INSOL INTERNATIONAL

BANK INSOLVENCY, AN INTERNATIONAL GUIDE FOR DEPOSIT INSURERS

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International Association of Restructuring, Insolvency & Bankruptcy Professionals

Bank Insolvency, an International Guide for Deposit Insurers

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As insolvency practitioners, we appreciate that the presence of a well-defined and enforceable set of insolvency laws is vital to the development and growth of a free market economy. This is equally true with respect to insolvencies involving financial institutions holding depository accounts, as was made apparent during the 1990's when financial crises triggered an unprecedented number of bank failures and highlighted deficiencies in global financial systems.

We initiated the development of this book because, despite its importance, there was a common consensus among deposit insurers and insolvency practitioners that there was very limited cross-border information on deposit insurance systems and related insolvency issues. We were fortunate that the Canada Deposit Insurance Corporation conducted in-depth surveys in 78 countries on these issues, and we were able to work with the CDIC to utilize that data to provide our overview.

This book covers six major countries that currently have strong deposit insurance systems in place. We hope that studying these systems will provide useful information about the various types of systems that are currently in use. In particular, we hope that this publication will promote improvements to existing deposit insurance systems and be a useful guide to policy makers in countries that do not currently have deposit insurance systems, but are planning to introduce such a system into their existing legal and financial framework.

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Foreword

It is inevitable that banks will fail in jurisdictions all around the world. If confidence is to be maintained in the banking system, governments cannot allow vast sums on deposit to be lost or large numbers of depositors to be affected. This is because banks play an essential role as intermediaries, transforming depositor funds into loans, thereby generating economic activity and growth. The central role banks play in the economy, the potential for bank runs and the need to mitigate contagion risk — these factors drive countries to establish financial system safety nets, including explicit deposit protection arrangements. Indeed, there are now about 85 deposit insurance systems around the world.

Following the financial crises of the 1990s, the Financial Stability Forum, under the chairmanship of Andrew Crockett, began to look at areas in the financial system where vulnerability to financial instability could be reduced. As part of this process, a Study Group and then a Working Group on Deposit Insurance developed guidance to strengthen limited-coverage deposit insurance systems. That initiative ultimately led to the formation of the International Association of Deposit Insurers (IADI), now headquartered at the Bank for International Settlements in Basel, Switzerland.

IADI's mission is to contribute to the effectiveness of deposit insurance by developing guidance and promoting international co-operation. Its vision of sharing deposit insurance expertise is fulfilled by encouraging wide international contact among deposit insurers and other parties that are directly affected by or involved in deposit insurance such as insolvency practitioners. Similarly, INSOL International takes a leadership role in promoting, facilitating and encouraging greater international co-operation and communication on cross-border insolvency issues.

As part of a research project, INSOL identified the importance of initiating discussions between deposit insurers and insolvency practitioners about effective practices in deposit insurance systems, to promote improvements to existing deposit insurance systems and to provide useful information to countries contemplating the creation of such systems.

In 2002, Canada Deposit Insurance Corporation conducted a survey of 78 countries with deposit protection arrangements systems. Forty-eight countries responded with their submissions in full or in part. The information was updated in 2002/03 and is now available on both the CDIC and IADI websites. The countries that responded are listed in the table on page 4. The papers presented in this publication have extensively used these survey results.

This publication Bank Insolvency, an International Guide for Deposit Insurers provides insight into the various deposit insurance systems and the different approaches taken by the countries covered in the book. It is hoped that policymakers and practitioners will find this resource helpful when establishing or reforming their deposit insurance systems.

J. P. Sabourin
Chair of the Executive Council and President
International Association of Deposit Insurers
and
President and Chief Executive Officer
Canada Deposit Insurance Corporation

Deposit Insurance Systems

Canada Deposit Insurance Corporation conducted a survey on the Deposit Insurance System in 2002 – 2003. The countries surveyed are listed below.

The results can be viewed at: www.cdic.ca and at www.iadi.org

Argentina	Hong Kong	Poland
Bahamas	Hungary	Portugal
Bosnia - Herzegovina	Iceland	Quebec
Brazil	Italy	Romania
Bulgaria	Isle of Man	Slovenia
Canada	Jamaica	Spain
Chile	Japan	Sweden
Colombia	Jordan	Taiwan
Cyprus	Korea	Tanzania
Czech Republic	Lithuania	Trinidad and Tobago
Denmark	Macedonia	Turkey
Ecuador	Mexico	Uganda
El Salvador	Nigeria	UK
Finland	Norway	United States
France	Peru	Vietnam
Greece	Philippines	Zambia

Bank Insolvency, an International Guide for Deposit Insurers

Introduction

The failure of a bank has the potential to trigger a much broader spectrum of harmful consequences than the failure of an ordinary business enterprise. A bank failure may be a direct source of larger losses to other participants in the financial system, and affect the entire financial system's liquidity and stability. An insolvent bank's inability to execute payment instructions may disrupt the operations of payment and securities transfer systems. A bank's insolvency may also cause losses to creditor counterparties in the inter-bank markets. The interruption of transactions, and the resulting loss of public confidence that a bank insolvency may produce, can cause a series of other bank failures and possibly a systemic crisis by jeopardizing otherwise healthy banks and disrupting the intermediation functions of the financial system.[1] Accordingly, bank insolvency is an issue of concern to policy makers and the general public, and the primary goal of any bank insolvency framework must be to safeguard those interests by ensuring the stability of the financial system. Essential components of a stable financial system include: (i) the smooth functioning of payment and settlement systems; (ii) the protection of the depositing public; and (iii) the preservation of the credit intermediation function.[2]

In recent years, it has become increasingly clear that a well-designed financial safety-net contributes directly to a stable financial system. A financial safety-net typically includes prudential regulation and supervision, a lender of last resort function, a governmental body as a ministry of finance, and deposit insurance. The manner in which powers and responsibilities are divided between the various safety-net players is for individual countries to determine. Some countries incorporate all financial safety-net functions within the central bank, while others assign certain responsibilities to separate entities.[3] As will be seen below, an effective Deposit Insurance System (DIS) is one component of a financial safety-net that can have a tremendous impact, not only on public confidence, but also on the success of the banking industry as a whole and the development of a healthy market economy.

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1 See "Legal, Institutional and Regulatory Framework to Deal with Insolvent Banks", Global Bank Insolvency initiative, The World Bank. Washington, D.C., at page 5.

2 Ibid.

3 See "Guidance for Developing Effective Deposit Insurance Systems", Financial Stability Forum, Basel, Switzerland, September, 2001, at page 7.

Background

The late 1990s saw waves of failures of banks and deposit-taking institutions, and financial crises in several nations. In response to these crises, the international community began to recognize the vital importance of banks and deposit-taking institutions to the economic health of a country. The fear of an even greater global crisis, caused by contagion and the domino effect of bank failures, led to a number of international initiatives.

In 1999, the International Monetary Fund (IMF) created the Financial Stability Forum (FSF) and it was chaired in a personal capacity by Andrew Crockett, the then General Manager of the Bank for International Settlements (BIS). The FSF's objectives are to: (i) promote international financial stability; (ii) improve the functioning of markets; and (iii) reduce systemic risk.[4] Recognizing the increasing use of deposit insurance as integral to an effective financial safety-net, the FSF established a Study Group on Deposit Insurance (the Study Group).

Mr. Crockett invited Mr. Jean Pierre Sabourin, President and CEO of Canada Deposit Insurance Corporation (CDIC) to form and chair the Study Group and it was asked to assess the desirability and feasibility of setting out international guidance on deposit insurance arrangements. The Study Group concluded that there was indeed a need for international guidance on deposit insurance to assist countries wanting to enhance or improve depositor protection arrangements, and a Working Group on Deposit Insurance (the Working Group) was established.
The mandate of the Working Group was to "develop guidance on sound deposit insurance arrangements for countries considering the adoption of a deposit insurance system or the reform of an existing one."[5] The mandate specified that such guidance should be developed through a consultative process that included countries interested in deposit insurance issues. The guidance was to be reflective of, and adaptable to, the broadest set of circumstances, settings and structures.[6]
In fulfilling its mandate, the Working Group met with policymakers from 119 countries and, in September 2001, presented a report entitled "Guidance for Developing Effective Deposit Insurance Systems".

The Working Group's final report was welcomed around the world, but deposit insurers sought a forum for the continued discussion of issues related to DIS. In recognition of this need, the International Association of Deposit Insurers (IADI), headquartered at the BIS, was created to foster best practices and provide guidance to deposit insurers and to countries wishing to establish DIS. The development of IADI and the other international initiatives set out above has

4 Ibid at page 5.
5 Ibid.
6 Ibid.

resulted in a greater understanding of the intricacies, issues, and key considerations in DIS, some of which are addressed below.

Basic Issues in DIS

(a) Implicit vs. Explicit DIS

Even in countries with no formal system of depositor protection, a form of implicit protection generally exists by virtue of the public's expectation that some type of government guarantee will be provided in the event of a bank failure. This expectation normally arises as a result of a government's past behaviour or commentary made by officials. As there are no defined guidelines or rules regarding the level of protection or form of reimbursement, implicit protection is characterized by either considerable uncertainty or a sense of complete protection against loss. While the uncertainty can result in depositors monitoring banks more closely, it can also undermine stability when banks do fail.[7]

In contrast to implicit protection is an explicit DIS. Here, statutes or other legal instruments typically set out the framework for the system, and rules are established to govern specific issues, including insurance coverage limits, the types of instruments covered, the methods for calculating depositor claims, and funding arrangements. An explicit DIS leads to certainty by clarifying the authorities' obligations to depositors and limiting the scope for discretionary decisions. A well-designed DIS needs to be supported by prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws. An explicit DIS with clearly defined roles can also provide an orderly process for dealing with bank failures and the settlement of depositor claims.[8]

(b) Moral Hazard

Moral hazard exists in all parts of the financial safety-net largely because of the role that public authorities (i.e. governments and central banks) play in the regulation and supervision of many of the functions and activities of deposit-taking institutions. One of the main challenges in devising a DIS is to create a system that will introduce market discipline and other incentives that will help minimize the risk of moral hazard. The term "moral hazard" is used to refer to the incentive for excessive risk-taking by banks or those receiving the benefit of protection.[9] Where there are no adverse consequences to depositors in an event of a bank failure, moral hazard can manifest in three different ways. First, depositors or other creditors who believe that they will be fully protected from losses have less incentive to actively monitor the health of their bank. Second, financial institutions, aware that depositors will not

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7 Ibid at page 8.
8 Ibid.
9 Ibid.

actively monitor their banks' health, face no competitive disadvantage to offering greater rates of return, even in the face of liquidity problems. Finally, a Supervisor[10] who knows that depositors will not suffer a shortfall in the event of a bank failure may have less incentive to intervene early, when losses may be less severe, in the hopes that the economy will improve or some other event will rescue the bank, rendering intervention unnecessary, and avoiding criticism.

The key to avoiding moral hazard is an explicit system that will respond to hardship, maintain confidence and alter harmful, risky behaviour, without providing a level of protection so great that the consequences of a bank failure cease to be of concern. This balance can be achieved by creating and promoting appropriate incentives through the use of the following: (i) good corporate governance; (ii) sound risk management for individual banks; (iii) effective market discipline; and (iv) frameworks for sound regulation, supervision, and the enforcement of effective laws.[11] In terms of the specific design features of a deposit insurance system, moral hazard may also be mitigated by limiting the amounts insured and excluding certain categories of depositors from coverage. Developing a DIS with the infrastructure to allow the deposit insurer to effect the early closure of troubled banks and take legal action against directors, officers and others where warranted will further reduce the threats of moral hazard.

(c) Interrelationship

As noted above, deposit insurance is an integral part of a country's financial safety-net. However, an effective DIS is only one component of a stable financial system. To ensure financial stability, co-operation and goodwill among all participants in the safety-net is essential. One of the key issues is the sharing of information in an efficient manner, while not compromising confidentiality. Since information sharing and co-ordination of roles will consistently be of key concern, explicit arrangements should be designed to avoid or minimize the unpleasant consequences of conflicts among and between safety-net players. Strong accountability regimes also require effective interrelationships between players as the safety-net is only as strong as the weakest link.

