insurance* (Cambridge, Mass.: MIT Press, 1985); K. Scott & T. Mayer, “Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform” (1971) 23 *Stan. L.R.* 857; and K. Scott, “Deposit Insurance and Bank Regulation: The Policy Choices” (1989) 44 *Bus. Law.* 907. See also G.J. Benston *et al.*, *Perspectives on Safe and Sound Banking* (Cambridge, Mass.: MIT Press, 1986) c. 1.

³⁰ The expected loss of failure is the probability that an institution will fail multiplied by the costs of that failure. These costs include the actual shortfall on liquidated assets and the administrative costs of bankruptcy proceedings.

The intuition underlying this claim can be gleaned from a comparison of the incentives that operate upon shareholders (and their agents—the managers) in two states of the world: one without deposit insurance and one with flat-rate based deposit insurance.³¹ In the first case, it will be assumed that: (i) deposit insurance is unavailable from either public or private sources; (ii) all financial institutions are owned and managed by single individuals and that these individuals are not risk averse; and (iii) there are no endemic collective action problems that limit depositors' ability to negotiate appropriate debt covenants. Under this scenario, the scope for opportunistic risk-taking is limited by the fact that owner-managers will be confronted with the full opportunity costs of any funds borrowed from outside creditors. Recognizing that in a levered corporation the risks of corporate investment decisions are borne asymmetrically by shareholders and creditors, creditors will require owner-managers to provide full *ex ante* compensation for any conduct that increases the prospect of firm default.³² This risk compensation can be provided in two principal forms: higher interest and restrictive covenants that reduce managerial discretion. Since these devices narrow the actual returns to equity investment, owner-managers will be judicious when constructing the institution's asset portfolio. Simply, owner-managers will only increase the overall risk of the institution's investment portfolio to the point where the marginal returns to investment equal the marginal costs occasioned thereby.

In contrast, if, under a second scenario, a financial institution is able to secure insurance to protect depositors from the full cost of failure, and the premium is only coarsely, if at all, sensitive to the underlying risk of the institution, then it can be predicted that owner-

³¹ Another, more formal way of considering the impact of various deposit insurance arrangements on the welfare of depositors, shareholders, and governments is through option pricing theory. See, for instance, R. Merton, "An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees" [June 1977] *J. Banking and Fin.* 1, and A. Marcus & I. Shaked, "The Valuation of FDIC Deposit Insurance Using Option Pricing Estimates" (1984) 16 *J. of Money, Credit and Banking* 446. For a basic introduction to the application of the option pricing model to deposit insurance, see M. Flood, "On the Use of Option Pricing Models to Analyze Deposit Insurance" (1990) 72 *Fed. Res. Board of St. Louis Rev.* 19.

³² Since risk is usually distributed around a mean, any increase in overall risk will increase, in a symmetrical fashion, the likelihood of both excessive gains and losses being sustained on invested sums. However, since depositors, as debtholders, receive a fixed rate of return on their investment (interest), they can be seen to bear the consequences of increased risk asymmetrically. That is, if, *ex post*, the investment generates a high return for the financial institution, all of the gains will accrue to shareholders, whereas if the investment is unsuccessful, the creditors may, depending upon the amount of the equity buffer, lose the sums furnished to the borrower.

managers of that institution will raise the overall risk of their investment portfolio from the levels observed in the non-insurance case. Here, owner-managers will realize that the costs of increased risk taking can be externalized on the insurer with virtual impunity, while the benefits (*i.e.*, increased prospect of high future payouts) can be wholly appropriated by the owner-managers. This risk-subsidy occurs because of the willingness of fully insured depositors to lend their money to institutions engaging in high risk activities, and the inability of insurers to correct this propensity by use of appropriately designed insurance premiums.³³ In essence, when the external costs on the third party insurer are taken into account, the level of aggregate portfolio risk will proceed to the point where the marginal private benefits to shareholders from investment risk are *less than* the marginal social costs. Thus, when viewed from a global perspective, flat-rate based deposit insurance will distort the allocation of capital in the economy toward risky assets.³⁴

Of course, in a real world setting, the incentive-retarding effects of flat-rate based insurance may be offset by a variety of factors, which effectively limit the size of the subsidy transmitted by the insurer to the insured. First, government regulation, in the form of premium surcharges, portfolio restrictions, capital adequacy requirements and reporting obligations, can reduce the scope for unlimited risk taking.³⁵

Second, to the extent that managers are unable to diversify away many of the risks tied to their human and financial investment in a financial institution, they will be loathe to exploit fully the benefits of the risk-subsidy because an increased risk of failure will also increase the chance that the manager will suffer protracted and debilitating unemployment. Managerial reluctance to assume additional risk will be manifest both in settings where management and ownership are fused

³³ In a regime characterized by complete insurance against default risk, depositors will not demand additional compensation for added portfolio risk, and, as a consequence, owner-managers will be able to increase the value of their residual claim by the amount of the present value of the subsidy on their interest payments to creditors. The amount of the subsidy is equal to the present value of the market interest rate on the institution's debt minus the present value of the interest rate actually paid on that debt.

³⁴ See Working Paper Series, *The Impact of Deposit Insurance on S&L Shareholders' Risk/Return Trade-Offs* (Working Paper No. WP-1989-24) by E. Brewer III (Chicago: Federal Reserve Bank of Chicago, 1989) for empirical confirmation of the risk subsidy claim.

³⁵ However, the effectiveness of these constraints is critically dependent on the capacity of the government to keep pace with industry innovations. A constant refrain among regulatees in the financial area is the inability of governments to anticipate industry innovation. Consequently, many laws are regulated out of date well before they are passed. See, for instance, H. Janisch, "Regulating the Regulator: Administrative Structure of Securities Commissions and Ministerial Responsibility," in *Law Society of Upper Canada Special Lectures* (Toronto: DeBoo, 1989) 97.

and where they are not—although, predictably, the pressure upon managers to assume more risk will be greater in the latter case than in the former.

Third, if depositors face less than complete insurance for their deposits, due to either explicit or implicit co-insurance requirements, they can be expected to be more vigilant in their supervision of the institutions in which they invest; this will correspondingly reduce the scope for unfettered managerial risk-taking. In Canada, the fact that formally insured depositors are often forced to bear at least some costs upon a failure (for example, withdrawal and reinvestment costs)³⁶ will mean that they are not completely indifferent to risk.³⁷

Finally, to the extent that industry participants are forced to cover the costs of deficiencies generated by the insurance fund, additional constraints on the scope for institutional risk-taking can be expected to be imposed through industry self-monitoring and whistleblowing.³⁸

Nevertheless, despite the potential that each of these factors has to attenuate the strength of the perverse incentives created by flat-rate based deposit insurance, there are still strong grounds for believing that the effect of these incentives has not been entirely mitigated. In large part, this result is attributable to defects that plague each of these instruments. For instance, while government mandated portfolio rules aspire to constrain the overall riskiness of an institution's portfolio, these rules try to achieve this goal by prescribing permissible investment classes (by type of asset) without regard to the considerable variance in the risk of different assets within these classes or to the actual risk contribution of certain assets to the entire pool. The rules are

³⁶ Although, in the event of liquidation, insured depositors of failed institutions are forced to bear the transactions costs of withdrawal and reinvestment (primarily administrative and search costs). These costs are relatively trivial and in many cases, may be avoided altogether if the government arranges for a purchase and assumption transaction. More significant, however, are the foregone interest costs experienced by depositors whose term deposits are prematurely cashed out by the liquidator when interest rates have fallen from the levels prevailing at the time that the deposit was originally made.

³⁷ Indeed, the fact that the highest proportion of uninsured Canadian deposits is found in large, diversified banks, while the smallest proportion is found in smaller, regionally concentrated trust companies lends some credence to this claim. (Data provided by Finance Department officials.)

³⁸ Self-regulation by industry members is, however, constrained by endemic information deficiencies. Review of the investor protection schemes devised by the Canadian insurance and securities industries reveals greater scope for industry self-monitoring. See J. Baillie, "Investor Protection Plans" in *Law Society of Upper Canada Special Lectures* (Toronto: DeBoo, 1989) 77 for a discussion of the operation of these schemes.

therefore extremely porous, and subject to abuse by management.³⁹ Similarly, the fact that the deficits sustained by the insurance fund can be financed through virtually open-ended, long-term borrowing from the Consolidated Revenue Fund impairs industry incentives for vigilant peer group monitoring.

3. Protection for uninsured depositors on a failure event through bank closure policies

The second way in which government intervention thwarts effective market vigilance is through the implementation of bank closure policies. Depending on the type of mechanism used by the government to close a failed financial institution, governments can provide full protection to depositors for their investment, even if a substantial part of that investment is uninsured, and would therefore be subject to impairment under a conventional liquidation.⁴⁰ The predilection for adopting closure policies that provide *de facto* full protection to depositors proves strongest the larger the size of the failed institution, which, of course, raises vexing ethical issues.⁴¹

³⁹ These restrictions normally operate to restrict the amount of total portfolio risk through limitations on types of assets, that is, commercial loans, direct real estate investments, and leasing. However, even within these broad class restrictions, it is possible to generate asset portfolios with specific risk characteristics by, for instance, increasing the geographic concentration of assets or by changing the weight of certain assets in the portfolio. This point is discussed by Clark, *supra* note 17 at 60. The relatively high percentage of assets that can be invested by loan and trust companies in first mortgages is predicated on the assumption that these assets are low risk. However, as the recent experience of savings and loan companies in the American South-West shows, by concentrating mortgage investment in certain geographic regions with non-diversified economies, it is possible to construct quite risky portfolios. See, for instance, K. Scott, "Never Again: The S and L Bailout Bill" and P. Horvitz, "The Collapse of the Texas Thrift Industry: Causes of the Problem and Implications for Reform," c. 6 and 7 in Kaufman, *supra* note 21. See also P. McAllister & D. McManus, "Diversification and Risk in Banking: Evidence From Ex Post Returns" Paper #201 in *Finance and Economics Discussion Series of the Federal Reserve Board* (June 1992) (significant reduction in institutional variance from geographic diversification).

⁴⁰ As Table 1, below, shows, of the 26 financial failures that have occurred from 1980 to 1991, only 4 (or 15 per cent) have actually imposed costs on uninsured depositors. Predictably, the institutions subject to liquidation were considerably smaller than the ones that were not. The same trends are evident in the United States. See Benston *et al.*, *Perspectives* (1986) *supra* note 29 at c. 2; A.D. Tussing, "The Case for Bank Failure" (1967) 10 J.L. Econ. 129; E.H. Garrett, "The Modified Payoff of Failed Banks: A Settlement Practice to Inject Market Discipline into the Commercial Banking System" (1987) 73 Virginia L.R. 1349; and J. Macey & G. Miller, "Bank Failures, Risk Monitoring, and the Market for Bank Control" (1988) 88 Col. L.R. 1153.