The issue of information sharing illustrates the importance of interrelationships in the financial safety-net. A deposit insurer's information needs will vary significantly based on its mandate and powers. Depending on the breadth of their individual mandates, deposit insurers may need to supplement information provided by Supervisors with information directly collected from member banks. For example, if a DIS implements a differential premium system, it must receive information

[10] The term "Supervisor" where used herein refers to any regulator or person acting in a prudential regulatory capacity.

[11] Supra note 3 at page 8.

directly from each bank. However, the deposit insurer's need for supplemental information must be balanced against imposing an undue burden on the industry, or requiring unproductive information. At a minimum, deposit insurers need information if they are to reimburse depositors' claims when necessary, including information on the amount of insured deposits held by individual depositors. A deposit insurer should have ready access to specific information related to a bank's solvency (potential bank failure) and deposit base, including the amount of insured and total deposits, so plans for resources and funding needs can be developed. Accordingly, guidelines may need to be issued or laws enacted to ensure that banks maintain and safeguard appropriate records.[12]

(d) Human Resources

A vital component of an effective DIS is a skilled staff capable of dealing with the complex and rapidly evolving issues that arise in the financial sector and influence deposit insurance issues. A DIS must be able to attract and retain qualified professionals who possess a unique skill set, not always found in other areas of the financial safety-net. To attract such individuals, policy-makers should provide appropriate remuneration and indemnification in the form of legal protection against lawsuits for actions taken in good faith.

Developing an Appropriate DIS — The Initial Stages

When a country sets out to adopt or reform a DIS, it does not do so in a vacuum; rather, it must devise a system that will fit within the existing financial landscape and institutional structure of the given nation. When looking to develop a DIS, officials are encouraged to first consider the public-policy objectives they are looking to fulfill, and then to conduct a situational analysis to guide their discussions.

(a) Public-Policy Objectives

A clear articulation of the public-policy objectives that a DIS is intended to achieve is crucial at the outset of designing a successful system. In most cases, the principal objectives for any DIS are to "contribute to the stability of the financial system and to protect less-financially-sophisticated depositors".[13]
A well-defined and clearly understood DIS reduces the likelihood of bank runs by depositors. In turn, this leads to conditions for banks and safety-net players that are much more conducive to developing strategies, formulating solutions and

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[12] J.R. LaBrosse (Secretary General of IADI), "Interrelationships and its Role in Promoting Effective Deposit Insurance Systems". Presentation to APEC Policy Dialogue on Deposit Insurance, Kuala Lumpur, February 17. 2004 at slide 5.

[13] Supra note 3 at page 11.

minimizing the cost of failures. The specific DIS components required to achieve these objectives may be markedly different from nation to nation, and will depend on many factors that are unique to each country. In all cases, a system should include clearly articulated roles for officials so that all activities are subject to full accountability and transparency. Independence and integrity should be the basis for internal governance arrangements in a DIS. In order for officials to maintain independence, they should never be given absolute power, but rather the responsibility for delegating power to qualified individuals. There should also be transparent procedures for the appointment of officials, internal audit arrangements, and clear standards for the conduct of personal affairs to maintain integrity within a DIS. Public confidence in DIS will be further enhanced through continuous evaluation and assessment to ensure that the system adapts to economic and social conditions.

(b) Situational Analysis

The purpose of a situational analysis is to determine how a DIS can best achieve its public policy objectives in light of the surrounding and sometimes changing conditions. Included in the factors to be addressed are: the level of economic activity; monetary and fiscal policies; the structure of the banking and legal systems in place; and the current regulatory and supervisory regimes. A thorough review of these subjects will identify areas of concern and may lead to broader reform in the context of establishing or improving a DIS. For example, a DIS that gives its officials powers of early intervention and the ability to close troubled banks will need a sound legal regime, the ability to enforce laws, and individuals with the required skill sets able to formulate and implement effective strategies. If the current legal system is unable to support DIS officials in fulfilling these functions, policymakers may be forced to seek the adoption of new legislation to give effect to those powers. In some circumstances, a legal system may be fundamentally incompatible with granting DIS officials broad powers of intervention and the DIS will have to be adapted accordingly. With the introduction of so many deposit insurance systems over the past decade, the need for specialized training has become increasingly evident and IADI has been active in identifying organizations that can help to address these needs.

The Structure of a DIS

Once a situational analysis has been completed, policymakers must determine the mandate, powers and structure of the DIS. As discussed above, part of this undertaking requires that policymakers contemplate how interrelationships will function between the deposit insurer and other regulators and supervisors that collectively make up the financial safety-net system within a country. Whether there is a strong prudential regulatory and supervisory system for financial institutions, and a sound legal framework for dealing with weak institutions, policymakers will need to take these factors into account as they will influence the mandate and powers granted to the deposit insurer.

Mandates of deposit insurers can be described and characterized in many different ways. For the purposes of this paper, the mandate and powers of a deposit insurer may range from a deposit insurer with a limited role of simply making insured deposit payments in the event of the failure of member financial institutions (referred to in this paper as a deposit insurance system with a "paybox" mandate) to one of being fully and independently responsible for managing all of the risks that it faces as a deposit insurer (referred to in this paper as a deposit insurance system with a "risk management" mandate), with a continuum of options in between. Schedule "A" summarizes the main characteristics of these two DIS models, discussed below.

(a) Paybox Mandate

In a pure "paybox" system, the deposit insurer's mandate is limited to paying the claims of insured depositors after a member institution has failed and to dealing with the recovery of assets in the event of a payout. In its most extreme form, a "paybox" deposit insurer would not be responsible for maximizing recoveries in the event of a failure of a member institution. However, a continuum of "pay box" deposit insurance systems exist in practice ranging from the "paybox" without responsibility for maximizing recoveries to a "paybox" mandate responsible (and held accountable) for maximizing such recoveries.

Despite the range of "paybox" deposit insurance options, a deposit insurer with a "paybox" mandate would not be responsible for minimizing its exposure to insurance loss (i.e., actively identifying and managing deposit risk exposures in advance of the failure of a member institution) as such a requirement would necessitate that the deposit insurer transform from a "paybox" role to that of a "deposit insurer with a risk management" role (and be given powers far beyond that of "paybox", such as powers to intervene in situations in which the failure of a member institution was likely).

Deposit insurers with a "paybox" mandate (irrespective of whether the deposit insurer is also accountable for maximizing recoveries in the event of a failure of a member institution), have limited need to interact with member institutions while such institutions are in sound financial condition (except perhaps to collect deposit insurance premiums that are typically paid by member institutions) or to interact with regulators and supervisors (except in situations in which an member institution has failed). The inter-relationship issues faced under a “paybox” system are limited mainly to accessing (post failure) deposit information crucial to the timely and effective (and in the case of recovery maximizers, efficient) reimbursement of insured depositors of a failed member institution, to obtaining funding to make payments to insured depositors and to collecting deposit insurance premiums. “Paybox” systems also require the appropriate authority to access depositor information (which is highly confidential), as well as access to adequate funding to make insured deposit payments.

One cited benefit of a “paybox” deposit insurance system is the minimum resources required to administer the system. Although the costs may appear low, a failure to hold the Supervisor or deposit insurer explicitly responsible for the costs of resolving failures may cloud the overall cost to the regulatory-supervisory framework and the financial system as a whole. This is because a lack of a specific loss minimization responsibility in the system may create an incentive to practice “regulatory forbearance”. Supervisors may be reluctant to intervene in a troubled institution for a number of reasons, including the potential for an improvement in the economy or the possibility of an injection of capital from another (often undefined) source. If Supervisors have the sole responsibility for intervening, they may be less likely to risk criticism by doing so if they believe depositors will be protected, in whole or in part. This reluctance ultimately may result in larger losses to the financial system as a whole than would otherwise result in the presence of a healthy tension between the Supervisor and the deposit insurer (when contemplating intervention).

Despite some potential shortcomings, a “paybox” deposit insurance system, if thoughtfully implemented, may represent the most appropriate system for protecting depositors in financial institutions in some countries.

(b) “Risk Management” Mandate

On the other end of the deposit insurance mandate spectrum from that of a “paybox” is a deposit insurer with a full “risk management” mandate. In its most extreme form, such a deposit insurer independently undertakes activities to ensure (and demonstrate) that its risks are being managed prudently, appropriately, effectively and efficiently. This requires such a deposit insurer to: (i) set conditions for deposit insurance (which provide grounds for taking intervention against member institutions that do not meet these conditions); (ii) accept (or reject) applications for deposit insurance coverage (thereby avoiding an unwarranted insurance risk at the outset); (iii) assess the deposit insurance risk posed by member institutions (through the conduct of on-site examinations and off-site assessments); (iv) intervene in situations in which the insurance risk is deemed unacceptable; (v) reimburse insured depositors (in the event that the difficulties being experienced by the member institution are of the kind, or to a degree, that result in the deposit insurer having to pay the insured claims of depositors); and (vi) maximize recoveries in the event of interventions against member institutions. However, deposit insurers with a “risk management” mandate typically operate as one component within an overall financial institution supervisory system within a country with the various components of supervision (i.e., regulation, financial soundness supervision, market conduct supervision, deposit insurance and the payments system) being conducted by more than one authority. Under such a scenario, a “risk management” deposit insurer normally would not conduct its affairs in complete isolation of the other members of this supervisory system. Rather, it would coordinate its activities with these other authorities in order to ensure that the system as a whole was operating both effectively and efficiently.

The Canadian deposit insurer, CDIC, is an example of a “risk management” deposit insurer that operates in coordination and cooperation with the other supervisory authorities within Canada. CDIC’s stated objectives are to: (i) provide insurance against loss of deposits with member institutions; (ii) promote standards of sound business and financial practices for member institutions; (iii) promote and otherwise contribute to the stability of the financial system in Canada; and (iv) pursue its objectives in a manner that minimizes CDIC’s exposure to loss. In order to effect its mandate, CDIC has the broad range of powers noted above, including the ability to control entry, make requests for information, conduct special and preparatory examinations, terminate the policy of insurance where necessary, and petition for the winding-up of a troubled institution. CDIC also is able to guard against excessive risk taking by charging differential or “risk-based” premiums where member institutions are not meeting CDIC’s insurance conditions. While previously performing the function of a “paybox” insurer (and thus subject to decisions of the Supervisor related to closure) CDIC’s recovery rate on failures was 52 cents on the dollar. Since its mandate was changed to that of a risk manager (with a specific loss minimization object), CDIC’s recovery rate on failures has declined on average to 17 cents on the dollar.

Irrespective of its form, “risk management” deposit insurers normally would be involved in all aspects of an institutions activity including its incorporation, ongoing activities and decisions concerning closure, as the case may be.

On the positive side, a “risk management” deposit system aligns the deposit insurer’s responsibility for prudently, appropriately, effectively and efficiently managing the risk (and the costs and potential losses associated with incurring the risk) stemming from this mandate with the range of powers required to fulfill this type of mandate (e.g., those powers described above).

On the negative side, a “risk management” deposit insurer could be perceived as engaging in activities that may appear to be duplicative of activities being conducted by other parts of the financial safety-net (although arguments could be made that such activities are not duplicative given that the mandate of the deposit insurer of identifying potential member institution failures and of determining and minimizing potential losses related thereto is different than the typical mandate of Supervisors, or that checks and balances between depositors and Supervisors is beneficial for the financial system).

(c) Conclusion

To be successful, a DIS must operate within a framework with a number of attributes:

(i) There must be a clear and well-defined mandate and role of the deposit insurer and the other authorities that comprise the country’s regulatory and supervisory system so as to avoid duplication and minimize conflict.

(ii) The mandate of the deposit insurer must be supported by appropriate and effective powers that are aligned with the achievement of the mandate.