⁴¹ L. Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues*, (New York: Basic Books, 1986) found that in 46 out of the 50 largest bank failures to 1985, no depositor suffered a loss, whereas in 43 out of the 100 smallest bank failures prior to 1985, depositors' claims were dealt with by

Federal government extension of *de facto* full insurance for depositors has been arranged through two principal methods: (i) direct financial assistance to faltering institutions, or (ii) purchase and assumption transactions (“weekend mergers”), which involve the purchase and assumption of the entire undertaking of the failed institution by a stronger industry member, usually with some form of government financial assistance.⁴² Since, in both cases, the assets of the insolvent institution are never liquidated, uninsured depositors are protected from experiencing losses upon failure. Nevertheless, the two methods do differ in the disciplinary effect they have on the institution’s other stakeholders. Whereas all stakeholders of the failed institution, at least in the short run, are protected by direct financial assistance, only depositors and some creditors are protected by a purchase and assumption transaction.⁴³

The arguments for full insurance protection are rarely made on the basis of the moral desirability of extending coverage to large, sophisticated depositors. Rather, when explicit, they are advanced on the basis of broad economic and political concerns, such as contagion effects, protection of the public purse, and harm to stakeholders. The common thread running through all of these arguments is the need to preserve the distinctive nature of financial institutions and the viability of the financial system.⁴⁴

payoff, which implies at least some loss on uninsured amounts. For a discussion of the ethical and efficiency impact of the selective use of closure policies, see Working Paper Series, “Issues in Financial Regulation,” *Are Some Banks Too Large to Fail? Myth and Reality* (Working Paper No. WP-89-14) by G. Kaufman (Chicago: Federal Reserve Bank of Chicago, 1989); and Garrett, *ibid.* note 40 at 1375-78.

⁴² Indeed, the Chairman of CDIC, Ronald McKinlay, is on the public record as favouring such transactions. See S. Gittins, “First City Deal Safest Option—CDIC Chief” *The Financial Post*, (20 Jan. 1992) 3: “It’s almost the rule that liquidation is the worst way to go, and it’s better to have a troubled institution taken over by somebody that’s got both some credibility and financial muscle.”

⁴³ Invariably, a condition precedent for the use of a purchase and assumption transaction is that senior management of the failed institution be removed and that the claims of shareholders and subordinated creditors be extinguished. However, there are even exceptions to this general rule. Subordinated creditors and shareholders in First City Trust were able to extract \$34 million in compensation from the purchaser, North American Life Assurance Co., of the institution’s assets, even though the transaction was facilitated by a \$175 million loan from the CDIC and an additional undertaking to absorb an additional \$300 million of future losses in certain circumstances. (S. Gittins, “CDIC Shores Up First City Deal” *Financial Post* (17 Jan. 1992) 1.) The fact that this compensation was in the form of twelve-year, non-interest-bearing, unsecured junior debentures of the successor institution (so-called “hope certificates”) largely explains the generosity of CDIC.

⁴⁴ However, even those commentators arguing for special treatment of banks concede the inevitability of bank failure. See, for instance, E. Corrigan, *Financial Market Structure: A Longer View* (New York: Federal Reserve Bank of New York, 1987) at 11. See also, the Estey Report, *supra* note 19. At 323, Estey argues that banks should be kept operating when their failure would have a “serious impact upon the community or upon the Canadian banking system at home or abroad.” However, at

a) *The contagion rationale*

The most frequently invoked *economic* claim for the full protection of depositors is based on the danger of “contagion” effects. Essentially, proponents of this view argue that the failure of one financial institution will, *ceteris paribus*, trigger the failure of other institutions in the industry, and will impair the government’s ability to realize certain macroeconomic objectives. Most often, commentators are concerned with the contractionary effect of multiple financial institution failures on the money supply and the attendant inability of the government to realize certain price and income objectives.⁴⁵

Contagion effects can result from two wholly different types of processes. The first process is informational in nature, and is based on the information-generating effects of a failure. In this case, investors with deposits in other institutions will use the failure event to reassess the soundness of the institutions in which their investments are currently deposited. The fact that an institution has failed could, for instance, implicate the regulatory regime under which that institution was chartered or the location and type of the assets in which the institution invested. In either case, the fact of failure may provide a jolt to investors who realize that their current investments may be in jeopardy. Accordingly, the failure will spawn a race to withdraw funds from “similarly situated” institutions—even if the conclusions drawn by investors respecting the implications of the initial insolvency are largely erroneous. This is due to the strong (and, in some cases, perverse) incentives operating upon depositors to pull their funds on even the most remote possibility of failure.⁴⁶ In the absence of generous liquidity assistance, a whole series of failures could follow from an initial failure.

267, he acknowledges the need to accept the inevitability of failure in the financial system.

⁴⁵ H. Garten, “Banking on the Market: Relying on Depositors to Control Bank Risks” (1986) 4 Yale J. of Reg. 129 at 160-63.

⁴⁶ Once a firm becomes subject to rumours of failure, it is in the interests of depositors to pull their funds out of that institution as quickly as possible so as to avoid bearing any share of the costs of failure should the rumours be accurate. In this climate, extremely strong racing incentives prevail, which undermines the stability of the financial system. In large part, the vulnerability of institutions to rumours and innuendo relates to the concentration of the lending activities of financial intermediaries in asset markets that are highly specialized. Inevitably, an *en masse* withdrawal of depositors’ funds will require the financial institution to recall a large proportion of its demand loans. Not surprisingly, borrowers are bound to generate heavy losses for the institution as they sell off assets securing the loans from the institution in extremely illiquid asset markets. This, in turn, converts a liquidity crisis into a solvency crisis. See, generally, D. Fischel, A. Rosenfield & R. Stillman, “The Regulation of Banks and Bank Holding Companies” (1987) 73 Virg. L.R. 301 at 307-310; and Macey & Miller, *supra* note 40 at 1156-59.

As a rationale for blanket assistance, the information-based contagion argument is troubling. If, as is generally the case, market pressure is thought to have some beneficial effect on the management of financial institutions, then institutions must be free to suffer the consequences of mass withdrawals based on new, accurate, albeit harmful, information. Indeed, these pressures are no different from those that impact on producers in a wide range of economic contexts.⁴⁷ In this context, the appropriateness of counteracting the disciplinary effect of bad news is deeply suspect. As the propensity to intervene becomes widely known, investors will have less incentive to monitor closely the status of the institutions to which they have lent money, which will then increase the scope for shareholder and managerial risk-taking, and ultimately, the breadth of institutional failure.

More difficult, however, is the case in which the information that is disseminated is grossly inaccurate, and unfairly places a well-managed institution under intense market pressure. Here, the issue is not whether some type of public intervention is merited, but the form that intervention should take. As a first measure, regulators should make public statements that explicitly address the status of the embattled institution. Perhaps the credibility of these statements would be enhanced if actual audited financial statements were released. If this fails, the institution should be able to obtain temporary liquidity assistance that prevents a massive sell-off of its assets at drastically reduced prices.⁴⁸ However, in order to ensure that such assistance is furnished only to basically sound institutions, effective safeguards will have to be devised.

The second process responsible for contagion effects is tied less to informational mechanisms and is instead the result of myriad interdependencies that exist among financial institutions in their day-to-day operations. Perhaps the most straightforward of these interdependencies are those that arise through the routine borrowing and lending activities of financial institutions in the settlement and interbank deposit market.⁴⁹ Because financial institutions frequently

⁴⁷ Publicly traded companies, for instance, are subject to discipline in capital markets through the operation of the "Wall Street Rule," whereby aggrieved shareholders of poorly managed companies sell their shares, consequently depreciating the market price of the company's equity.

⁴⁸ G. Kaufman, "Bank Runs: Causes, Benefits and Costs" (Winter 1988) *Cato J.* 559.

⁴⁹ Financial institutions frequently hold investments, especially deposits, in each other. This pattern is largely inspired by government regulation, which provides that a specified percentage of assets be held in cash or equivalent reserves. Among permitted "equivalent" investments are deposits with banks. Since these investments routinely pay interest in excess of other permitted investments, interbank lending is an attractive investment strategy for financial institutions. The size of the interbank market

lend money of varying terms to each other, the failure of any one institution could impair the assets, and hence capital, of other institutions, causing the collapse of the latter.⁵⁰ Concern over this phenomenon was successfully invoked by U.S. federal government officials in the Continental Illinois bailout to justify protection to *all* depositors.⁵¹

The interdependence rationale, particularly in respect of the support it has lent to those advocating complete financial protection for depositors, has been criticized for the dubious empirical claims upon which it relies.⁵² For instance, staff members of the House Committee examining the Continental Illinois failure argued that, of the 179 institutions identified by federal regulators as being vulnerable to failure because of investments in the bank, only 28 were actually at serious risk, providing support for the claim that the danger of widespread systematic injury was greatly inflated.⁵³

underscores its importance—well over \$1 trillion in 1982 (data from the Bank for International Settlements discussed in R.C. Bryant, *International Financial Intermediation* (Washington: Brookings Institute, 1987) at 29). The principal critic of the adequacy of current payment and settlement mechanisms is E. Gerald Corrigan, the President of the Federal Reserve Bank of New York. Corrigan has repeatedly expressed concern with the potential for a failure of a financial intermediary to affect other institutions through the payments mechanism. See Corrigan, *supra* note 44. Risks to bank solvency that are transmitted through the payments system are discussed by R. Clair, “Daylight Overdrafts: Who Really Bears the Risk?” and G. Milano, “Payment System Risk: A Private Sector View” c. 7 and 8 in C. England, ed., *Governing Banking’s Future: Markets Versus Regulation* (Norwell, Mass.: Kluwer, 1991).

⁵⁰ Because the deposits of financial institutions are often obtained from other financial institutions, the solvency of one often impacts directly on the solvency of others. In particular, if an institution holding extensive deposits loaned by other institutions fails, the losses sustained by these other institutions may be high enough to deplete required levels of capital, thereby forcing liquidation.

⁵¹ H. Foulkes, “The Federal Deposit Insurance Corporation: The Rescue of Continental Illinois National Bank and Trust Company” (1985) *Annual Survey of American Law* 137.

⁵² Benston *et al.*, *supra* note 29 at 55-78. At 77, Benston states: “U.S. history suggests that runs on individual banks or groups of banks only rarely spread to other banks that are not subject to the same conditions that started the run, and that most bank runs have been contained by appropriate action, with only minimal and short-lived adverse effects on national financial stability and economic activity.”

⁵³ The FDIC predicted that the failure of Continental Illinois would cause the failure of 66 banks (each of which had more than 100 per cent of its equity deposited in the bank) and would weaken and possibly cause the failure of another 113 banks (each of which had between 50 and 100 per cent of its equity invested in the bank). See memorandum of R. Shumway, Director of Division of Bank Supervision to FDIC Chairman Issac, “Exposure of Downstream Correspondent Banks to Continental Illinois” (20 June 1984) (reprinted in *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank, Hearings Before the Subcommittee on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess.* (1984) at 599). See also testimony of C.T. Conover, Comptroller of Currency at 287. However, as Foulkes, *supra* note 51, observes, there was considerable skepticism expressed regarding the accuracy of these estimates by the staff of the House Committee (Staff of the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, 98th Cong. 2d Sess., *Continental Illinois National Bank Failure and its Potential Impact on Correspondent Banks* (4 October 1984) (reprinted in

Even assuming that interdependencies among financial institutions do exist, which would allow a failure of one institution to threaten others, it is not at all clear that complete depositor protection is an appropriate policy response. As discussed in relation to the information-based contagion rationale, although the extension of complete depositor protection may appear to reduce the prospect of destructive contagion effects, its suppression of market vigilance may in fact increase substantially the actual incidence (hence, costs to society) of failure.⁵⁴ This is so despite the efforts of many commentators to shroud financial institutions in a quasi-public veil.⁵⁵ In these terms, the potential for contagion effects generated by interdependencies could be controlled by a number of different instruments. To the extent, for instance, that potentially perverse interdependencies arise through long-term interbank lending, effective portfolio restrictions limiting the scope of this activity could be implemented. For short-term, settlements-based exposure, the prescription is for more timely settlement. With these *ex ante* controls, the exposure of the financial system to an epidemic of failure should be contained.

b) *Protection of the public purse*

Another economic rationale frequently invoked to support wholesale assistance to depositors is based on preservation of public finances. According to the proponents of this argument, it is cheaper for the government to arrange for the purchase and assumption of the assets of an institution (entailing full protection of depositor claims), even if governmental financial support (in the form of cash infusions,

the House Hearings at 418)). At 145, Foulkes notes that if the benefits of formal deposit insurance protection, the proceeds of a sale of Continental's assets and a decrease in overnight investments as the crisis approached are taken into account, the Staff Committee predicted the failure of only 6 banks and the serious weakening of another 22. If all of these banks failed, only \$58 million would have been lost.

⁵⁴ Surely this is one of the lessons to be learned from the savings and loan debacle in the United States. G. Benston & G. Kaufman, "Understanding the Savings-and-Loan Debacle" (1990) 99 *The Public Interest* 79 at 92.

⁵⁵ This quasi-public role derives from the impact that decisions made in the banking sector can have on broader public policy objectives, such as the control of the money supply or the allocation of capital within the economy. See Corrigan, *supra* note 44 and discussion in the Estey Report, *supra* note 19 at 265, respecting the status of banks as quasi-public institutions. Nevertheless, as a number of commentators have recently noted, the importance of the banking system, as measured in terms of the percentage of capital it attracts in relation to other investment vehicles, mainly market intermediated instruments, is dwindling. See R. Litan, *The Revolution in U.S. Finance*, (Washington: Brookings Institution, 1991). The contracting role of financial intermediaries certainly works to diminish the public importance of these institutions.

loan guarantees, and loan puts) is required. This is because the cost of this assistance is perceived to be lower than the ultimate cost to the insurer of liquidation.⁵⁶ Essentially, high liquidation costs derive from defects in the process by which the assets of financial institutions are transferred to suitable purchasers.

In a first-best world, the sale of assets of a failed institution would be effected by an open, competitive auction process.⁵⁷ To be effective, such a process would require several conditions to be met: (i) multiple, uncoordinated bidders must participate in the auction; (ii) capital markets must work reasonably efficiently so that competent bidders with high subjective valuations of the assets will have the ability, not just the willingness, to pay; (iii) each bidder must be able to form reasonably accurate assessments of the underlying value of the assets subject to auction; and (iv) the process must be completed as soon as possible after a regulatory finding of insolvency or impending insolvency is made.⁵⁸

At first blush, the prospects for an efficient auction model to operate in the financial institutions context seem fairly limited. The primary deficiency with the model is informational in nature. Because of the very illiquid markets in which the lending activities of financial intermediaries are concentrated, there are no ready market reference

⁵⁶ Historically, in the United States, the decision as to how the assets of a failed bank are disposed of has been governed by a statutory cost test that compares the magnitude of the cost to the insurance fund of a standard liquidation with the costs of a purchase and assumption transaction (12 U.S.C. § 1823 (c) (1982)). However, the test is less restrictive than it would appear because of discretion on the part of the regulators to decide whether an institution is insolvent in the first place or "essential to the community," and, therefore, subject to open bank assistance. See Garrett, *supra* note 40 at 1352-60 and J. Portis, "FDIC's Powers After A Bank Failure" (1988) 65 Univ. Detroit L.R. 259.

⁵⁷ Macey & Miller (*supra* note 40 at 1187-91) are sensitive to the innate problems in using the auction model in this setting, and recommend an open bidding process that would allow sufficient time for bidders to prepare a bid. For a discussion of the role of auctions in achieving the privatization of state owned assets in formerly command economies, see R. Daniels & R. Howse, "Reforming the Reform Process: A Critique of Proposals for Privatization in Central and Eastern Europe" [forthcoming]. For a general discussion of the role of auctions, see C. Smith, *Auctions: The Social Construction of Value* (New York: The Free Press, 1989).

⁵⁸ Because of the propensity of management and shareholders to engage in excessive risk-taking on the eve of bankruptcy, government regulators will usually insist on the resignation of management upon a finding of insolvency. (The perverse incentives of management and shareholders in pre-bankruptcy situations is discussed in G. Triantis, "Secured Debt Under Conditions of Imperfect Information" (1992) 21 J. Legal Stud. 225 at 256.) However, to the extent that the institution's managers are replaced by government officials untutored in the management of private sector enterprise, the assets of the institution will be subject to rapid depreciation. These problems are only partially ameliorated by the appointment of interim receivers given the lack of strong external scrutiny imposed by government officials. For a recent discussion of these problems, see K. Yakabuski, "Standard Trust in Worse Shape Than Liquidator Thought" *The Toronto Star* (10 August 1992) C1.

points for lenders to use when assessing the existing value of the failed institution's assets.⁵⁹ As a consequence, each bidder is required to undertake a painstaking, in-depth examination of each of the assets in the portfolio before making a bid. Typically, this will involve the actual on-site inspection of the asset by a trained appraiser, who will be able to assign a value to that asset based on familiarity with prevailing prices in that asset market. Not surprisingly, when the number of assets in a given portfolio is considered, the pre-acquisition investigation process becomes an extremely costly exercise. In addition, since a bidder cannot—assuming a competitive auction—be assured of actually purchasing the assets, the recovery of the costs of pre-acquisition search and analysis becomes speculative. The effect of such high up-front costs on the auction process is predictable: bidders will either refrain from participating in the process at all, or deeply discount the price they are willing to pay for the assets so as to provide a cushion to protect them against the possibility of inflated appraisals.⁶⁰ In either case, the integrity of the auction process is compromised.⁶¹

Ironically, the favoured governmental response to infirmities in the auction process does address the willingness to bid problem, but in a way which erodes private incentives to manage the acquired assets effectively. As Table 1 reveals, the CIBC has frequently been forced to provide loan guarantees and other financial inducements (*i.e.*, giving the buyer the right to put the assets back to the insurer at some stipulated period in the future for the purchase price) to buyers to

⁵⁹ Of course, book value is of little use given the fact that most assets of a failed institution will have declined from their historic acquisition value.

⁶⁰ One of the ways in which CIBC has attempted to lower the magnitude of these entry barriers is by making available the results of the studies they or other regulators have conducted on the assets of the failed institution prior to closure. Nevertheless, given the very subjective nature of the appraisal process in highly specialized illiquid markets, bidders are often desirous of having the pre-bid investigation conducted by their own appraisers. Further, even if the information collected by the government is believed to be accurate, its utility may be undermined by the period of time that passes between the filing of the appraisers' reports and the commencement of the auction. Governmental willingness to disclose the results of these investigations may, therefore, provide only a weak subsidy to potential bidders.

⁶¹ The high up-front costs involved in assessing the underlying value of a failed institution's assets is not the only barrier impeding prospective bidders in the auction process. Governmental restrictions on the eligibility of bidders (because, for instance, a bidder is linked to commercial enterprises, and is, therefore, discouraged from owning a financial institution under federal rules) reduce the number of prospective bidders. In Canada, this restriction means that only a small number of institutions will be anxious to participate in the process. For a critique of the restriction on commercial and financial linkages in Canada, see Conference on Deregulation and Reregulation, *Crumbling Pillars: Creative Destruction or Cavalier Demolition* (Working Paper) by T. Courchene (Lethbridge, Alberta: University of Alberta, 1989).

secure the completion of purchase and assumption transactions. The rationale for such assistance is expressed in terms of its ability to remove some of the debilitating uncertainty that prospective bidders face in valuing assets subject to auction. Nevertheless, by protecting acquirers from the risks of an erroneous valuation, the government commits two serious errors. First, it bestows an undeserved windfall on acquiring institutions that protects them from any depreciation in the value of the acquired assets, even when the depreciation is not in any way related to faulty appraisal.⁶² Second, in comparison to the situation that would result if the acquiring institution were required to bear the full downside risks of its investment, the extension of government financial assistance dulls the incentive for the acquirer to manage the assets effectively. It is far easier for the institution to put the asset back to the government than to expend resources in a cost-justified work-out.⁶³ In this respect, the solution to the problems created by the perverse incentives of deposit insurance does little more than reintroduce many of the most vexing incentive problems under a different guise.

⁶² For instance, an institution that successfully acquires assets from a failed institution, for example, real estate, and later suffers a loss on that investment that can be traced to secular market forces (for example, high interest rates and deflation) should not be entitled to compensation from the government.

⁶³ This problem has arisen recently in the acquisition of the "healthy" assets of Standard Trust by Laurentian Bank. By the end of the first year, more than one third of the assets had been put back to the government. See Yakabuski, *supra* note 58.