(iii) The regulatory and supervisory system requires the clear articulation of information required by the deposit insurer in order to achieve its mandate, and appropriate and effective mechanisms that ensure the provision of this information to the deposit insurer on a timely basis.

The Role of a Deposit Insurer in Failure Resolution

In designing an overall system to address bank insolvency, a country must choose between one based on the type of proceedings generally applicable to insolvent corporations (with appropriate modifications) or a special regime designed exclusively for banks. Regardless of the type of system implemented, specific guidelines on when a regulator should intervene and the role of the deposit insurer, during and post-intervention, will be required.[14] Effective strategies for dealing with failed banks will enhance confidence in the financial system and help avoid adverse effects on the banking industry as a whole.

From a deposit insurer’s perspective, the objectives of an effective failure-resolution process are to: (i) ensure depositors are reimbursed promptly and accurately; (ii) minimize resolution costs and disruption of markets; (iii) maximize recoveries on assets; (iv) settle *bona fide* claims on a timely basis; and (v) reinforce discipline

[14] Supra note 1 at Chapter 2.

through legal actions where appropriate.[15] The FSF Working Group defines "resolution" as "a method of disposing of a failed bank, which is directed by the responsible safety-net participant, and generally is designed to reimburse insured depositors while minimizing costs to the deposit insurer."[16] There are three basic resolution options available through which deposit insurers can hope to achieve their objectives, namely purchase-and-assumption transactions (sales), open-bank financial assistance, and liquidation. A review of each of these alternatives is helpful to understanding the variety of roles a deposit insurer may perform in failure resolution.

(a) Purchase-and-Assumption Transactions (Sales)

In a purchase-and-assumption transaction, the viable part of an insolvent bank's business is transferred to another institution (such as a healthy bank) or a group of investors. In some cases, the acquirer assumes all of the bank's assets and liabilities, resulting in almost a full merger. In other cases, only a portion of the insolvent bank's business assets and obligations are transferred, similar to a partial merger. In all cases, the acquirer purchases only assets and liabilities, but not the corporate entity or its license. The insolvent bank is maintained as a legally distinct entity, and the Supervisor must still deal with the restructuring or liquidation of any remaining operations.[17]

A variation of the purchase-and-assumption method often used to deal with failures of large and complex banks is the "bridge bank" technique. Here, the appropriate safety-net participant takes ownership or control of the failed bank, and operates it for a period of time until a permanent resolution can be found. In Canada, the *Canada Deposit Insurance Corporation Act* (the "CDIC Act") allows for a form of a bridge bank arrangement wherein CDIC may take temporary ownership of a failed institution in order to preserve value and explore resolution alternatives. To date, the CDIC Act provisions that provide for this type of action have not been used.

Depending on its mandate, the role of a deposit insurer where a purchase-and-assumption transaction is the chosen method of resolution will vary, especially with respect to information requirements. A deposit insurer with a paybox mandate will require broad access to depositor information in order to ensure that depositor claims are administered efficiently, and that claims are not paid to depositors whose liabilities have been acquired by the healthy bank. A deposit insurer with a full risk minimization mandate will want access to information on the acquirer, in order to evaluate whether the transaction will in fact be beneficial, or whether a different resolution method would offer greater cost savings and better protection to depositors in the long term.

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[15] Supra note 3 at page 31.
[16] Ibid at page 32.
[17] Supra note 1 at page 43.

(b) Open-Bank Financial Assistance

An alternative method of resolution is to provide financial assistance to an operating bank that is in danger of failing. This is typically done in situations where closing the bank would pose a considerable threat to the stability of the financial system. A deposit insurer with a paybox mandate will have little or no input into the details of this type of resolution, as claims of depositors need not be paid. On the other hand, a deposit insurer acting as a full risk-manager may play a major role in brokering the arrangement; it may be required, for example, to retain ownership rights in the bank and additional capital from outside investors; or to replace existing managers and directors.[18] In this type of resolution, uninsured depositors and certain other creditors typically remain fully protected, while bondholders and shareholders may be exposed to significant losses.

(c) Liquidation

A third method of failure resolution, and perhaps the one in which deposit insurers have the greatest involvement, is liquidation. In liquidation, a failed bank is dissolved after a Special Administrator[19] assumes legal control of its estate, collects and realizes on its assets, and distributes the proceeds to creditors in accordance with the principle of equal *(pari passu)* treatment for similarly situated creditors. To be successful, a liquidation framework should comprise clear rules for formally placing the bank in liquidation, terminating the bank's activities, and assigning the responsibility for overseeing the process to a qualified official.

The role of a deposit insurer in a liquidation will in large part depend on the ranking of depositor claims. The priorities applicable to the distribution of funds among claimants are typically governed by legislation. Priorities of distribution are also affected by the collateralization of the bank's obligations, and the extent to which a creditor's debts to a bank may be set-off against the creditor's claims.

(i) Depositor Ranking in Liquidation

When creating a DIS, policymakers need to be cognizant of the potential impact of depositor priority laws or statutes on the ultimate failure-resolution costs to be borne by the insurer. If depositor claims have a priority over other unsecured creditors, the deposit insurer will clearly be a major stakeholder in the liquidation, and perhaps the only stakeholder that can realistically expect recovery. In this type of situation, the deposit insurer is likely to assert a tremendous influence on the liquidation process, and the DIS may be structured accordingly to allow for the benefits of such priority to be optimized. For example, in the United States, where depositors are granted

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[18] Supra note 3 at page 33.

[19] The term "Special Administrator" where used herein refers to a liquidator or any other person charged with administering the assets of a failed bank.

a priority over unsecured creditors, the Federal Deposit Insurance Corporation (FDIC) is also responsible for liquidating the assets of a failed bank and settling its claims. In its role as a Special Administrator, the FDIC is in an ideal position to protect its interests, reduce costs, and maximize the value of the estate (i.e., by diligently pursuing directors where appropriate and scrutinizing the validity of creditor claims).

In contrast to the position of the FDIC in the U.S., depositors in Canada have no priority over unsecured creditors. When an institution fails, CDIC, when it "steps into the shoes of depositors", is obligated to reimburse insured depositors for the full amount of their claims, up to the statutory limit of $60,000. CDIC, uninsured depositors and all other general creditors then have equal standing and receive a proportionate return on their claims from the proceeds of the liquidation of the assets. CDIC monitors troubled banks, consults with the Supervisor, and determines whether a formal liquidation is the least cost solution. If the liquidation route is chosen, CDIC works closely with the Special Administrator to optimize recoveries. As is illustrated by the case of CDIC, policymakers faced with a legal framework that does not provide for depositor priority should create a DIS with clearly defined interrelationships among safety-net players. This will ensure that the deposit insurer has input in all stages of the liquidation process.

(ii) Collateralization

When developing a DIS, policymakers should be mindful of the effects of collateralization. In some countries, the deposit insurer, depositors and unsecured creditors share only in the unencumbered assets of the failed bank; as such, their recoveries are reduced by the collateralization of other parties' claims. Where there is extensive collateralization of a bank's liabilities, the deposit insurer may face increased costs and a reduced ability to provide financial assistance to a troubled bank, as certain assets may be unavailable. Collateralization may also lead creditors to attempt to mitigate losses by making early withdrawals or shortening maturities.[20]

(iii) Rights of Set-Off

The term "set-off' is used to refer to the situation where the claim of a creditor in an insolvent bank (i.e. a deposit) is deducted from a claim of the bank (i.e. a loan) against the creditor. Where set-off is provided for, creditors who are also debtors of a failed bank may increase their recoveries, possibly even above the insured limit, with the effect that other creditors' recoveries are reduced. One positive feature of set-off is that is can lead to a decrease in administrative costs by reducing the number of individual creditors and debtors. In determining

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[20] Supra note 3 at page 39.

whether or not set-off should be allowed, a key issue for policymakers to consider is whether it should apply to all loans, or be restricted only to those due or in default. Many countries restrict set-off in cases where the loan is in default, as set-off against a performing loan could result in a “call” on a loan to a viable business. Furthermore, set-off obligations against loans in good standing may reduce the value of such loans as a realizable asset. Given the potential impact set-off may have in a bank insolvency, it is crucial that the circumstances in which set-off will be applied are clearly articulated.[21]

Conclusion - DIS in the World Today

The foregoing discussion was intended to provide a glimpse into issues faced by policymakers and the key considerations they must address when creating a DIS. Thanks to the work of international groups like the FSF Working Group on Deposit Insurance and IADI, there is now a broad network of practitioners eager to share their experiences in resolving bank failures and develop methods for enhancing the effectiveness of DIS worldwide. At present, 85 countries have a deposit insurance agency or some type of depositor protection in place. The vast majority of IADI’s 34 members are national organizations, and there is a continuing effort to increase membership and participation of organizations interested in deposit insurance issues. As part of its continued role as the leader in the field of deposit insurance, CDIC has done its part to foster DIS education and awareness through its strong support in the creation of IADI and in administering the International Deposit Insurance Survey. The purpose of the survey is to gather information from deposit insurers and share the information with the international community to assist policymakers in establishing or reforming a DIS. The ultimate hope is that the results of the survey will form a body of qualitative and quantitative data, to be updated on a continuous basis, in order to facilitate practitioner-focused research.[22]

The survey was conducted between April 1st, 2002 and September 30th, 2002, and contained over 163 questions on 14 areas of deposit insurance. In the summer of 2003, CDIC asked participants to update their answers to ensure that the evolving body of knowledge remains current. [What follows is a summary of those answers.]

John Raymond LaBrosse, *Secretary General, International Association of Deposit Insurers*
Gale Rubenstein, *Goodmans LLP*
Robert O. Sanderson, *KPMG LLP*

21 Ibid.
22 Summary of the CDIC International Deposit Insurance Survey (IDIS) Results, online: international Association of Deposit Insurers <http:www.iadi.org> (date accessed: March 31, 2004).

Schedule A

MANDATE	PAYBOX	RISK MANAGEMENT
POWERS	• Reactive (e.g. clean-up, liquidation) • Insured deposit payouts • Maximize payout recoveries	• Proactive (e.g. risk identification, risk assessment and management) • Setting deposit insurance conditions • Accepting (or rejecting) applications for deposit insurance • Assessing deposit insurance risk • Intervening against problem member institutions • Paying insured depositors • Maximizing payout and intervention recoveries
INTERACTION DURING LIFE CYCLE OF INSTITUTIONS (BEGINNING, MIDLIFE, END)	• Failure	• Beginning, Midlife, Troubled
EFFECTIVENESS AND COST MINIMIZATION	• Low	• High
INTER-RELATIONSHIP ISSUES	• Mainly information sharing	• Requires well-defined roles, responsibilities, co-ordination information sharing and co-ordination
FINANCIAL RESPONSIBILITIES	• None or Recovery Maximization	• Loss Minimization

CANADA

Deposit Insurance Systems - Canada

1. Objectives, Mandates & Powers

The Canada Deposit Insurance Corporation (“CDIC”, sometimes referred to herein as the “Corporation”) was created by an act of the federal parliament of Canada in 1967 to insure depositors in banks, trust companies and loan companies against loss. Its current stated public policy objectives are to:

(a) provide insurance against loss of deposits with member institutions;

(b) promote standards of sound business and financial practices for member institutions;

(c) promote and otherwise contribute to the stability of the financial system in Canada; and

(d) pursue the above objects for the benefit of depositors and in such a manner as to minimize CDIC’s exposure to loss.

The public policy development process is a continuous one; CDIC’s objectives (and mandates) have changed over time to reflect changes in the financial sector and government priorities and planning. Reviews of CDIC’s public policy objectives are conducted, at a minimum, at five year intervals.

CDIC is government legislated and administered, and is provided with a number of powers in order to facilitate an effective deposit insurance system (“DIS”). CDIC determines whether to pay depositor claims and has the ability to enter into contracts and to set regulations and by-laws. CDIC also has the authority to establish the terms and conditions of membership, and to terminate the insured status of a member institution. CDIC is given access to depositor information (both from member banks and supervisory authorities) and has the power to use various methods for reimbursing depositor claims. With respect to enforcement and intervention, CDIC has a broad range of powers, including: (a) conducting examinations and/or reviews; (b) setting guidelines for member institutions; (c) cancelling deposit insurance of a member institution; and (d) holding officers and directors accountable for failed institutions. In failure situations, CDIC has the authority to decide on the appropriate forum of failure resolution and to provide financial assistance (by purchasing assets from the institution or some other process). CDIC has the ability to undertake formal liquidation, purchase and assumption (sale and merger), and open assistance (bridge bank). CDIC also has the ability to act as a receiver and/ or liquidator.

2. Governance

CDIC is a legally separate organization that is governed by a board of directors (the "Board"). There are eleven directors including the Chairperson. Five directors are ex-officio (i.e. they hold other offices), namely, the Governor of the Bank of Canada, the Deputy Minister of Finance, the Superintendent of Financial Institutions (the "Superintendent"), an Assistant Superintendent of Financial Institutions and the Commissioner of the Financial Consumer Agency of Canada (the "FCAC"). The Chairperson is appointed by the Governor in Council (Cabinet) and the five other directors from the private sector are appointed by the Minister of Finance with the approval of the Governor in Council (Cabinet). These directors cannot be directors, officers or employees of member institutions.

The *CDIC Act* gives the Board authority to make by-laws or regulations (i.e. subordinate legislation) on a wide range of matters. A few of these by-laws (those which can be viewed as having a "tax-like" quality, such as the by-law for the assessment of premiums) require the approval of the Minister of Finance; most do not.

The CDIC Board is responsible for the selection and oversight of senior management and the responsibility to review management, operations and the performance of the organization against expected results. This includes the requirement that the Board ensure that there be in place effective strategic and risk management processes.

CDIC is managed by the President and Chief Executive Officer (who is also a Governor in Council appointee) and officers appointed by the Board. CDIC fulfils its mandate through two primary management functions:

(a) Insurance and Risk Management Division, which is concerned with assessing, reducing and managing risks as well as managing pay-outs when needed and maximizing the return on CDIC's claims and recoveries arising from the liquidation of assets of failed member institutions. CDIC utilizes a variety of Board, inter-agency and special advisory committees to assist in the conduct of its affairs.

(b) Corporate Affairs Division and a Finance and Administration Division which both report to the CEO.

3. Information Sharing & Interrelationship Among Safety-Net Players

At the federal level in Canada, the primary supervisory authority with which CDIC communicates and co-ordinates its activities is with the Office of the Superintendent of Financial Institutions (“OSFI”). At the provincial level, it interfaces with regulators of provincially incorporated trust and loan companies. CDIC also communicates and co-ordinates on a regular basis with the federal Ministry of Finance on issues pertaining to policy, legislation and regulation, and with the Bank of Canada on issues related both to the payment system and to the Bank’s status as lender of last resort.

Information-sharing at the federal level is generally facilitated by the Financial Institutions Supervisory Committee (“FISC”). The FISC is established under the provisions of the *OSFI Act*. Its mandate is to facilitate consultations and the exchange of information among its members (the Superintendent of Financial Institutions, the Chairman of CDIC, the Governor of the Bank of Canada, the Commissioner of the FCAC and the Deputy Minister of Finance) on all matters relating directly to the supervision of federal financial institutions. The committee is chaired by the Superintendent and meets as often as required.

CDIC and OSFI have created several mechanisms to improve effectiveness in the performance of their respective roles and responsibilities. These mechanisms include: a “Guide to Intervention for Federal Financial Institutions”, which sets out the roles and responsibilities of the two agencies when dealing with supervisory issues and interventions; a Strategic Alliance Agreement, to enhance the ability of both agencies to perform their mandates efficiently; and the OSFI/CDIC Liaison Committee to address both specific and industry-wide issues.

There are also coordination mechanisms between CDIC and provincial regulators. These mechanisms include: monthly meetings with each provincial regulator designated to examine member institutions on behalf of CDIC; regular meetings with other provincial regulators that supervise CDIC members; and annual meetings with all regulators (federal and provincial) to discuss issues of common interest and concern.

4. Membership

In Canada, membership in a deposit-protection scheme is mandatory for all retail deposit-taking institutions. To become a CDIC member, an institution must be a bank, or a federally or provincially incorporated trust or loan company. Deposit-taking institutions operating as cooperatives (co-ops or credit unions) are insured by their incorporating provincial governments. Insurance companies and investment houses which offer “deposit-like” products belong to insurance schemes operated by their industries.

All deposit-taking institutions in Canada must obtain approval from two sources before they are able to accept deposits from the public. The first step is to receive approval to incorporate. The Minister of Finance (the “Minister”) approves the incorporation of federal financial institutions on the recommendation of the federal regulator; provincial authorities approve the incorporation of provincial financial institutions. The second step is to receive approval for deposit insurance. Under the provisions of the *CDIC Act*, the CDIC Board may consider applications for deposit insurance only from financial institutions that are incorporated and licensed under the *Bank Act*, or federal or provincial trust or loan companies legislation. Where the applicant is a provincial institution, the institution must also be authorized by the province of incorporation to apply for deposit insurance.

The Insurance and Risk Assessment Division (“IRA”) of CDIC reviews and analyses applications and prepares a summary report and recommendation to CDIC’s Board for approval or rejection of the application. Once the Board has reached a decision, all interested parties are notified. The decision can be one of unconditional approval, conditional approval or rejection with no appeal process.

As part of the approval process, the institution under scrutiny must agree to abide by CDIC’s Policy of Deposit Insurance, which is a comprehensive policy of deposit insurance to which all members are subject, requiring that members provide regular financial information annually, and a business plan upon request.

Foreign bank subsidiaries which accept retail deposits (defined as deposits of less than CDN$150,000) are required to be members. However, under recent legislation, foreign bank branches (which do not accept deposits below $150,000) are not required to be CDIC members. There are currently 86 member institutions in Canada, and as of April 30, 2003, total member assets equalled CDN$1700 billion, total member deposits equalled CDN$1036.6 billion and total insured deposits equalled CDN$363.2 billion.

5. Coverage

A primary consideration for CDIC when determining coverage limits is that the chosen level provide credible protection for the majority of depositors in the financial system. Under the *CDIC Act*, basic insurance coverage is CDN$60,000 per person in each member institution. The CDN$60,000 maximum, which covers both principal and interest, applies to the aggregate amount held by the institution for the depositor (the depositor can be an individual, a company, or another form of entity). The deposit must be payable in Canada in Canadian dollars with a maturity date of not more than five years. Separate protection is provided for joint accounts, deposits held in trust, and deposits held in registered retirement savings plans and registered retirement income funds.

The coverage amount set by CDIC is not indexed and CDIC does not use coinsurance.

6. Reimbursing Depositors

CDIC may reimburse depositors in two ways: by direct payout, or by insured deposit transfer.

In a direct payout, when an institution's affairs are assumed over by the regulatory authority, or a court has issued a winding-up order, CDIC issues payments to all insured depositors for the full amount of their claims (up to the statutory limit for basic coverage of CDN$60,000). A liquidator is appointed by the court to dispose of the assets of the failed member. Uninsured depositors and other general creditors of the insolvent member generally do not receive immediate or full reimbursement of their claims. In a liquidation, CDIC stands in the place of the insured depositors; CDIC, uninsured depositors and all other general creditors have equal standing and receive a proportionate return on their claims from the liquidation of the assets.

In an insured deposit transfer (sometimes referred to as a “modified payout”), CDIC makes a lump-sum payment to a transferee member institution equal to the total amount of insured deposits less any transfer premium paid to CDIC by the transferee. Insured depositors then have a claimant withdrawing their deposit insurance payment from the transferee institution or leaving it with the institution. Again, uninsured depositors and creditors are not fully protected and may suffer losses as their outstanding claims remain in the estate.

Whether in a direct payout or insured deposit transfer, there is no requirement for depositors to file a claim. Where a winding-up order has been made, CDIC is obligated to reimburse depositors as quickly as possible. The payment typically takes between one and eight weeks. In emergency situations, CDIC has the option of making advance payments to depositors in situations; cheques can be issued within 24 hours.

Post mortems are conducted after each failure to document lessons learned and to improve the efficiency and effectiveness of the reimbursement process in the future.

7. Risk Assessment & Intervention

CDIC does not itself examine members but receives reports on member institutions from regulators and examiners on a regular basis (e.g. annual examination reports). Financial information received from member institutions is held on information systems shared by CDIC, the primary regulator and the Bank of Canada (the central bank). CDIC shares information related to its standards with the regulator.

CDIC has developed a comprehensive risk assessment framework for the early warning of member institution problems, to enable the Corporation to minimize its exposure to loss. While the CDIC framework incorporates risk-based supervisory approaches used by regulators in their examination reports, it adds to this various CDIC information and off-site information sources such as market information and economic and emerging issues. There are five major components of the model currently in place:

(a) CDIC Information;

(b) Supervisory/regulatory information;

(c) Financial performance and condition indicators;

(d) Market information; and

Economic and emerging information.

The risk assessment is done on an institution by institution basis and for the CDIC membership as a whole. The approach is both backward and forward-looking and assesses past, current and relative performance of member institutions. CDIC works closely with the regulators and is usually aware when an institution is experiencing difficulties. In determining when and how to intervene, CDIC uses a variety of criteria, such as failure to meet regulatory capital requirements or failure to meet the terms of compliance orders.

When in CDIC's view a member is or is about to become insolvent, CDIC is deemed to be a creditor. As a creditor CDIC has status under the federal *Winding-up and Restructuring Act* to petition the court for a winding-up on the grounds of insolvency, although the regulator usually brings such a petition. Since it is often hard to prove insolvency on a book value basis, CDIC usually works closely with the regulator. The federal regulator, OSFI, may also ask the Attorney General of Canada to petition for a winding-up on grounds other than insolvency (such as failure to meet regulatory capital requirements) and this is often a surer way to proceed. In any liquidation, CDIC and the federal regulator work together to obtain a court order and both usually provide evidence (viva voce and by way of affidavit).

8. Failure Resolution

Pursuant to the *Bank Act* and *Trust and Loan Companies Act*, the Superintendent may take control of an institution where, among other things, the institution's deposit insurance has been terminated by CDIC (unless the Minister of Finance advises the Superintendent that the Minister is of the opinion that it is not in the public interest to do so). CDIC may terminate the deposit insurance of a member institution on 30 days notice where: CDIC is advised by the examiner that a member has failed to follow a standard of sound business and financial practices, or has breached any of the CDIC by-laws applicable to it or the conditions of it's policy of deposit insurance, and CDIC is not satisfied with the member institution's progress in following the standard or in remedying the breach (unless the Minister advises CDIC that the

Minister is of the opinion that it is not in the public interest to do so). The Superintendent may also take control of an institution where, for example, it has failed to pay its liabilities or will not be able to pay its liabilities as they become due and payable, or where the regulatory capital of the bank has reached a level that may detrimentally affect its depositors or creditors.

The bankruptcy process utilized for federally regulated financial institutions is administered through *Winding-up and Restructuring Act*. Usually within a matter of days or weeks of having taken control of the institution, the Superintendent will request the Attorney General of Canada to apply for an order winding-up the institution pursuant to section 10.1 of *Winding-up and Restructuring Act*. CDIC will usually provide the Attorney General with an affidavit in support of the application, attesting to the number of insured deposits with the institution and CDIC's preparedness to pay out the insured deposits. Section 10.1 provides that a court may make a winding-up order in respect of an institution if the court is of the opinion that for any reason it is just and equitable that the institution should be wound up.