TABLE 1
Financial Institution Failures: Amount of Losses to the Federal Government and Uninsured Depositors^a

Name of Institution	Date of Failure	Location of Charter	Asset Size	Resolution ^b	Payment and/or Rehabilitation Cost (\$ m.) ^c	Recoveries to Dec 1991 (\$ m.) ^d	Protection of Uninsured Depositors
Astra Trust Company	July 1980	Fed.	N/A	liquidation	21	18	no
District Trust Company	Mar 1982	Ont.	\$125,600,000	agency/liquidation	231	216	N/A
Crown Trust Company	Jan 1983	Ont.	\$1,095,200,000	agency/liquidation	930	886	yes
Seaway Mortgage Corporation	Jan 1983	Fed.	\$115,300,000	agency/receiver manager	120	120	yes
Seaway Trust Company	Jan 1983	Ont.	\$385,400,000	agency/liquidation	300	236	yes
Greymac Mortgage Corp.	Jan 1983	Fed.	\$219,700,000	agency/receiver manager	174	71	yes
Greymac Trust Company	Jan 1983	Ont.	\$276,000,000	agency/liquidation	240	85	yes
Fidelity Trust Company	Jun 1983	Fed.	\$1,000,000,000	agency/liquidation	791	434	yes
Amic Mortgage Inv. Corp.	Jul 1983	Fed.	\$35,838,473	liquidation	28	7	N/A
Northguard Mortgage Corp.	Dec 1984	Fed.	\$30,000,000	liquidation	28	20	no
Pioneer Trust Company	Feb 1985	Fed.	\$275,000,000	liquidation	201	172	yes
Canadian Commercial Bank	Mar 1985	Fed.	\$3,086,616,000	liquidation	817	0	yes
London Loan Mortgage Corp.	Apr 1985	Ont.	N/A	liquidation	24	19	yes
Western Capital Trust Co.	Apr 1985	Fed.	\$200,000,000	liquidation	77	74	N/A ^e
Northland Bank	Sep 1985	Fed.	\$1,080,696,000	liquidation	651	0	yes

CCB Mortgage Inv. Corp.	Jun 1985	Fed.	\$115,104,326	advisory contract/ receiver manager	47	20	yes
Continental Trust Company	Sep 1985	Fed.	\$129,000,000	liquidation	113	113	yes
Bank of British Columbia	Jun 1985	Fed.	\$3,250,487,000	purchase & assumption	200	0	yes
North West Trust Company	Jun 1985	Alta.	\$760,000,000	purchase & assumption	275	0	yes
Columbia Trust Company	Sep 1986	B.C.	N/A	liquidation	99	97	N/A
Principal Savings & Trust Co.	Aug 1987	Alta.	\$158,000,000	liquidation	116	99	N/A
Financial Trust Company	Sep 1988	Ont.	\$1,500,000,000	purchase & assumption	74	74	yes
Standard Trust Company	Apr 1991	Fed.	\$1,600,000,000	liquidation	1,164	0	no
Standard Loan Company	Apr 1991	Fed.	\$163,000,000	liquidation	157	0	yes
Bank of Credit & Commerce Canada	Sep 1991	Fed.	\$202,515,000	liquidation	22	2	no
Saskatchewan Trust Company	Oct 1991	Sask.	\$60,000,000	liquidation	64	0	yes

- Notes:** (a) Save for the last column, data were furnished by the CDIC. (Correspondence from Karen Sauvé, Director, Legal Services, dated December 31, 1991). Data on protection of uninsured depositors were culled from a review of newspaper reports and, where appropriate, discussion with liquidators.
- (b) "Resolution" by means of liquidation, agency agreement, advisory contract, appointment of receiver/manager, to manage assets of a member institution or a purchase and assumption transaction.
- (c) "Payment and/or Rehabilitation Cost" means outflow of funds from CDIC, Agent, and Government.
- (d) "Recoveries" means inflow of funds to CDIC, Agent, and Government.
- (e) According to *The Financial Post*, deposits of all but about 10 of its 7000 customers were insured by the CDIC. See P. Best, "Financial Troubles Keep Dogging the West" *The Financial Post* (13 April 1985) 1.
- (f) According to the liquidator, B.I. Robertson & Associates, final distributions have not yet been made and it is not possible to estimate if uninsured depositors will in fact bear a loss.

c) *Protection of stakeholders*

It is a striking feature of the argument in support of the adoption of policies which have the effect of protecting uninsured depositors against the risk of institutional failure that this group is seldom identified as the intended beneficiaries of these policies. Instead, attention is usually focused on other stakeholder groups, namely, employees, suppliers, customers (borrowers and lenders), and communities.⁶⁴ For employees, suppliers, and communities, the claim in favour of protection differs little from that made in the context of commercial companies undergoing bankruptcy. Stripped to essentials, the stakeholder protection argument turns on the highly specialized investments (usually in the nature of human capital) that stakeholders have made in their corporations.⁶⁵ Because these investments are not easily diversified by stakeholders, and because they are often made on the basis of erroneous information, stakeholders will suffer serious personal harms when bankruptcy (or any other event which radically upsets pre-existing expectations) occurs.⁶⁶

As in the case of failures of commercial companies, the stakeholder claim suffers from several innate frailties. At an empirical level, it has not been clearly established that commercial failures will, in all cases, irreparably injure stakeholders.⁶⁷ A finding of injury will depend on the alternative opportunities available to the displaced stakeholder, and on the costs of exploiting those opportunities. Obviously, some stakeholders (for example, older, unskilled workers located in one-company towns) will be severely affected by bankruptcy, while other workers (for example, younger, skilled workers located in population

⁶⁴ See, generally, G. Benston & G. Kaufman, *Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options* (Monograph Series in Finance and Economics) (New York: Salomon Brothers Center for the Study of Financial Institutions, 1988).

⁶⁵ For a full elaboration of this claim in the commercial context, see R.J. Daniels, "Mergers and Acquisitions and the Public Interest: Don't Shoot the Messenger" in L. Waverman, ed., *Corporate Globalization Through Mergers and Acquisitions* (Calgary: University of Calgary Press, 1991) 195 and R.J. Daniels "Stakeholders and Takeovers: Can Contractarianism be Compassionate?" U.T.L.J. [forthcoming] [hereinafter "Stakeholders and Takeovers"].

⁶⁶ "Stakeholders and Takeovers," *ibid.*

⁶⁷ This argument is developed by M. Trebilcock *et al.*, *The Political Economy of Business Bailouts* (Toronto: Ontario Economic Council, 1985) c. 3. See also Royal Commission on the Economic Union and Development Prospects for Canada, *The Political Economy of Economic Adjustment* (Background Papers, vol. 8) by M. Trebilcock (Toronto: University of Toronto Press, 1985) c. 1; and "Stakeholders and Takeovers," *ibid.* 65.

centres with myriad employment options) may escape the failure with little long-term damage.

However, even assuming that *some* groups of stakeholders are injured by bankruptcies, it does not necessarily follow that the state should intervene to limit the impact of these transactions. Unfortunately, the lifeblood of a market economy is dislocation and adjustment (Schumpeter's gale of creative destruction).⁶⁸ Without the chaos of restructuring activity, the ability of the market to move resources to their highest-valued use would be impaired. In other words, bankruptcy signals only the death of companies, it does not signal death of the human and physical resources that have fuelled their activities. In these circumstances, a better way to deal with the tragic dislocations occurring in the wake of painful restructuring activity would be to provide humane and timely assistance to deserving stakeholders through generous state-backed adjustment schemes.⁶⁹

So far the claim in favour of protection for stakeholders in the context of financial institution failure has differed little from the more general claim made by stakeholder proponents in the commercial setting. Quite simply, the fact that a financial institution had failed adds little force to the case for stakeholder protection.⁷⁰

Most advocates of specialized protection for financial institutions concede this point, but then argue that the case for special protection does differ when the damage to the interests of borrowers is considered.⁷¹ This damage ranges from benign to severe. At the benign end of the continuum, the failure of an institution may disrupt some of the specialized relationships that have been created between borrowers and the failed institution's employees. Assuming that responsibility for loan monitoring is transferred to another institution upon the demise of the original lender, borrowers will be forced to make additional expenditures on activities designed to familiarize the lender with the borrowers' operations and creditworthiness. For most borrowers, these costs are significant mainly for their annoyance value. At the severe end of the continuum, however, failure may result in the

⁶⁸ Schumpeter, *supra* note 5 at 87.

⁶⁹ The argument in favour of generalized adjustment schemes is made powerfully by M. Trebilcock in *The Political Economy of Economic Adjustment*, *supra* note 67. See also M. Trebilcock *et al.*, *Trade and Transitions: A Comparative Analysis of Adjustment Policies* (London: Routledge, 1990) c. 6.

⁷⁰ As Horvitz has observed, "[t]he failure of the textile mill in a one-mill New England town is almost certainly a greater community disaster than the failure of the local bank in a one-bank town." P.M. Horvitz, "Simulating Bank Competition Through Regulatory Action" (1965) 20 J. Fin. 1 at 3.

⁷¹ I am grateful to Jim Baillie for alerting me to this argument.

immediate termination of the borrower's loans, and precipitate the collapse of the borrower's activities or investments. It is concern over this scenario that drives governmental efforts to salvage financial institutions. By arranging for the purchase and assumption of the entire undertaking of the failed institution, borrowers can be assured that their loans will not be called prematurely, and that their highly personalized lending relationships will be maintained.⁷²

There is little question that premature disruption or, more severely, termination of lending relationships can impose extreme hardship on borrowers, and that this hardship can translate into large scale macroeconomic woes. Nevertheless, as in the case of other stakeholders, the question is not so much one of the legitimacy of protection, but the means of achieving it. Instead of relying on instruments which generate large on-budget expenditures and create debilitating moral hazard problems, governments should invoke a variety of other, more finely honed, instruments to achieve their goals. In the case of borrowers, a policy bundle that involves a mixture of strengthened consumer protection-type legislation for borrowers, combined with more liberal use of macroeconomic stimulants, may well suffice to address the most serious threats to global economic welfare.

4. Summary—compensating for perverse policy and the destructive effect of the regulatory ratchet

In this section, the corrosive effects of two of the core features of financial institution regulation in Canada—flat-rate based depositor insurance and *de facto* full deposit insurance—on the goals of assuring the solvency and soundness of financial institutions were emphasized. By sterilizing depositor incentives for effective monitoring, the current

⁷² Some commentators have questioned the severity of the disruption to stakeholders from a failure. See, for instance, G. Benston & G. Kaufman, "Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Options" (Staff Memorandum 88-1 of the Federal Reserve Bank of Chicago). The authors state at 14, "[t]hus, bank failures generally do not leave communities without banking facilities. Rather, customers are likely to face banks under different managements and ownerships. This may cause some hardships, but these should not be overly severe." Of course, assuming a climate of stable or decreasing interest rates, an acquiring institution will have little incentive to recall the fixed rate loans of a borrower having demonstrated a stable history of credit service. In addition, if the outstanding loans are at floating rates of interest, the direction of interest rate movements should have no impact whatsoever. If, however, the successor institution to a failed bank decides to accelerate loan repayments under its strict contractual rights, a variety of judicial and legislative safeguards will be triggered. See, for instance, notice requirement under s. 244 of the *Bankruptcy and Insolvency Act* (R.S.C. 1985, c. B-3); and *Ronald Elwyn Lister v. Dunlop Canada Ltd.* (1982) 135 D.L.R. (3d) 1 (S.C.C.) (requirement of reasonable period of notice before enforcing security interest after demand made).

system of regulation encourages shareholders and managers of regulated institutions to engage in excessive levels of risk taking which in the long run, increases the probability, and hence the total costs to society, of institutional failure. Nevertheless, despite these infirmities, public decision makers have been unable to abandon their commitment to market suppressing policies. Both in Canada and the United States, flat-rate based deposit insurance and complete protection for depositors in the event of failure, are concepts which have become enshrined in the architecture of regulation. Indeed, close inspection of Bill C-48, the federal government's recent amendments to the *CDIC Act*, shows the resiliency of the commitment to these policies.⁷³

The inevitable effect of continued allegiance to flat-rate based deposit insurance and *de facto* full protection for depositors is an increase in the burden placed on government regulators in the vindication of their safety and soundness mandate. Quite simply, regulation has to work harder to compensate for the rational apathy of depositors and the heightened opportunism of insiders of financial institutions. Inevitably, working harder means the promulgation of more obtrusive forms of regulation—the so-called regulatory ratchet.⁷⁴ The regulatory ratchet is troubling not only for its capacity to erode the sphere devoted to individual liberty in the modern state, but also for its perverse effect on market conduct. Because governments are inherently less competent than market actors in responding to financial incentives, institutions will have more scope for opportunistic risk taking than would be found in a setting of vigorous market oversight.⁷⁵

⁷³ Bill C-48, *An Act to amend the Canada Deposit Insurance Corporation Act and to amend other Acts in consequence thereof*, 3d Sess., 34th Parl., 1992 was the progeny of the Estey Report's (*supra* note 19 at 323-340) recommendation that federal regulators be given enhanced powers to seize and restructure a troubled institution well in advance of actual failure. Embedded in Bill C-48 is a preference for transactions which are designed to protect the going concern value of failing institutions, which, whether intentionally or not, has the effect of conferring extensive protection to uninsured depositors (as well as unsecured creditors). This point was elegantly made by J. Baillie and D. Baird in correspondence dated March 2, 1992 to the Standing Committee on Finance of the House of Commons (Chair: Hon. Murray Dorin).

⁷⁴ Kane (1985), *supra* note 29.

⁷⁵ *Supra* note 10.

B. *Market Impediments and their Impact on the Competitive Federalism Model*

The claim that government regulation has spawned a series of limitations on the effectiveness of market forces is well known. More novel, however, is the claim that these market-suppressing policies also have profound and detrimental effects on the incentives of governmental actors within a federal structure. In particular, as Miller, and Butler and Macey have argued, these policies can cause lower-level governments (that is, states and provinces) to produce regulations that are less responsible than would be observed in a setting characterized by different policy commitments.⁷⁶ This is attributable to the desire of bureaucrats and politicians in lower-level governments to use solvency regulation of financial institutions as a vehicle for vindicating myriad objectives unrelated to solvency, and the scope that the current regime allows for governments to pursue these extraneous goals with impunity.

In the main, the source of these problems lies in the ability of provinces to charter loan and trust companies without having to assume any of the financial costs that are generated when one of these institutions fails.⁷⁷ Instead, the full brunt of liability is borne by the

⁷⁶ See G. Miller, "The Future of the Dual Banking System" (1987) 53 Brooklyn L.Rev. 1; and H.N. Butler & J.R. Macey, "The Myth of Competition in the Dual Banking System" (1988) 73 Cornell L.R. 677. In contrast, however, see Fischel, Rosenfield & Stillman, *supra* note 46 at 335: "Although the existence of twin sets of regulators will inevitably impose some duplication costs, the race to the bottom argument lacks merit." See also K. Scott, "The Dual Banking System: A Model of Competition in Regulation" (1977) 30 Stan. L.R. 1 for a more balanced assessment of the benefits and costs of the dual banking system.

⁷⁷ Interestingly, to the extent that the insurance and regulatory functions of the federal government are not completely fused in one agency of government, there may be scope for externalities to arise within one level of government. Indeed, the Estey Report recommended a consolidation of the supervision and insurance functions of financial regulation into one federal agency in order to capitalize on the natural instinct of the insurer to minimize the risks of failure. (Estey Report, *supra* note 19 at 277). However, since the most onerous ownership and transfer restrictions are contained in federal legislation, and these restrictions erode the commitment of managers to the goal of shareholder wealth maximization, the demand by federally chartered institutions for legislation conducive to excessive risk taking is likely not as intense as that expressed by provincially chartered institutions. This is because when ownership and management functions are severed, and ownership is widely dispersed, management's natural risk aversion will thwart the adoption of strategies that increase shareholder wealth through enhanced risk assumption. (See *supra* note 18 and accompanying text.) Inter-agency competition in the same level of government has also been observed in the United States, and has, predictably, supported calls for consolidation of regulation in one federal agency. See, for instance, J. Robertson, "Federal Regulation of Banking: A Plea for Unification" (1966) 31 L. & Contemp. Prob. 673; and S. Friedman & C. Friesen, "A New Paradigm For Financial Regulation: Getting From Here to There" (1984) 43 Maryland L.R. 413.

federal government in its capacity as national deposit insurer. To the extent that demands have been placed on the CDIC that exceed its available funds, the federal government, rather than requiring the CDIC to obtain additional funds from the industry, will cover the shortfall itself by way of loans from the Consolidated Revenue Fund. However, while the federal government is the residual risk bearer for the costs occasioned by default of *all* insured institutions, its powers of regulation have traditionally been limited to those institutions that it charters. As a consequence, provincial governments—with few modest exceptions⁷⁸—are able to charter and regulate financial institutions without having to assume any responsibility for failure.⁷⁹

The knowledge that the federal government is financially liable in the event of a failure undermines the incentive for provincial regulators to create a regulatory regime that imposes appropriate constraints on industry behaviour. This is a particularly serious defect given the need for second generation financial regulation to serve as a corrective for the perverse incentives introduced by the commitment to flat-rate based insurance and complete protection for depositors. In its most benign form, the regulatory product produced by provincial politicians will simply be indifferent to the costs that lenient regulation can impose on the federal government. However, when one considers the full range of benefits that accrue to provincial politicians and bureaucrats as a result of an indigenous financial industry, the prospects for more active exploitation of the federal government's insurance obligation are heightened.

What form do these benefits take? Disregarding the issue of the personal benefits that provincial bureaucrats and politicians might reap from financial regulation,⁸⁰ the most obvious source of gain derives

⁷⁸ In the Greymac Affair, the Ontario government was held responsible for the costs of liquidation. The Province was also required to contribute to the bail-out of Financial Trustco. (Information provided by Ontario regulators).

⁷⁹ Although Quebec has a separate deposit insurance scheme—the Quebec Deposit Insurance Board (QDIB)—its financial responsibility extends only to Quebec deposits. Consequently, the failure of a Quebec chartered institution with extensive deposits outside of the province would have little disciplinary effect on provincial regulators. (The Agreement outlining the respective roles of CDIC and QDIB (dated December 23, 1968) is discussed in the Annual Report of CDIC for the year ended December 31, 1980 at 13.)

⁸⁰ Bureaucrats and politicians may desire to increase their share of the financial institution regulation market because of the personal benefits they receive in the form of enhanced prestige and power that comes from regulating a powerful industry. According to Butler and Macey, *supra* note 76, it is the rents accruing to government officials, both elected and unelected, that is the central motivating factor behind the desire of governments to protect or expand their share of the market for financial regulation. The more complex and impenetrable the process is to outsiders, the greater the scope for

from the ability of provincial officials to encourage indigenous institutions to fund certain favoured industrial policy projects, thereby obviating an on-budget expenditure.⁸¹ The ability to channel these funds into politically desired uses is valuable, given the increasing fiscal pressure that contemporary governments are under to balance their budgets.⁸² These projects can take a variety of forms, from large-scale infra structural investments (hydro generation plants, roads, *etc.*) to other, less foundational applications (commercial real estate, equity for local industrial companies, *etc.*). Although the precise mix of projects varies from province to province, they all share one basic characteristic: in the absence of an embedded public subsidy furnished by the federal government, provincial financial institutions would be constrained by market forces from investing in them.

Why would provincially chartered institutions be willing to invest in projects that would be shunned in a world of full cost internalization? One possibility is that governmental powers of persuasion are more effective when that government also happens to be the regulator charged with supervising the solvency of chartered institutions. Under this scenario, the owners of financial institutions cave in to both overt and subtle forms of governmental pressure to finance favoured activities. A failure to do so risks the opprobrium of the regulator, which, in a regime characterized by considerable discretion, may inflict great costs on the institution in the long run. The difficulty, however, with the scenario is its crude, overly cynical view of the regulatory process. Most financial institution regulators are dedicated to faithful enforcement of the spirit of solvency and soundness regulation, and would, therefore, not be predisposed to penalizing institutions for failure to follow the whims of the political branch of government.

government discretion, and the greater the ability of officials to extract rents.

⁸¹ Quebec has placed greatest emphasis on utilizing indigenous sources of capital to achieve industrial policy objectives. See A. Saumier, "Musings on Quebec Inc." in T. Courchene, ed., *Quebec Inc.: Foreign Takeovers, Competition/Merger Policy and Universal Banking* (Kingston: Queen's School of Policy Studies, 1990) c. 3 (discusses the role that leading financial institutions within Quebec played in formulating an industrial policy programme for the province in the 1980s); and T. Courchene, *supra* note 61. For a careful critique of the impact of Quebec Inc. on the formation of a national economic union, see Royal Commission on the Economic Union and Development Prospects for Canada, *Economic Regulation and the Federal System* (Background Papers, Vol. 42) by R. Schultz & A. Alexandroff (Toronto: University of Toronto Press, 1985) at 132-37.

⁸² In Canada, fiscal pressure has been greatest for lower-level governments. R. Boadway has argued that this is largely the result of a reduction in the level of subsidies transferred by the federal government to the provinces in support of various shared cost programmes. See Public Policy Workshop, *Shaping Canada's Future Together: One Economist's Reflections* (Working Paper) by R. Boadway (Toronto: Faculty of Law, University of Toronto, 1992).

A more likely explanation lies in the capacity of the provincial legislature to entice institutions to undertake these investments, but on terms that enable lending institutions to increase their risk taking. Given that one of the central tasks of provincial safety and soundness regulation is to temper many of the perverse incentives unleashed by flat-rate based deposit insurance and bank closure policies, legislatures can, by judicious use of portfolio rules, carve out occasions for opportunistic risk-taking in areas that coincide with provincial industrial policy objectives. Thus, by lending in areas deemed desirable by provincial governments, both the province and the owners of provincially chartered institutions will be able to exploit the benefits of subsidized debt at the expense of the federal government. An extreme example of this activity is furnished by the disproportionately high levels of investment that American savings and loan corporations made in regionally concentrated commercial real estate loans during the 1980s.⁸³ Even though these investments were extremely risky (as the collapse of the industry has shown), the industry was permitted (even encouraged) to make them by complicitous state officials anxious to reap the benefits that such lending would produce.⁸⁴ And, as in the Canadian case, it was the federal government as residual insurer who ended up shouldering the financial fallout from this activity.