Generally, once the Superintendent has taken control of an institution, it is closed and the court application for the appointment of a provisional liquidator or a liquidator is made as soon as possible. In Canada, the court-appointed liquidator fulfills the role of the "receiver". While the liquidator is an officer of the court, the liquidator does consult with CDIC regarding the management of the assets of the institution and the liquidation of the estate because CDIC is a major creditor of the estate (being subrogated to the rights of depositors following pay out of the insured deposits).

Typically, the liquidator disposes of the assets of the failed institution (as opposed to the institution itself), disperses the proceeds from the disposition of the assets to the creditors of the Corporation until those proceeds are exhausted, and "winds up" the legal entity which, with the disposition of assets and satisfaction of the obligations, is nothing more than a corporate shell. However, there are other methods of failure resolution that may be utilized by CDIC.

In each case of failure, CDIC undertakes a post-mortem, so that the experience can be of value in dealing with problem member institutions in the future. Further, after every failure, CDIC undertakes a forensic review to determine if there is sufficient evidence of wrongdoing and, if so, commences litigation against the management, board of directors and auditors of the failed institution for purposes of redressing its losses.

9. Claims, Recoveries & Estate Management

When a CDIC member is in difficulty, CDIC examines (in collaboration with the institution's primary regulator) a variety of intervention options. Depending on the circumstances, such options may range from a sale of all or part of an institution to formal liquidation and payment of insured deposits. CDIC's mandate dictates that its review of intervention options be conducted in view of the least cost option and lowest impact on the overall stability of the Canadian financial system. Typically, on liquidation, CDIC pays the claims of insured depositors and then works with court-appointed liquidators to maximize net recoveries from the disposition of assets, thereby minimizing losses to the Corporation. Throughout this process, CDIC ensures that Canadian depositors receive prompt settlement of their full entitlement with respect to their insured deposits in failed institutions.

CDIC's claims and recoveries strategies involve the use of a 'virtual organization' consisting of asset managers, lawyers, accountants and other professionals for asset recovery and estate administration. In most cases, CDIC nominates qualified professionals to perform liquidations as court-appointed liquidators and thereafter recommends adjustments to the size of the effort as the liquidation proceeds.

The following are the principal methods of failure resolution currently employed by CDIC:

(a) Formal liquidations in which CDIC pays depositors the value of their insured deposits and assumes the depositors' claims against the failed institutions (the "estates"), whose assets are normally liquidated under the jurisdiction of a court-appointed liquidator.

(b) Purchase and assumption agreements involving the acquisition of the failing member institution by another member.

(c) The organization of workout companies to realize upon problem assets.

(d) Deficiency coverage agreements in which CDIC provides a third party, which is acquiring impaired assets of a member institution, with a guarantee on those assets up to a specified limit, to reduce the risk of loss on eligible assets.

To manage its risks and enhance the alignment of interests between CDIC and its suppliers, CDIC exercises strategic management through planning, reporting, and performance requirements outlined in appointment agreements. CDIC also negotiates incentive plans with various suppliers, including asset managers and liquidators. These plans are designed to increase the probability that CDIC will benefit from net realizations in the upper range of projections, measured on a net present value basis, and that the asset manager or liquidator will focus on the need to minimize costs as well as to achieve the highest gross realizations from the assets.

To the extent a depositor is insured, the depositor exchanges by subrogation his claim against the failed member institution in return for an insurance payment. CDIC acquires the depositor's claim and assumes the depositor's share of the loss implicit in the failure. The assets of the failed member institution (the "estate") are normally liquidated according to the provisions of the *Winding-up and Restructuring Act* under the jurisdiction of a court-appointed liquidator.

CDIC has the statutory authority to be liquidator in a winding-up, but has not done so to date. CDIC has been appointed an inspector of estates, a formal position, pursuant to a court order, and contemplated by the *Winding-up and Restructuring Act*. The Act provides little guidance concerning the role of inspector, other than it is "to assist and advise" the liquidator.

Typically, the relevant regulator consults CDIC prior to the winding-up application concerning its preference as to a liquidator. CDIC canvasses the market, considering the qualifications, cost structure and potential conflicts of interest of any candidate. Generally, CDIC enters into a nomination agreement with its choice, confirming the willingness of the candidate to report to CDIC on an agreed upon basis and to provide access to information required for the payout or transfer of deposits, and setting out compensation arrangements including incentive compensation, if any.

The court orders the appointment of the liquidator. If it accepts CDIC's nominee (and, to date, it has always done so), the nomination agreement will govern the relationship between CDIC and the liquidator. However, the agreements specifically recognize that the liquidator is a court officer, answerable to the court. If any provision of the agreement is inconsistent with the liquidator's obligations as a court officer, the obligations take precedence. The court may authorize a liquidator to borrow against the security of estate assets, if required.

CDIC monitors the performance of the liquidator on an ongoing basis, requiring business plans, budgets, support for costs, and comparisons of actual results to plans and budgets.

CDIC's role in a liquidation is not comparable to that of other stakeholders because it generally has a larger interest in the estate by many magnitudes and greater professional resources to manage the relationship. It is however not legally different.

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HONG KONG

Deposit Insurance Systems - Hong Kong

1. Objectives, Mandates & Powers

The failure of Bank of Credit and Commerce Hong Kong Limited in July 1991 prompted consideration as to whether a deposit insurance scheme should be introduced in Hong Kong. After years of debate and extensive public consultation carried out by the Government of the Hong Kong Special Administrative Region, and in light of the growing trend in international financial systems which favour explicit forms of deposit protection, the Deposit Protection Scheme Ordinance (the "Ordinance") was passed by the Legislative Council of Hong Kong on 5 May 2004.

The Ordinance is not yet in force except in relation to the establishment of a Hong Kong Deposit Protection Board (the "Board") which is responsible for managing the Deposit Protection Scheme (the "Scheme") under the Ordinance. It is expected that the Scheme will come into operation in 2006.

The Scheme is intended to provide compensation to depositors with banks in Hong Kong in the event of failure of such banks. A Deposit Protection Scheme Fund (the "Fund") will be established under the Scheme.

The following are key features of the Scheme contemplated in the Ordinance:

(a) the Scheme will be managed by the Board whose role will be to assess and collect contributions, oversee investment of the Fund and pay compensation to depositors in the event of a bank collapse;

(b) the Board will perform its functions through the Hong Kong Monetary Authority ("HKMA");

(c) participation in the Scheme by licensed banks is mandatory but overseas-incorporated banks may apply for exemption on the basis that the bank participates in a comparable scheme in its home jurisdiction and that scheme covers the deposits taken by the overseas-incorporated banks in Hong Kong;

(d) the coverage limit is HK$100,000 per depositor per bank;

(e) the target size of the Fund will be 0.3% of the total amount of the relevant deposits, which will be built up through collection of contributions from banks; and

(f) a differential rating system based on the supervisory ratings of individual banks will be used to assess contributions.

Under the Ordinance, the Board, amongst other things :

(a) may borrow money from the Government or any other person for the purpose of performing its functions;

(b) is responsible for the assessment and collection of contributions and investment of the Fund;

(c) has authority to decide whether to exempt banks from membership of the Scheme in accordance with the Ordinance or to impose conditions for exemption;

(d) may require Scheme members to submit information to facilitate the Board's performance of its functions; and

(e) may issue guidelines for banks or depositors.

In failure situations, the Board may, amongst other things:

(a) access the premises and records of the failed Scheme member;

(b) with the consent of the Financial Secretary, petition to the High Court of Hong Kong for the winding up of the Scheme member;

(c) prove in the liquidation of the failed Scheme member;

(d) provide indemnity to the liquidator or provisional liquidator of the failed Scheme member for the purpose of obtaining an early payment out of its assets;

(e) determine the entitlement of depositors of the failed Scheme member compensation, pay the compensation and recover the same from the assets of the failed Scheme member; and

(f) make any compromise, agreement or arrangement in respect of its claim in the liquidation of the failed Scheme member.

2. Governance

The Board will consist of not fewer than six and not more than nine members. Two members will be ex officio members, namely, the Secretary for Financial Services and the Treasury, and the HKMA, or their respective representatives. The other four to seven members are to be appointed by the Chief Executive of Hong Kong according to their experience in finance, accounting, banking, law, administration, information technology, consumer affairs or other suitable fields. These members cannot be public officers or directors or employees of member institutions. The Chief Executive will also appoint the Chairman of the Board.

The Board shall perform its functions through the HKMA so as to relieve the Board of the need to maintain a staff level that is required to handle the workload in the event of a bank failure but otherwise not needed in normal times. The HKMA shall, under the direction of the Board, implement the decisions of the Board and carry out the day to day administration of the Scheme.

The Chief Executive may, after consultation with the Chairman of the Board, give the Board written directions as he thinks fit with respect to the performance of any of the Board's functions. The audited statement of accounts of the Fund together with the auditor's report thereon, and a report on the activities of the Board are to be submitted to the Financial Secretary on a yearly basis, and the Financial Secretary shall arrange for the same to be tabled to the Legislative Council.

3. Information Sharing & Interrelationship Among Safety-Net Players

The Ordinance gives the Board the power to obtain information from a Scheme member to facilitate the performance of its functions, and such information shall be submitted within such period and in such manner as the Board may specify. However, the Board is not responsible for carrying out any supervisory functions in collaboration with the bank regulator.

The HKMA may disclose information to the Board for the purpose of enabling or assisting the Board to exercise its functions, e.g. for assessment of contributions to be paid by Scheme members. In addition, the HKMA may, after consultation with the Hong Kong Association of Banks ("HKAB"), require Scheme members to maintain, in respect of the relevant deposits, assets in Hong Kong.

The HKMA has indicated that they would, in a bank failure situation, liaise with the Securities and Futures Commission ("SFC") so as to ensure that there will be no duplicate compensation made to depositors by the SFC and the HKMA.

4. Membership

In Hong Kong, every bank (excluding restricted licence bank and deposit-taking company) will be a member of the Scheme and will remain as such until it ceases to be a bank by virtue of section 18(3) of the Banking Ordinance or its banking licence is revoked under that Ordinance.

Banks incorporated outside of Hong Kong will be entitled to apply to the Board for an exemption from participating in the Scheme. The Board has the discretion whether to grant the exemption. To be eligible for the exemption, the deposits taken by the bank at its Hong Kong offices need to be protected by a deposit protection scheme, or other scheme of a similar nature, established and maintained in the jurisdiction in which the bank is incorporated. The scope and level of protection available to those deposits under the "equivalent" scheme must not be narrower or lower than those that would be available to those deposits under the Scheme if the bank were not exempted. When granting the exemption, the Board may impose such other conditions to the exemption as the Board considers appropriate. If any bank is aggrieved by the Board's decision, the Ordinance provides a mechanism for appeal.

An exempted bank will be required to pay an annual exemption fee and notify the Board of any change of circumstances which may affect the exemption. The bank shall as soon as practicable inform in writing its depositors or the intended depositors of the exemption and details of the deposit protection scheme maintained in the jurisdiction outside Hong Kong.

5. Coverage

Under the Ordinance, the coverage limit is HK$100,000 per depositor per bank. This means that each depositor shall receive payment of deposit of up to HK$100,000 if a bank collapses. When determining the amount of compensation from the Fund, the liabilities of a depositor shall be taken into account. The compensation shall be paid out in Hong Kong Dollars. Protection under the Scheme will also be provided for deposits held by the depositor in a client account for a client or under a trust.

6. Reimbursing Depositors

Compensation will be paid under the Scheme only after a "specified event" in relation to a Scheme member has occurred. The specified event shall have occurred if

(a) a winding-up order has been made by the High Court of Hong Kong; or

(b) the HKMA has served on the Board a notice of the HKMA's decision that compensation shall be paid to the depositors of a Scheme member.

The HKMA shall serve on the Board written notice of the HKMA's decision that compensation shall be paid to the depositors of a Scheme member, where (a) either the HKMA has appointed a Manager under section 52 of the Banking Ordinance to take over a Scheme member or the court has appointed a provisional liquidator, and (b) the HKMA is of the opinion that the Scheme member is likely to become unable to meet its obligations, or that it is insolvent or about to suspend payment to its depositors.