IV. THE EQUALS APPROACH AND THE DEMISE OF COMPETITIVE FEDERALISM

As long as market-suppressing policies remain a keystone of the Canadian regulatory regime, the prospects for the production of optimal legislation through competitive federalism are bleak. In addition, given the external costs imposed on the federal government through the concerted action of provincial governments and industry actors, financial institution regulation will remain inimical to harmonious federal-provincial interaction. This is especially so when the magnitude of these costs is considered. For example, the bail-out of the Canadian Commercial Bank (CCB) and Northland banks generated costs for CDIC in excess of \$500 million, an amount that vastly exceeds the magnitude

⁸³ Horvitz, *supra* note 70 and Benston & Kaufman, *supra* note 72.

⁸⁴ These benefits range from subsidized commercial premises to the desirable employment effects of real estate construction.

of most government led bail-outs of commercial firms.⁸⁵ Given the scope of federal government responsibility under this system, it is simply inconceivable that Ottawa will continue to countenance the perpetuation of a system in which it is forced to underwrite the self-serving activities of provincial governments and industry shareholders on a virtually open-ended basis.

Indeed, interviews with both federal and provincial financial regulators confirm the growing penetration of the provincial regulatory sphere by both the CDIC and the Office of the Superintendent of Financial Institutions (OSFI).⁸⁶ In the case of the CDIC the expansion of jurisdiction is easily accommodated by the Corporation's statutory enabling authority,⁸⁷ and by the fact that it is difficult, if not impossible, to separate insurance from regulatory functions.⁸⁸

Yet, somewhat surprisingly, the most ambitious incursion into the regulatory domain of the provinces was not launched by Ottawa, but by Ontario in its widely condemned 1987 "Equals Approach."⁸⁹

⁸⁵ See appendix to chapter 1 of Trebilcock *et al.*, *The Political Economy of Business Bailouts*, *supra* note 67.

⁸⁶ Although OSFI is charged with supervising federally chartered institutions, many of its regulatory initiatives (for example, mandating various investment standards pertaining to, *inter alia*, mortgage backed securities and appropriate levels of commercial loans) have influenced provincial regulators in their supervision of provincial institutions.

⁸⁷ cursory inspection of CDIC's enabling legislation (the *Act*, *supra* note 25) reveals extensive statutory scope for the insurance corporation to regulate the day-to-day affairs of provincial institutions once they join the fund. See s. 7(b): "The objects of the corporation are to be instrumental in the promotion of standards of sound business and financial practices for member institutions ..."; s. 11(2)(e): "The board may make by-laws ... prescribing standards of sound business and financial practices for member institutions"; s. 17(b): "On application by a ... provincial institution, the Corporation may insure the deposits held with the institution to the extent and in the manner provided in this Act and the by-laws, if ... the institution agrees, in carrying on its business, not to exercise powers substantially different from the powers exercisable by a [federal] trust company ... and a [federal] loan company ..."; and s. 28, which empowers the CDIC to make annual inspections of provincial member institutions. Interviews with provincial and federal officials confirmed the growing role of the CDIC in regulation of provincial institutions.

⁸⁸ After all, the best way to protect the deposit insurance fund from unanticipated losses is to ensure that member institutions are maintained in a safe and sound condition.

⁸⁹ The Equals Approach was contained in the Province's 1987 modernization of its loan and trust regulation (Bill 116). Critics of the initiative include L. Pelly, "Harmonization: A Federal Perspective" (Prepared speech at the Institute for International Research Conference on the New Financial Services Regulation, 25 February 1992): "While the trust and loan companies may be the main victims of the lack of uniformity, the principal perpetrator of the injustice is the *Loan and Trust Corporations Act (1987)* of Ontario"(at 3). See also J. Chertkow, "Worst Among Equals: An Analysis of Ontario's Equals Approach" (Address to the Canadian Institute, 27 February 1989) [unpublished]; J. Ziegel, "The Regulatory Evolution: Is there Light at the End of the Tunnel" (Prepared Remarks for Insight Conference on Financial Services Reform, 7-8 April 1992); and Senate Standing Committee on Banking,

Essentially, the Equals Approach requires any extra-provincially incorporated loan and trust corporation wishing to carry on business in Ontario to agree to comply with the core regulatory features of Bill 116 before being granted a licence to operate in the province.⁹⁰ By mandating compliance with Ontario's standards for appropriate capital levels, permitted investments, self-dealing restrictions, reporting requirements, and corporate governance structures, the Equals Approach all but nullifies the chartering jurisdiction's loan and trust legislation to the extent that its provisions are more lenient than comparable provisions in Ontario. Since virtually all Canadian loan and trust companies raise at least a portion of their funds from Ontario depositors, this enactment means that the ambit of Ontario regulation now extends to the activities of virtually all Canadian loan and trust companies.

The impact of the Equals Approach on the competitive federalism model is obvious and profound: by insisting that all institutions operating in Ontario comply with Bill 116, the gains from jurisdictional shopping are effectively obliterated. For any institution contemplating activity in Ontario, the Equals Approach means that a non-Ontario charter will only invite additional costs in the form of compliance with duplicative and, in some cases, contradictory legislation, with few compensating benefits.⁹¹ As a consequence, the only real

Trade and Commerce, *Canada 1992: Toward a National Market in Financial Services* (Ottawa: The Committee, 1990). (Because of the Equals Approach, "Ontario regulation and supervision effectively dominates the trust industry, at least for those institutions that wish to access the Ontario market. The Committee's view is that this is unacceptable and must come to an end" (at 72)).

⁹⁰ Unfortunately, however, the courts have not developed a consistent line of jurisprudence respecting what, in fact, constitutes conduct that is so severe as to sterilize federal corporations. Curiously, appellate courts have held that a range of seemingly obtrusive provincial actions, such as expropriation of substantially all of the assets of the corporate undertaking and extensive restrictions on capital raising, are not colourable under the sterilization doctrine. Despite these traditional authorities, it is arguable that if the constitutionality of an initiative like the Equals Approach were tested by a modern court, it may be found *ultra vires* the provinces either on the basis of its destructive effects on interprovincial trade and commerce (trenching on the federal government's s. 91(2) jurisdiction) or on the basis of its deleterious effects on extraprovincial interests. This argument is developed further in R.J. Daniels, "Breaking the Logjam: Proposals for Moving Beyond the Equals Approach" (1993) 22 C.B.L.J. 132.

⁹¹ The violence that overlapping, contradictory legislation has inflicted on the vitality of the competitive model should not obscure an appreciation of the various disabilities that industry members face in undertaking their normal course of business activities. First, with the *de facto* regulatory regime stitched together from the laws of a number of different jurisdictions, the underlying coherence of regulation will be compromised. Obviously, such a "mix and match" system will lack the rigour or legitimacy of a regulatory regime that is the by-product of extensive legislative investigation and deliberation.

Second, because the only safe way to avoid prosecution is by complying with the jurisdiction having the most onerous standards, the regulatory regime that actually governs the conduct of

option for institutions aspiring to enter the Ontario market is to obtain an Ontario charter. And so, in lieu of the competitive provision of legislation, monopoly provision has been unilaterally substituted.

What motivated the Ontario government to fire the shot that marked the end of competitive federalism in the loan and trust area—especially, since it was the federal government that had the most to lose from the continuation of subsidized, provincial risk-taking? The standard explanation offered by Ontario regulators is that the initiative was designed to limit the scope for risk taking by extraprovincially incorporated institutions, most of whom raise the lion's share of their

regulatees will consist of the most restrictive standards of each of the regulating jurisdictions, raising troubling fairness concerns. This concern is heightened when the scope for significant and legitimate differences in the approach taken by regulators to achieve safety and soundness goals in the realm of financial institution regulation is acknowledged. Regulators committed, for instance, to a system of command-based regulation may eschew reliance on internal and external governance controls, preferring instead to rely on an extensive menu of conduct-specific directives, while regulators committed to incentive-based regulation may take the opposite stance. For a discussion of the differences between command and market or incentive based regulation, see R. Howse, "Retrenchment, Reform or Revolution? The Shift to Incentives and the Future of the Regulatory State" (1993) 31 *Alta. L.Rev.* 455. However, if an institution is forced to comply with the most onerous standards of each jurisdiction's regime, it will be precluded from availing itself of the offsets available under each regime, which will place it at a competitive disadvantage in comparison to other institutions regulated by a single jurisdiction.

Third, the actual costs of compliance will be increased for institutions subject to control by multiple jurisdictions. These costs range on a continuum from the trivial to the severe. At one end, the costs of duplicative regulation may be relatively trivial, and be distinguished mostly by its annoyance value. This occurs when the content of regulations does not vary much from jurisdiction to jurisdiction, and the only real burden of multiple regulation relates to the modification of a standard compliance strategy, for example, the filing of essentially similar information across different jurisdictions. At the other end of the continuum, however, the transaction costs of multiple jurisdictional activity may be so severe as to actually deter the consummation of value-increasing transactions. This occurs when conduct deemed permissible by one jurisdiction is expressly prohibited by another. In between these two poles is conduct which contravenes the requirements of one of the regulating jurisdictions, but which that jurisdiction may permit as a result of lobbying by the affected institution and, perhaps, a commitment by that institution to modify certain activities. Of course, neither of these options is without cost to the institution, and may, at the margin, dissuade the institution from actually undertaking the activity. Of course, to the extent that jurisdictional barriers deter multi-jurisdictional activity, cost-efficient diversification may be hobbled, thereby impairing the welfare of the institution's investors (both depositors and shareholders).

A fourth and final defect in a system of multiple, diffused regulation is the erosion of rule of law and public accountability values, both of which lie at the heart of democratic systems of government. This erosion derives from the inevitable compromises to which regulators will have to agree in order to make a system of conflicting laws work. Yet, because mutual adjustment in the laws enforced by regulating jurisdictions is done on a non-transparent basis involving the exercise of considerable discretion, the ability of regulatees to participate in the rule-making process, and then to know with certainty the identity of the laws that will actually be enforced by regulators, is compromised. Some of the core tenets of democratic government, are therefore violated and the prospects for arbitrary and uncontrolled exercises of regulatory authority are greatly increased. (See Janisch, *supra* note 35).

funds from Ontario depositors.⁹² Under this view, the intended beneficiary of the Equals Approach was the Ontario depositor. By insisting that extraprovincially incorporated institutions abide by Ontario laws, the Ontario government sought to reduce the likelihood that these institutions would fail, and take the funds of Ontario depositors' down with them. As such, the Equals Approach can be defended simply on the basis that it is nothing more than consumer protection legislation.⁹³

Nevertheless, despite the surface plausibility of such an account, it suffers from several deficiencies. First, as an empirical matter, the degree of chartering activity undertaken by other provinces is quite marginal, and would not appear to pose a serious threat to Ontario citizens.⁹⁴

Second, given the extensive formal and informal protection offered by the federal government to insured and uninsured depositors, the scope for legitimate concern over the welfare of depositors of failed institutions is quite limited. This is particularly so when decisions respecting the breadth of assistance to depositors are undertaken by the federal government—not the provincial chartering government—upon failure.⁹⁵ Further, even if there are grounds for

⁹² Ontario depositors provide loans and trusts registered in Ontario with 60 per cent of all their deposits (B. Cass, "Complying With the New Financial Services Regulations, Identifying Emerging Market Opportunities, Regulation and Harmonization" (Speech delivered at The Institute for International Research, 25 February 1992) at 9).

⁹³ *Ibid.*

⁹⁴ For instance, in 1989, most of the trust companies incorporated in Canada were chartered with the federal government (56 companies having 85 per cent of the total CDIC insured deposits), with Ontario having 17 firms comprising 10.7 per cent of total industry deposits. Significantly, Quebec aside, there were only 10 institutions chartered in the remaining provinces (3 in Alberta, 1 in British Columbia, 2 in Manitoba, 1 in Nova Scotia, and 2 in Saskatchewan), and the combined insured assets of these institutions was only 3.4 per cent of the total industry's. (I am indebted to J. Lanthier of CDIC for the industry data.) These data reveal in quite arresting terms the fact that, contrary to the claims made by Ontario, the thrust of the Equals Approach is aimed not at provincially chartered institutions outside of Ontario, but at federally chartered institutions and their investors. That is, Ontario, which enjoys the patronage of firms comprising only 10.7 per cent of the total industry's assets, is setting the regulatory agenda for the federal government, which enjoys almost eight times that amount. Given the almost exclusive financial responsibility that the federal government bears for the failure of financial institutions, the necessity, indeed, legitimacy, of Ontario intervening to protect depositors (meaning the federal deposit insurance fund) from irresponsible federal legislation is, to say the least, curious.

⁹⁵ As a consequence, the danger of discriminatory treatment of provincial and extra-provincial depositors upon a failure is substantially reduced. The potential for discriminatory treatment of resident and non-resident investors by a chartering province is more than an academic possibility. Following the collapse of the Principal group of companies in 1987, the Alberta government (which had granted the companies a charter under provincial investment contracts legislation) offered compensation that was proportionate only to the amount of money lost by Alberta residents. Selective treatment of investors

concern over the status of uninsured depositors, the suitability of intervening to protect them is, as argued earlier, highly suspect.⁹⁶

Third, even if one provisionally concedes the possibility that the welfare of depositors is actually at risk from the actions of opportunistic owners of extra-provincially chartered institutions, it is a matter of some doubt whether the mere enforcement of stringent regulatory standards will, in the absence of an integrated, closely coordinated system of supervision, be capable of deterring irresponsible behaviour. Instead, the effect of the Equals Approach may well be to implicate the integrity of the Ontario regulatory regime each and every time an extra-provincially regulated institution fails, without having any meaningful deterrent impact on opportunistic institutional behaviour.⁹⁷

In view of these problems, the motives fuelling the province's adoption of the Equals Approach are somewhat mysterious. Although it could be argued that the policy is designed to shield provincial regulators from the political fallout of an institutional failure—even for a company chartered elsewhere—the fact that the Equals Approach increases the effective scope and depth of regulatory responsibility would appear to increase, rather than decrease, the exposure of provincial officials to a charge of regulatory misfeasance.

Possibly, the answer lies in the desire of Ontario regulators to maintain the province's traditional share of the financial institution regulation market. Under this scenario, it could be argued that Ontario recognized that the adoption of a more stringent regulatory regime would, in the absence of some external constraint, provoke a wholesale exodus of institutions from Ontario to other, more lenient jurisdictions. Such an exodus would reduce the individual welfare of provincial bureaucrats charged with the administration of loan and trust regulation, and also reduce the province's ability to effect any influence over indigenous capital allocation. By adopting the Equals

was designed to place pressure on other provinces to make their own Principal investors whole. See "Playing Regulatory Catch-Up in the Wake of the Code Report" *Financial Times* (24 July 1989) 36. Indeed, the strategy worked. See, for instance K. Howlett, "BC Will Payout \$25 Million in Principal Compensation" *The [Toronto] Globe and Mail* (23 September 1989) B-1.

⁹⁶ As mentioned earlier, the federal government has usually intervened to protect all depositors in a failed institution. However, it has not always done so, leaving open the possibility that in some failures, uninsured depositors will actually suffer a loss on their investment. See Table 1, above.

⁹⁷ The willingness of non-chartering provinces to compensate resident investors for losses sustained on their investment in the Principal Group followed from reports by provincial ombudsmen of provincial regulatory failure—even though the regulatory regime constructed by the host provinces was fairly shallow (Howlett, *supra* note 95). The intense public pressure placed on governments following the failure of an institution is discussed by McGuinness & Abrams, *supra* note 19 at 323.

Approach, the province effectively negated any incentives for companies to migrate, thereby preserving the province's market share.⁹⁸

V. A PLAN FOR REVERSING THE EQUALS APPROACH AND FOR REVIVING COMPETITIVE FEDERALISM

The revival of Canadian federalism in the area of financial institutions regulation calls out for immediate and bold reform. While these reforms should have as their first priority the unravelling of Ontario's Equals Approach, they should not be aimed at restoring the environment that led to its adoption. It is neither realistic nor desirable that a regime which saddled the federal government with the full costs of failure of provincially chartered financial institutions, be resurrected.

In a first-best world, market-suppressing governmental policies should be reformed so that greater discipline is brought to bear on the shareholders and managers of financial institutions, thereby attenuating the risk of loss to the federal government. In the main, enhanced market vigilance could be achieved by the federal government's abandoning its commitment to the twin policies of flat-rate based deposit insurance and full protection to depositors upon institutional failure.⁹⁹ In terms of the former—reform of deposit insurance regulation—policy analysts have advocated the adoption of changes to the existing scheme of deposit insurance which would have the effect of reducing the scope for moral hazard by implementing: (i)

⁹⁸ Scott, *supra* note 76 at 18-31, provides data showing a high degree of mobility of financial institutions between the state and federal governments in the United States in response to changes in substantive regulation. He credits the defection of institutions from a chartering jurisdiction with responsibility for legislative changes that match the innovations introduced in the destination jurisdiction. As in the Canadian case, Scott observes at 33 that "[b]anking agencies apparently respond more vigorously to the loss of existing members than to the prospects of obtaining new members; behaviour is more defensive than aggressive." J. MacIntosh argues that this type of "passive defensive strategy" best describes the behaviour of provincial bureaucrats in the Canadian corporate law market. See J. MacIntosh, "The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law: A Second Look" (Law and Economics Working Paper Series) (Toronto: Faculty of Law, University of Toronto, 1993).

⁹⁹ For a lively debate over the normative and positive dimensions of enhanced market discipline in the control of banking risk, see Garten, *supra* note 45; *supra* note 18; "Still Banking on the Market: A Comment on the Failure of Market Discipline" (1988) 5 Yale J. on Reg. 241; and J. Macey & E. Garrett, "Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments" (1988) 5 Yale J. on Reg. 215.

risk-rated deposit insurance premiums;¹⁰⁰ (ii) restrictions on the operation of brokered deposits;¹⁰¹ (iii) increases in the required level of capital that must be invested by shareholders and subordinated creditors in regulated institutions;¹⁰² and (iv) various co-insurance schemes which would force depositors to share some of the risks of failure with the deposit insurer.¹⁰³ Some analysts have even gone so far as to recommend a complete overhaul of the scope of deposit insurance

¹⁰⁰ The debate over risk rating focuses on its workability, namely, the inability of regulators to make accurate and timely assessments of the overall risk of a given institution's portfolio. See Wyman Report, *supra* note 19 at 27 (risk rating not possible at present time because there is no consensus on objective measurement techniques); Scott & Mayer, *supra* note 29 at 886-895 (authors express concern that risk rating would require too much administrative discretion which would leave exercise open to political pressure); Benston *et al.* (1986), *supra* note 29 at c. 9 (authors recognize administrative, political, and informational defects in government administration of risk rated scheme, and suggest that scheme be supplemented with market information derived from monitoring of net interest margins, rates on brokered deposits, price of unsecured debt, and market value accounting); L. Goodman & S. Shaffer, "The Economics of Deposit Insurance: A Critical Evaluation of Proposed Reforms" (1984) 2 Yale J. on Reg. 145 at 154 (risk rating will increase stress for banks in tight monetary environment, thereby exacerbating economywide problems).

The empirical data respecting the workability of risk rated premiums is mixed. See, for instance, Finance and Economics Discussion Series, *Market Based Deposit Insurance Premiums: An Evaluation* (Working Paper No. 150) by K. Kuester & J. O'Brien (Washington: Federal Reserve Board, 1991) (stock market based, risk adjusted deposit insurance premiums are sensitive to accounting information and have predictive power for future performance, but do not contain all information contained by accounting data).

¹⁰¹ Macey & Miller, *supra* note 40 at 1199-203 (brokered deposits enable troubled institutions to raise insured funds with only modest interest rate premiums. The channelling of funds to marginal institutions forces other institutions to increase the riskiness of their investment activities in order to compete. The scope for brokered deposits should be restricted by placing caps on the aggregate amount of funds an individual can insure across all institutions); Wyman Report, *supra* note 19 at 30-31 (recommends right of CDIC to impose freeze on brokered deposits and restrict percentage of brokered deposits in the asset base).

¹⁰² Working Paper Series, *Capital in Banking: Past, Present and Future* (Working Paper No. WP-1991/10) by G. Kaufman (Chicago: Federal Reserve Bank of Chicago, 1991) (finds level of capital in banking system deficient by historical standards). A number of commentators have endorsed the concept of mandatory levels of subordinated debt in bank capital structure as a way of increasing market discipline. See K. Cooper & D. Fraser, "The Rising Cost of Bank Failures: A Proposed Solution" (1988) 10:3 J. of Retail Banking 5; S. Keehn, *Banking on the Balance: Powers and the Safety Net* (Chicago: Federal Reserve Bank of Chicago, 1989); and L. Wall, "A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt" (July/August 1989) Federal Reserve Bank of Atlanta Econ. Rev. 2. However, empirical data provides only weak support for the ability of subordinated debt markets to reflect bank riskiness: R.A. Gilbert, "Market Discipline of Bank Risk: Theory and Evidence" (1990) 72 Federal Reserve Bank of St. Louis Rev. 1.

¹⁰³ Wyman Report, *supra* note 19 at 28 (10 per cent co-insurance to begin with first dollar, and not to exceed \$100,000). See, however, Senate Committee (1990), *supra* note 89 at 13-14 (rejected Wyman's first dollar co-insurance because of its harsh impact on small depositors who lacked accurate information and instead recommended full insurance for first \$25,000 deposited and 80 per cent insurance for next \$50,000.)

by restricting it solely to those institutions whose investments are restricted to government debt.¹⁰⁴ In terms of the latter—reform of bail-out policies—two proposed changes have received the closest attention: (i) non-discretionary, graduated discipline of institutions (including seizure) informed by actual equity ratios;¹⁰⁵ and (ii) universal adoption of the modified payoff of depositors upon failure (creditors would receive only the expected value of their claims in a failed institution, at the time of failure, irrespective of how the failure is dealt with by the regulators).¹⁰⁶

The adoption of these policies could have a profound effect on the nature of the financial regulatory enterprise in Canada. By internalizing the cost of institutional risk-taking onto the shareholders, managers, and depositors of financial institutions, the efficacy of the system of financial regulation could be enhanced. Further, with an effective, rational system of regulation, a foundation for a vibrant and productive federalism would be laid.