The HKMA shall also report the occurrence of a "specified event" to the Chief Executive in Council. Having regard to the interests of the depositors and the general stability of the banking system in Hong Kong, the Chief Executive in Council may confirm or revoke the HKMA's decision that compensation should be paid to the depositors of a Scheme member.

Under the Ordinance, if a depositor holds the deposit in his own right, he is entitled to compensation from the Fund. If a depositor holds the deposit as a bare trustee under a bare trust, the beneficiary, but not the depositor, will be entitled to compensation from the Fund. If a depositor holds the deposit in a client account for a client, the client, but not the depositor, will be entitled to compensation from the Fund. If a depositor holds the deposit as a trustee under a trust, the depositor will be entitled to compensation from the Fund as such trustee of the trust. The depositor may be required to supply the Board with information in support of the entitlement of the depositor or other persons to compensation from the Fund. No action to enforce any entitlement to compensation may be brought in any court unless the action is commenced within five years after the date of the specified event concerned.

The Board may make interim payments of compensation to avoid any undue delay in payment owing to uncertainties as to the amount of compensation payable to the depositors.

7. Risk Assessment & Intervention

The Board is responsible for determining the amount of contribution payable by each Scheme member on the basis of the “MA supervisory rating” of the Scheme members. The MA supervisory rating is the rating from time to time assigned to the Scheme members by the HKMA. It reflects the HKMA’s assessment of a Scheme member’s overall financial condition and quality of the Scheme member’s management. Currently, the rating assigned to individual banks are determined through a CAMEL rating system, which takes into account the following risk aspects of a bank:

(a) Capital;

(b) Asset Quality;

(c) Management;

(d) Earning; and

(e) Liquidity.

It is intended that the size of the Fund shall be 0.3% of the total amount of relevant deposits (equivalent to approximately HK$1.6 billion). It is aimed that the Fund would be established over a five-year period by charging banks different levies ranging from 0.05% to 0.14% each year on their relevant deposits, depending on the MA supervisory rating of the bank.

In order to determine the level of levies payable by the banks, the Board may require any Scheme member to submit, within such period and in such manner as the Board may require, returns showing the amount of the relevant deposits maintained with the Scheme member and the breakdown of those relevant deposits. The Board may also require the Scheme member to submit a report prepared by an auditor appointed by the Scheme member as to whether or not, in the opinion of the auditor, such information or return so submitted, is correctly compiled in all material respects and whether or not the Scheme member has in place systems of control that are adequate to enable the Board to perform its functions.

8. Failure Resolution

If, after a Manager has been appointed by the HKMA under the Banking Ordinance or a provisional liquidator has been appointed in respect of a Scheme member, the HKMA is of the opinion that the Scheme member is likely to be unable to meet its obligations, or is insolvent or about to suspend payment to its depositors, the HKMA may, after consultation with the Financial Secretary, decide that compensation should be paid from the Fund to the depositors. The HKMA would serve a written notice of its decision to the Board and report the occurrence of the event to the Chief Executive in Council.

Under the Banking Ordinance, the Financial Secretary, acting in accordance with the direction of the Chief Executive in Council, has the power to petition the High Court of Hong Kong for a winding up of the failing Scheme member on the grounds of insolvency or public interest. The Ordinance also empowers the Board, with the consent of the Financial Secretary, to petition for the winding up of that Scheme member.

Before presenting the winding-up petition, the HKMA may, after consultation with the Financial Secretary, give a direction under the Banking Ordinance that the affairs, business and property of the Scheme member be managed by a Manager. Such appointment shall continue in force until revocation by the HKMA, after consultation with the Financial Secretary or at the order of the Chief Executive in Council. Upon the appointment of a provisional liquidator or a liquidator, the failed Scheme member will undergo the usual court liquidation process in accordance with Companies Ordinance and Companies (Winding-up) Rules in Hong Kong.

9. Claims, Recoveries & Estate Management

The liquidator of any failed Scheme member will be appointed by the Hong Kong court. The Board will not be involved in the liquidator's performance of his duties in the liquidation, unless it becomes a member of the Committee of Inspection of the failed Scheme member. It will however have the power to make any compromise, agreement or arrangement with the liquidator in respect of its claim against the assets of the failed Scheme member.

On occurrence of the "specified event", the Board shall as soon as practicable inform the depositors of the failed Scheme member by notice published in any daily newspaper in circulation in Hong Kong at the time of the occurrence. Upon receipt of information and documents as the Board considers necessary, the Board shall assess the entitlement of each depositor to compensation and pay the compensation to each depositor from the Fund.

Once the Board has made a payment of compensation to a depositor of a Scheme member from the Fund, the rights and remedies of that depositor in respect of claims in the liquidation of that Scheme member - to the extent of the actual amount paid - is subrogated to the Board. The Board may maintain an action in respect of all such rights and remedies.

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JAPAN

Deposit Insurance Systems - Japan

1. Objectives, Mandates & Powers

The objectives of the Deposit Insurance Corporation (the "DICJ") are to protect depositors and other parties, secure the intermediary function of failed financial institutions in the payment and settlement system, and maintain an orderly financial system by:

(a) providing for the payment of deposit insurance claims and the purchase of deposits and other claims in the event that repayment of said deposits is suspended by a financial institution;

(b) providing appropriate financial assistance to facilitate mergers or other resolutions of failed financial institutions;

(c) providing for financial administrators for failed financial institutions;

(d) providing for the succession of business of failed financial institutions; and

(e) establishing a system of appropriate measures to respond to financial crisis.

In order to achieve these objectives, the DICJ, among other things:

(f) collects insurance premiums;

(g) reimburses insured deposits and other claims;

(h) provides financial assistance and compensation for losses;

(i) purchases deposits and other claims;

(j) in some circumstances, acts as a financial administrator;

(k) manages the business of bridge banks;

(l) subscribes for shares;

(m) loans funds to failed financial institutions;

(n) performs on-site inspections of financial institutions;

(o) purchases assets from financial institutions;

(p) pursues civil and/or criminal liability on the part of executives of failed financial institutions;

(q) makes capital investment in, loans funds to, and guarantees debts for loans by the Resolution and Collection Corporation (“RCC”);

(r) provides guidance and advice to the RCC concerning its resolution and collection operations;

(s) conducts asset investigations of debtors of the RCC; and

(t) makes capital investments in the Industrial Revitalization Corporation.

2. Governance

(a) Supervising authorities

The Ministry of Finance (the “MOF”) and Financial Services Agency (the “FSA”) are the supervising authorities of the DICJ. The two authorities jointly oversee the activities of the DICJ.

(b) Governing body

The Policy Board is the supreme governing body of the DICJ. The Policy Board consists of a maximum of thirteen members, comprised of members of Executive Management of the DICJ and outside members with expertise in finance appointed by the Governor with the approval of the Prime Minister and the Minister of Finance. The Policy Board oversees the following matters:

(i) amendments to articles of incorporation;

(ii) operational guidelines and amendments;

(iii) annual budget and financing program;

(iv) settlement of accounts;

(v) insurance premium rates;

(vi) payment (provisional or otherwise) of deposit insurance;

(vii) financial assistance; and

(viii) purchase of deposit claims and other claims.

(c) Management

Executive officers are appointed by the Prime Minister, subject to the approval of both Houses of the Diet. The Governor is responsible for the management of the DICJ.

3. Information Sharing & Interrelationship Among Safety-Net Players

The safety-net participants of Japanese financial system are as follows:

(a) Ministry of Finance (MOF);

(b) Financial Services Agency (FSA);

(c) The Bank of Japan (BOJ); and

(d) Deposit Insurance Corporation of Japan (DICJ).

Coordination among these participants is governed by law, such as the Deposit Insurance Law.

For example, when there is an extremely serious threat posed to the maintenance of financial stability in Japan or a region where Japanese financial institutions conduct operations, the Prime Minister, after consulting with the Financial System Management Council, may confirm the need to implement exceptional measures. Such measures include capital injection to banks, financial assistance to cover amounts exceeding the pay-out cost or acquisition of shares by the DICJ (special crisis management). The members of the Financial System Management Council are the Prime Minister, Chief Cabinet Secretary, Minister for Financial Services, Commissioner of the FSA, Minister of Finance and Governor of the BOJ.

4. Membership

According to the *Deposit Insurance Law,* the following institutions, which have head offices in Japan, are required to participate in the Deposit Insurance System:

(a) Banks as provided in the *Banking Law*;

(b) Long-term credit banks as provided in the *Long Term Credit Bank Law*;

(c) Shinkin banks;

(d) Credit cooperatives;

(e) Labor banks;

(f) Shinkin Central Bank;

(g) The Shinkumi Federation Bank; and

(h) The Rokinren Bank.

Overseas branches of the above institutions, governmental financial institutions and branches of foreign banks in Japan are not covered by the system.

5. Coverage

The deposits insured under the deposit insurance system are as follows:

(a) deposits;

(b) installment savings;

(c) installment contributions;

(d) money in trust with a guarantee of principal (including loan trusts);

(e) bank debentures (custody products);

(f) accumulating or asset-forming instruments of the deposits in (a) to (d) above; and

(g) deposits related to investments in fixed-contribution pension reserves.

The following types of deposits are not insured:

(a) foreign currency deposits;

(b) negotiable certificates of deposit (NCD);

(c) deposits in special international financial transaction accounts (Japan off-shore market accounts);

(d) deposits from the BOJ (except treasury funds);

(e) deposits from insured financial institutions (except those related to the investment of fixed contribution pension reserves);

(f) deposits with the DICJ;

(g) anonymous bank accounts;

(h) deposits under another party's name (including those under a fictitious name);

(i) deposits to be loaned to a third party;

(j) money in trust with no guarantee of principal; and

(k) bank debentures (other than custody products).

6. Reimbursing Depositors

The DICJ can make an insurance payment when an insurable contingency, such as suspension of the repayment of deposits, has occurred. The maximum amount of deposits protected by deposit insurance is ¥10 million in principal plus interest per depositor per financial institution. After the DICJ has determined the insured deposit amounts for each depositor, depositors may receive repayment of insured deposits in the same way as ordinary deposit transactions, as long as a payment counter function has been arranged with the assuming financial institution.

When an insurable contingency has occurred and it is anticipated that insurance payments or the repayment of insured deposits will not be made for a considerable length of time, partial payments may be made to cover the immediate living expenses and other costs of depositors in the failed financial institution. As stipulated by Cabinet Order, partial payments are made against the balance of ordinary savings (principal only) of each depositor, up to a limit of ¥600,000 per account.

7. Risk Assessment & Intervention

Risk assessment and intervention is undertaken by the FSA.

8. Failure Resolution

(a) Financial Assistance

When a financial institution fails, the DICJ may extend financial assistance to an assuming financial institution or bank holding company (referred to below as “assuming financial institution”) that implements a business transfer, merger, or other operation, or to the failed financial institution to facilitate the merger or other operation.

As a result of the financial assistance, deposits and other claims are taken over and protected by the assuming financial institution. Financial assistance may take the form of a monetary grant, loan or deposit of funds, purchase of assets, guarantee or assumption of debts, subscription of preferred stock, or loss sharing.

Pending authorization of the eligibility of a merger or recommendation of a merger by the Prime Minister (legally mandated to the Commissioner of the FSA), an assuming financial institution may apply to the DICJ for financial assistance. Upon receipt of the application, the DICJ decides, subject to a resolution by the Policy Board, whether or not to extend financial assistance and, if granted, the amount, method, and other details of the financial assistance. When making such a resolution, the Policy Board is required to consider the financial condition of the DICJ, the estimated amount of financial assistance required, the pay-out cost, and the efficient utilization of DICJ assets. If the DICJ decides to provide the requested financial assistance, it enters a financial assistance agreement with the assuming financial institution.

(b) Payment of Deposit Insurance

Insurance payouts are made against claims filed by depositors once depositor identification and other necessary steps have been taken at the financial institution where an insurable contingency has occurred. Insurable contingencies resulting in insurance payments by the DICJ are divided into the following two types:

(i) *Category One Insurable Contingency:*

Suspension of repayment of deposits by a financial institution.

In such cases, the DICJ decides whether or not to make insurance payments within one month of the occurrence of the insurable contingency, subject to a resolution by the Policy Board (if necessary, this period may be extended by a further month).

(ii) *Category Two Insurable Contingency:*

Revocation of a financial institution's operating license, declaration of bankruptcy, or resolution to dissolve the financial institution.

In such cases, insurance payments are made without requiring any decision by the DICJ. The amount of insured deposits to be reimbursed to each depositor is the total principal of insured deposits deposited in the financial institution subject to the insurable contingency, plus interest. The principal may not exceed the sum of ¥10 million per depositor, as prescribed by Cabinet Order (however, insurance payments on deposits pledged as security may be deferred until the right of pledge has lapsed).

9. Claims, Recoveries & Estate Management

The RCC, a subsidiary of the DICJ, mainly performs debt recovery, real estate management and asset disposal work on behalf of the DICJ. The DICJ may provide the RCC with guidance and advice concerning resolution strategies and collection operations. The guidance and advice covers a wide spectrum including, support for recovery operations by uncovering hidden assets as well as pursuit of civil and/or criminal liability, using the investigative powers entrusted to the DICJ.

The role for the DICJ is to provide overall stability of the financial system in the case of a formal insolvency. In order to assume the role, the DICJ is to protect depositors through reimbursement, to provide appropriate financial assistance to facilitate mergers or other resolutions of failed financial institutions, and to secure payment and settlement of failed financial institutions.

Failed financial institutions are managed by financial administrators appointed by the Commissioner of the FSA. Lawyers, certified public accountants, and financial experts are normally appointed as financial administrators. However, the DICJ, with its accumulated know-how in failed bank resolution, may also resolve failures as a financial administrator

Financial administrators undertake operations on behalf of the failed financial institutions, including management and disposal of assets. They may also, following a request by the Commissioner of the FSA, report on the state of operations and assets of the institution, prepare its business plan, and temporarily maintain and continue its operations. Similarly, financial administrators may also implement a business transfer to an assuming financial institution, as well as file civil or criminal charges against former executives responsible for the business failure.

The Netherlands

Deposit Insurance Systems - The Netherlands

1. Objectives, Mandates & Powers

The EU Directive 94/19/EC of 30 May 1994 on deposit-guarantee schemes and the EU Directive 97/9/EC of 3 March 1997 on investor-compensation schemes require EU member states, including the Netherlands, to introduce and officially recognise one or more deposit-guarantee schemes for credit institutions. Pursuant to the EU directives, credit institutions may not take deposits or carry on investment business, unless they are a member of a deposit-guarantee scheme and an investor-compensation scheme. The EU directive was implemented into Dutch law by expanding the scope of the then existing deposit-guarantee scheme as follows:

(a) a new clause was inserted in the Dutch Banking Act (*Wet toezicht kredietwezen 1992*) to provide a legal basis for the deposit-guarantee scheme; and

(b) the Collective Guarantee Regulation of Credit Institutions for Repayable Monies and Investments (*Collectieve Garantieregeling van Kredietinstellingen voor Terugbetaalbare Gelden en Beleggingen*, referred to herein as “CGR”) was amended.[1]

The CGR provides for a deposit-guarantee scheme covering both monies of deposit holders and securities as well as other investments of investors deposited with, and owed by, credit institutions. When a credit institution fails, the Dutch Central Bank (*De Nederlandsche Bank N.V.*, referred to herein as the “DCB”) will make payments of up to EUR 20,000 to deposit holders and investors, and will then recover the costs from credit institutions participating in the CGR.

The CGR designates the DCB as the supervisory authority responsible for implementing the CGR. Pursuant to the CGR, the DCB has the power to:

(a) invite credit institutions to participate in the CGR;

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[1] Dutch legislation for the financial sector is currently undergoing a major overhaul, which is intended to be completed on 1 July 2005. As part of the overhaul, it is proposed that the provisions of the Dutch Banking Act and the CGR be transferred to a new Act on Financial Supervision *(Wet financieel toezicht)*. However, the deposit-guarantee scheme is likely to remain largely unchanged.

(b) set rules and procedures regarding the continuation and termination of participations in the CGR;

(c) terminate participations of credit institutions in the CGR;

(d) withdraw the banking license of a credit institution in case of non-compliance with the requirements of the CGR;

(e) determine when the protection offered to deposit holders and investors under the CGR comes into effect (i.e. to assess whether a credit institution is failing);

(f) have access to information of the failed institution on deposit holders and investors as well as their claims;

(g) assess the validity of claims from, and make payments to, deposit holders and investors covered by the CGR;

(h) allocate the costs among, and collect contributions from, the participants in the CGR;

(j) take recourse against the failed institution; and

(k) amend the CGR.

In addition and among other things, the DCB is responsible for the stability of the Dutch financial sector and, together with other supervisory authorities, the supervision of financial institutions. In this respect, the DCB has extensive powers relating to risk assessment, intervention and failure resolution.

2. Governance

The DCB is a non-listed public limited liability company (naamloze vennootschap, N.V.). It is managed by a board of directors, which is supervised by a supervisory board. The supervisory board adopts the annual accounts of the DCB, subject to the approval of the general meeting of shareholders. The president of the DCB reports to a Bank Council on general economic and financial developments and discusses policy matters with the Bank Council.

The board of directors consists of a president and three to five other managing directors. The president and the other managing directors are appointed by the government for periods of seven years. For each vacancy on the board of directors, the board of directors and the supervisory board jointly recommend three individuals. The president and the other managing directors may be suspended or dismissed only if they no longer meet the requirements for holding office or are in serious breach of their duties.

The supervisory board consists of nine to twelve members. One member is appointed by the government for a period of four years. The chairman and the other members of the supervisory board are appointed by the general meeting of shareholders for periods of four years. The supervisory board recommends three individuals for each vacancy on the supervisory board.

The Bank Council consists of eleven to thirteen members, including the supervisory board member appointed by the government, one supervisory board member delegated by the supervisory board and nine to eleven members appointed by the Bank Council for periods of four years. The board of directors recommends at least two individuals for each vacancy in the Bank Council. The Bank Council appoints its own chairman. The board of directors is entitled to attend meetings of the Bank Council.

The DCB is accountable to the government, in particular the Ministry of Finance, which must approve the DCB's budget.

3. Information Sharing & Interrelationship among Safety-net Players

In the performance of their duties, the Ministry of Finance, the DCB and the other authorities supervising the financial sector, obtain information at their request and on a regular basis from various sources. In principle, the authorities have a duty of confidentiality with regard to such information. However, the authorities may share information with each other and other Dutch and foreign governmental and supervisory authorities, unless specific circumstances apply.

The DCB and the other Dutch authorities supervising the financial sector consult, coordinate and cooperate with each other in respect of issuing rules, regulations and policies and the supervision of financial institutions (including credit institutions). For example, the DCB and the Netherlands

Authority for the Financial Markets have agreed to consult each other before taking action in respect of intervention or failure resolution.

4. Membership

Only credit institutions with a banking license can participate in the CGR. In order to obtain a banking license, a credit institution must satisfy requirements relating to, among other things, its programme of operations, its own funds and its directors' trustworthiness and expertise. It is not required that a credit institution participates in the CGR. However, as non-compliance with the CGR may lead to withdrawal of a banking license, a credit institution is de facto required to participate in the CGR.

The following institutions are required to participate in the CGR:

(a) credit institutions established in the Netherlands with a banking license from the DCB, together with their branches abroad; and

(b) credit institutions established outside the EU and operating in the Netherlands by means of a branch with a banking license from the DCB.

The laws of their jurisdiction of establishment will require credit institutions established in the EU, but not the Netherlands, to participate in one or more deposit-guarantee schemes in their jurisdiction of establishment. However, such credit institutions with a branch in the Netherlands, may opt for participation in the CGR to the extent that the CGR provides more extensive coverage than the deposit-guarantee scheme(s) in the jurisdiction of establishment.

The DCB records which entities participate in the CGR in its public register of (branches of) credit institutions with a banking license.

The CGR does not apply to securities institutions, as they are subject to a branch-specific investor compensation scheme based on the EU Directive 97/9/EC of 3 March 1997 on investor-compensation schemes.

All participants in the CGR have an obligation towards the DCB and each other to comply with the provisions of the CGR. When a credit institution fails and payments are made to deposit holders and investors pursuant to the

CGR, participants in the CGR contribute to the costs in an amount equal to a percentage of the total amount paid to deposit holders and investors. This percentage is set in relation to each credit institution by the DCB on the basis of accounts submitted by the participants to the DCB, and after consultation with representative organisations for credit institutions. Should the DCB and the representative organisations fail to agree on the method of calculation and the applicable percentages, the DCB may set both provisionally, following which the participants must pay 90% of their (provisional) contributions. Participants are required to pay their contributions (as calculated by the DCB) to the DCB as soon as possible. The DCB is authorised to collect contributions on a monthly basis, contemporaneously with payments to deposit holders and investors.

Contributions of participants may not exceed certain amounts. In any calendar year, the contributions of all participants together may not exceed 5% of their own funds taken together, and the contribution of any participant may not exceed 5% of its own funds. If these percentages are exceeded, the DCB will foot the amount due without charging interest. In addition, the DCB may stipulate that contributions of participants are subject to a minimum threshold and that other participants pick up the extra costs if the minimum threshold is not reached.[2]

5. Coverage

The CGR covers both monies and securities as well as other investments deposited with, and owed by, credit institutions to individuals, partnerships and legal entities.

Where a credit institution fails, the DCB will (after setting off debts owed) pay the claims of deposit holders and investors an amount of up to EUR 20,000 per deposit holder and up to an amount of EUR 20,000 per investor. Claims may include interest accrued on interest-bearing deposits. Credit or debit in joint accounts will be split among the account holders and the result will be added to, or set-off against, their individual claims. Thus, any given individual, partnership or legal entity may not recover more than EUR 40,000 each (EUR 20,000 for deposits and EUR 20,000 for investments). This is

2 In the past few years, the current *ex post* funding of the CGR has been subject to discussion. It is argued that the CGR be amended to incorporate (partial) *ex ante* funding (whereby participants pay premiums, calculated according to risk, on a regular basis).

regardless of the number or location of accounts which it holds with the failed institution.

The DCB may refuse to honour claims from deposit holders or investors that are incorrect or fraudulent. In addition, a number of other claims are excluded from cover by the CGR. For example, claims from "large" companies (i.e. those that cannot draw up abridged balance sheets), credit institutions, investment institutions, insurance companies, pension funds, central or regional governments and directors, shareholders as well as group companies of the failed institution are excluded, as are claims resulting from money laundering.

6. Reimbursing Depositors

Protection under the CGR will be afforded as soon as the DCB determines that, in its opinion, a credit institution does not seem to be able to repay deposits or to meet its obligations resulting from investments of investors, and does not appear to be able to do so in the near future, for reasons that are directly related to its financial position.

A credit institution will in any case be regarded as a failed institution:

(a) within 21 days of the DCB's first assessment that a petition for emergency measures or bankruptcy may be made; or

(b) when a court in a EU member state has ordered that rights of recovery of deposit holders and investors against the credit institution are suspended for reasons directly related to the credit institution's financial position.

When the DCB regards a credit institution as a failed institution, the DCB will advertise in newspapers that deposit holders and investors may submit claims to it within five months. In principle, claims submitted after this five month period will not be honoured. The DCB will assess the validity and the amount of the claims submitted (it will add and set off amounts held by or owed to the institution by deposit holders and investors, including interest accrued). This assessment will take place on the basis of the accounts of the failed institution and is final.