In view of the benefits to be realized from restructuring the system of regulation, the refusal of policy makers to adopt many of the reforms canvassed above is curious. In both Canada and the United States, the policy community is well acquainted with the case for these reforms, but has thus far declined to implement them in any meaningful

¹⁰⁴ The narrow bank proposal has been credited to R. Litan, *What Should Banks Do?* (Washington: The Brookings Institution, 1987). See also J. Kareken, "Federal Bank Regulatory Policy: A Description and Some Observations" (1986) 59 J. Bus. 3; and John M. Olin Program in Law and Economics, *Deposit Insurance and Bank Regulation: The Policy Choices* (Working Paper No. 46) by K. Scott (Stanford: Stanford Law School, 1988).

¹⁰⁵ The American Shadow Financial Regulatory Committee has proposed the adoption of a graduated mechanism for government intervention in the operation of a financial institution that is based on the market value of an institution's invested capital (See "An Outline of a Proposal for Deposit Insurance and Regulatory Reform" Statement No. 41 of the Shadow Financial Regulatory Committee, 13 February 1989, discussed by R. Eisenbeis, "Restructuring Banking: The Shadow Financial Regulatory Committee's Program for Banking Reform" in Kaufman, ed., *supra* note 21, c. 3 at 29-32). Under the scheme, institutions at one extreme having equity to asset ratios exceeding 10 per cent would be subject to only modest regulation, while, at the other extreme, institutions having a ratio below 2 per cent would be subject to mandatory recapitalization and reorganization. Of course, if regulators are able to close a bank at the point of technical insolvency of a financial institution (*ie*, the moment when value of assets dips below value of liabilities and shareholders' equity), then no depositor should suffer any loss on investment, whether insured or not.

¹⁰⁶ To lessen the political resistance to liquidation, commentators have called for the resolution of failure by way of a modified payoff, where insured depositors are paid off in full upon failure and uninsured depositors are paid an amount reflecting the expected proceeds from the liquidation of the failed bank. See Garrett, *supra* note 40; and Macey & Miller, *supra* note 40 at 1184-87. This technique is a useful supplement in the regulatory arsenal when regulators have delayed too long in the closure of a bank.

way.¹⁰⁷ Although the perpetuation of perverse policies can be rationalized in a public choice framework as the by-product of the triumph of salient interest groups over diffuse public interest, this explanation is unsatisfactory.¹⁰⁸ At one level, the winners under these policies (shareholders and depositors of marginal financial institutions) would not appear to have the necessary organizational support to trump other political interests.¹⁰⁹ Further, when the magnitude of the costs that can be inflicted on the public purse from opportunistic risk-taking is considered (at least one hundred billion dollars in the United States from the savings and loan debacle),¹¹⁰ the political saliency of these claims seems even less significant.

An alternative explanation for the continuation of these policies lies in the long-standing devotion of financial institution regulators to secrecy-based regulation.¹¹¹ Given the dependence of capital markets on timely information, the suitability of grafting changes into a secrecy-based system of regulation designed to augment market vigilance is problematic. Without full, timely disclosure of information regarding the status of financial institutions, the ability of depositors to make informed, rational decisions respecting their investments is subverted.¹¹² In the absence of accurate information, depositors are forced to rely on crude proxies (for example, assets, years in business, reputation) for solvency in deciding among competing institutions. In this setting,

¹⁰⁷ See, for instance, S. Labaton, "Final Push to Finish Bank Bill" *The New York Times* (27 November 1991) D1; L. Wayne, "Treasury Criticizes Plan to Limit Bank Insurance" *The New York Times* (19 June 1991) D2; and S. Labaton, "House Panel Bars Proposal to Limit Deposit Insurance" *The New York Times* (15 May 1991) D1.

¹⁰⁸ Mueller, *supra* note 11.

¹⁰⁹ M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, Mass.: Harvard University Press, 1965).

¹¹⁰ *Supra* note 54.

¹¹¹ The basis for secrecy regulation is rooted in the fear that timely release of information containing subjective assessments of the solvency of an institution will spark a debilitating run. In contrast to the premium that regulators of public securities markets attach to the timely and full disclosure of all material information bearing on the value of a given investment, financial institution regulators are much more inclined to withhold material information. The value of information in the operation of economic markets is discussed by R.J. Gilson & R.H. Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 *Virginia L.R.* 549. A graphic example of the tension between the underlying ideologies of the securities and solvency regimes, and the way in which these ideologies inform regulatory behaviour, can be observed in the events leading up to the failure of a publicly traded financial institution—Standard Trust. (See D. Fagan, "Other Trusts Could Fail, Official Tells Hearing" *The [Toronto] Globe and Mail* (14 June 1991) B-3.)

¹¹² A.J. Boro, Jr., "Banking Disclosure Regimes for Regulating Speculative Behaviour" (1986) 74 *Calif. L.R.* 431; and Wyman Report, *supra* note 19 at 29-30.

lending to financial institutions is reduced to a legalized form of gambling, with depositors having to place bets both on the soundness of an institution, as well as on the likelihood that the institution will attract government assistance in the event that it fails.

In these terms, it is clear that the stark incompatibility between market discipline and secrecy-based regulation must be resolved before any amendments designed to increase market oversight can be undertaken to the current system. This is not a trivial task. The commitment to secrecy is deeply embedded in the fabric of financial regulation. Faith in secrecy emanates from bureaucratic concern over the prospect of public embarrassment, even financial liability, arising from a mistaken assessment of institutional soundness,¹¹³ and from concern that increased disclosure would reduce the creative flexibility enjoyed by bureaucrats in resolving financial difficulties without engendering public apprehension and mistrust. In any event, until government officials reduce their faith in the value of secrecy-based regulation, any effort to increase market discipline is vulnerable to criticism based on both efficiency and equity considerations.

Recognizing that the adoption of market-enhancing reforms is, unfortunately, unlikely to occur in the near future, the task of reforming financial regulation in order to support a more vigorous federal dynamic must be achieved through other instruments. One possibility is to marry the right of provinces to regulate financial institutions with the responsibility to insure them. The insurance responsibility could be undertaken in two different ways: (i) by the

¹¹³ The danger of these consequences emanates from the highly subjective, assumption laden nature of the evaluation process. In forming a conclusion as to the soundness of a financial institution, regulators will have to consider a range of complex issues, including the competence of management, the quality of highly illiquid assets in an institution's portfolio, and the risk to the institution from changing market conditions. Since most of these decisions cannot be made solely with accounting data, there is a discretionary component to any conclusion, which invariably invites competing and often contradictory claims from the owners and managers of the subject institution. Indeed, even when business valuations are constructed solely on accounting data, the range of techniques available to the valuator makes the appraisal process extremely capricious. For a discussion of these issues in the context of the corporate law appraisal remedy, see J. MacIntosh, "The Shareholders' Appraisal Right in Canada: A Critical Reappraisal" (1986) 24 Osgoode Hall L.J. 201. Nevertheless, it is important not to overstate the importance or, indeed, legitimacy of these fears. A large part of the data impacting on the solvency of institutions—for example, loan arrears, aggregate capital, and debt to equity ratios—can be gleaned from the periodic unaudited reports filed by the industry, and which can therefore be disseminated without requiring any bureaucratic endorsement. Even where bureaucratic judgment is required, the doctrine of crown immunity effectively insulates bureaucrats from all but the most egregiously malevolent exercise of their discretion.

establishment of stand alone provincial insurance schemes;¹¹⁴ or (ii) by retention of the existing scheme of federal deposit insurance, modified by the creation of risk pools designated by chartering jurisdictions.¹¹⁵ In either case, the costs of failure of financial institutions would be reflected back onto the primary regulator. The virtue of tethering regulation with insurance is straightforward: by insisting that provinces be responsible for whatever costs are generated by the failure of their institutions, the incentive for provinces to game strategically the federal government by offering industry participants lax regulation would be dulled.¹¹⁶ Indeed, assuming that at least some of the costs of failure of institutions within the provincial pool are imposed back on remaining institutions in the form of higher insurance premiums, a crude system of risk rating would be created.¹¹⁷

VI. CONCLUSION

The delivery of various types of corporate and commercial policies through competitive governments has proved to be a durable and, as I have argued, a desirable feature of Canadian regulation. The heartiness of Canadian federalism in many areas should not, however,

¹¹⁴ The formation of provincial insurance schemes is subject to the criticism that, although sensitive to federal government concerns regarding excessive provincial risk taking, it does not address provincial government concerns with the scope for discriminatory treatment among depositors on the basis of provincial domicile. One way to address this problem, without furnishing explicit commitments to *uninsured* depositors, is for provinces to agree to accord the same treatment to depositors located outside the chartering jurisdiction as to those located within. To address the dangers of strategic behaviour, whereby institutions raise all of their funds outside of the chartering jurisdiction, provinces could adopt mutual hostage strategies. (The terminology is from Williamson and is discussed in O. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985) c. 7.) For instance, as a condition of operation, institutions could be required to raise a specified percentage of funds in the chartering jurisdiction, ensuring that provincial governments will not be able to respond to depositor demands in an indifferent or capricious way. Another objection, however, to the formation of provincial deposit insurance schemes is the relatively dismal track record of state run schemes in the United States. K. Scott in "Deposit Insurance—The Appropriate Roles for State and Federal Governments" (1987) 53 Brooklyn L.R. 27 at 41-43 argues that, on *a priori* grounds, the federal government possesses a comparative advantage in the establishment and maintenance of a deposit insurance scheme owing to its superior risk diversification ability and its greater credibility in dealing with financial disasters that require the infusion of a considerable amount of money into the financial system.

¹¹⁵ The concept of segregated pools has been endorsed by the Senate Committee (1986), *supra* note 15 at 4, but on the basis of institutional character, not domicile of incorporation.

¹¹⁶ Nevertheless, the solution is clearly second best given the disparity in the level of sensitivity of bureaucrats and private managers to financial incentives.

¹¹⁷ In this respect, the scheme is analogous to provincial workers compensation schemes that have risk rated pools.

be taken as an assurance of its continued longevity. As the case study of loan and trust legislation has shown, the viability of federalism is delicately related to other government policies and initiatives. To the extent that policies are introduced that tend to distort outcomes generated by federal-provincial competition, the system can be jeopardized. Commentators and policy-makers therefore need to be more sensitive to the effects of substantive policies on the integrity of the federalism framework.