The DCB will pay honoured claims (up to a maximum of EUR 20,000) as soon as possible, but in any case within three months after such claims have been submitted. This period may be extended by another three months. Honoured claims will be paid in Euros, regardless of the currency of the deposit or investment accounts, and only to accounts of deposit holders and investors with (branches of) credit institutions in the EU.

To the extent that payments have been made, the DCB subrogates to the claims of deposit holders and investors against the failed institution and any such claims are transferred to the DCB. To the extent that deposit holders or investors have received only part of their claim against the failed institution from the DCB, they may submit claims in the amount of the shortfall in any of the three methods of failure resolution.

Should deposit holders or investors have received more than their entitlement, the DCB may recover the surplus from them. Payments to persons charged with money-laundering may be suspended.

7. Risk Assessment and Intervention

The DCB supervises a credit institution on the basis of both general guidelines, rules and regulations (including solvency and liquidity requirements), and risk assessments specific to that credit institution's risk profile, risk management and risks incurred by it. For example, the DCB may require a particular credit institution to maintain own funds in excess of what is generally required.

The DCB monitors compliance with applicable requirements continuously. To that end, the DCB obtains information from the following sources: (i) credit institutions, which are required to report regularly (including monthly on liquidity and solvency ratios) and provide information at request, (ii) investigations by the DCB at the address of credit institutions and others (including external accountants), and (iii) auditors, who must inform the DCB as soon as possible of violations of legal obligations or threats to the continuity of a credit institution discovered in the process of auditing annual accounts.

In case of non-compliance or if the solvency, liquidity or the interests of (current and future) creditors of a credit institution are at risk, the DCB may call this to the attention of the credit institution and issue orders to the credit institution and warnings to the public. If the problem is not addressed to the satisfaction of the DCB, it may take a number of measures, including the appointment of a special administrator who must give his or her consent to all or certain corporate action and who may give orders to managing and supervisory directors and others involved with the credit institution. The DCB may withdraw a banking license, for example if the CGR is not complied with or if orders are not followed. In addition, the DCB may impose administrative fines and penalties and report violations of applicable law to the public prosecutor. Ultimately, the DCB may petition the district court to apply emergency proceedings to a credit institution, which may lead to its liquidation.

8. Failure Resolution

There are three methods of failure resolution for credit institutions: (i) dissolution and liquidation of assets outside of bankruptcy and emergency proceedings, (ii) bankruptcy, and (iii) emergency proceedings. The DCB plays an important role in each.

A failed institution may decide by shareholders' resolution to liquidate its assets and/or to be dissolved. However, the institution must inform the DCB as to the method of liquidation and/or dissolution thirteen weeks before giving effect to the shareholders' resolution. Unless the articles of association of the credit institution stipulate otherwise, the directors of the institution will act as liquidators. If there are none, the DCB may petition the district court to appoint liquidators. The liquidators will assess the (in)solvency of the credit institution. If the institution is found to be insolvent, the liquidators must submit a petition to the district court that the institution be declared bankrupt, unless all creditors agree otherwise.

The district court may declare a credit institution bankrupt:

(a) either following a petition from the liquidators, the credit institution itself, the public prosecutor or at least two of its creditors jointly, or out of its own motion;

(b) if the accounts of the institution show a deficit; and

(c) the DCB has been given an opportunity to be heard. The DCB may petition the district court to apply emergency proceedings instead. If a petition for bankruptcy involves the Dutch branch of a credit institution established elsewhere in the EU, the DCB must consult with the home state regulator of that credit institution.

Once a credit institution has been declared bankrupt, a receiver will be appointed, who will assess the bankrupt estate and liquidate its assets.

The DCB may petition the district court to apply emergency proceedings, if:

(a) the solvency and the liquidity of a credit institution show signs of a dangerous development and no improvement in such development is reasonably foreseeable, or

(b) in the opinion of the DCB, it is foreseeable that the institution is unable to meet its obligations in full as they fall due in respect of monies deposited with it.

The district court must give both the failed institution and the DCB an opportunity to be heard. The DCB may recommend candidates as administrators. The district court may apply emergency proceedings, which are in effect a suspension of payments, and appoint administrators for an initial term of up to one and a half years and, following a petition from the DCB, for one or more additional terms of up to one and a half years in total. During this time, the administrators and the DCB may petition the district court to take special measures in the interests of all creditors of the failed institution, including transfer or termination of contracts, (partial) sale of the institution's assets and liquidation. Emergency proceedings are terminated by (i) a decision of the district court to that extent, or (ii) the credit institution being declared bankrupt.

On 8th November 2004, a legislative proposal amending various aspects of failure resolution for credit institutions was submitted to parliament. The proposal intends to implement the EU Directive 2001/24/EC of 4 April 2001 on Reorganisation and Winding-up of credit institutions. Although the directive should have been implemented into Dutch law by 5 May 2004, it is not clear when and what form the legislative proposal will enter into effect.

9. Claims, Recoveries & Estate Management

In all three methods of failure resolution, the DCB must try to recover claims of deposit holders and investors (to which it has been subrogated) from the failed institution to the extent possible. However, the DCB's obligation is secondary to its other duties as imposed by law (e.g. the DCB must not carry out such recovery if this would imperil financial stability). The total amount recovered must be distributed among the participants in the CGR, in accordance with the percentage of their contributions.

To the extent that deposit holders or investors have received only part of their claims against the failed institution pursuant to the CGR, they may submit their claims in the amount of the shortfall in any of the three methods of failure resolution. Deposit holders, investors and the DCB to the extent it is subrogated to their claims, are equal in rank to unsecured creditors of the failed institution.

The United Kingdom

Deposit Insurance Systems - The United Kingdom

1. Objectives, Mandates & Powers

The Financial Services Compensation Scheme (the "Scheme") is a single compensation scheme created by the Financial Services Authority, the UK's financial regulator, (the "Authority") under the Financial Services and Markets Act 2000 (the "Act"). The Scheme became operational on 1 December 2001, when the Act came into force. It covers deposits, insurance and investments, and replaces eight previous compensation schemes (including the Deposit Protection Scheme).

The Scheme relates to firms that are regulated by the Authority (or any participating European firm) (each a "Firm") and is funded by levies on each Firm. The purpose of the Scheme is to compensate consumers who suffer loss in various circumstances as a consequence of the inability of a Firm to meet its liabilities. In general this is when a Firm has become insolvent or gone out of business.

The Scheme is not intended to provide compensation for a regulatory breach by a Firm (for example where a Firm has made misleading statements to induce people to make deposits), other than in cases where that breach results in the insolvency of the Firm. The Scheme does not assess or seek to mitigate the risk of Firms becoming unable to pay claims against them and has limited powers of intervention in relation to Firms in financial difficulty. These responsibilities lie with the Authority as part of its regulatory objectives of maintaining market confidence, promoting public understanding of the financial system, securing appropriate consumer protection and reducing financial crime.

The current stated aims and objectives of the Scheme include:

(a) to claimants - to provide a high quality compensation scheme that is efficient, fair, approachable and responsive; and, where appropriate, to work proactively with insolvency practitioners and other persons and organisations in securing cost-effective redress for claimants and delivering compensation;

(b) to its industry stakeholders - to provide an accountable and cost-efficient compensation service funded to the correct level; and to work proactively to secure recoveries from firms in default;

(c) to the Authority - while acknowledging its independence, to be accountable to the Authority as required by legislation; and generally to work in partnership for the benefit of the UK's regulatory system;

The Scheme has a number of powers to enable it to achieve these objectives. Its principal power is to compensate consumers in the event of the failure of any Firm, which includes the failure of any deposit-taker. The Scheme is able to make levies on Firms to enable it to pay compensation or meet the other costs of discharging its functions.

The Scheme has general corporate powers to do all things necessary to exercise its functions, including specific powers to borrow money, establish subsidiaries and make investments. The Act also confers powers on the Scheme, including the power to require relevant persons to provide certain information. In exercising its functions, the Scheme must have regard to its effective, economic and efficient operation.

2. Governance

The Scheme was established by the Authority to exercise certain compensation related functions conferred by the Act. The Scheme is a company limited by guarantee and is a separate organisation from the Authority.

The Scheme must administer a compensation scheme in accordance with the rules in the Authority handbook (the "Handbook") and any other rules prescribed by law to ensure that the compensation scheme is administered in a procedurally fair manner and in accordance with the European Convention on Human Rights.

The conduct of Scheme is the responsibility of its board of directors. The directors are appointed by the Authority on terms that are intended to ensure that they run the Scheme independently of the Authority. The appointment and removal of the chairman of the Scheme is subject to Treasury approval. Although the Scheme is independent from the Authority, it is accountable to it and ultimately to the Treasury.

The Scheme has set up three industry committees covering deposits, insurance and investments. The committees are made up of Scheme board members and experienced representatives co-opted from industry. The comittees may invite other industry experts to advise them from time to time. The role of the committees is to:

(a) look at industry issues that could affect the Scheme;

(b) review the flow of work and likely future workload for the Scheme; and

(c) monitor the Scheme's relationship with levy payers.

The Scheme has appointed the Authority to act as its agent to collect relevant data, raise and issue any levies and collect all payments due on its behalf. This is designed to avoid duplication and reduce costs to Firms.

3. Information Sharing & Interrelationship among Safety-net Players

The Authority is the single regulator for financial services in the UK. It is an independent non-governmental body established under the Act in the form of a company limited by guarantee. The Act provides the Authority with four regulatory objectives (which are summarised in paragraph 1.3 above). The Act gives the Authority wide powers to achieve these objectives.

The Authority co-operates closely with other UK agencies and government departments that have related responsibilities, including HM Treasury, the Bank of England and the Department of Trade and Industry. The Authority's Enforcement Division works with other regulatory bodies and law enforcement agencies, both in the UK and abroad.

There is a memorandum of understanding in place between the Authority and the Scheme, which sets out the relationship of the two parties and their obligations to each other. The parties undertake to share information and to keep each other informed of any issues considered relevant to their respective roles. They agree to meet regularly, at the appropriate levels of seniority, to discuss matters of mutual concern and agree, wherever possible and appropriate, to give each other advance warning of relevant issues. The Scheme must submit a report to the Authority at least once a year as to the discharge of its functions and may provide other reports as requested.

The parties recognise that identification of situations where there is entitlement to compensation is an important source of regulatory information about hazards to consumers. On the Authority's part, it agrees to keep the Scheme informed in as timely a manner as is reasonably practicable of any regulatory and market developments that may impact on the operation of Scheme.

4. Membership

The Scheme is a safety net for customers of financial services firms that are regulated by the Authority. A claim under the Scheme may be made against a body that was a Firm (or the appointed representative of a Firm) at the time of the act or omission that gave rise to the claim.

In general, a Firm is a body that has been given permission by the Authority to carry out one or more regulated activities. These regulated activities include accepting deposits (not all types of deposits are protected under the Scheme, however).

A European Economic Area ("EEA") firm that operates in the UK, but is authorised by its home state regulator, may also be a Firm covered by the Scheme. EEA firms can apply to "top-up" into the UK Scheme if the level of cover offered by their home state scheme is less that that offered by the Scheme in the UK. If they do "top-up", only their UK branches are covered by the increased limit.

UK branches of non-EEA institutions are regulated by the Authority and are in consequence covered by the Scheme. Cover for these institutions is the same as that offered to UK incorporated institutions.

Where a Firm was not incorporated in the UK, the rules and legislation of its place of incorporation may affect the rights and powers of the Scheme or the Authority in relation to the insolvency of that Firm.

5. Coverage: Deposits with Banks and Others

A person is eligible to claim compensation from the Scheme if he has made a protected deposit with a Firm and he does fall within a category that has been specifically excluded by the Handbook. Persons not eligible to claim compensation include:

(a) persons authorised by the Authority to carry out regulated activities (other than sole traders or small businesses);

(b) overseas financial services institutions;

(c) collective investment schemes; and

(d) large partnerships.

On application from an eligible claimant, the Scheme may pay compensation if it is satisfied that the claim is in respect of a protected deposit and is made against a Firm that is in default. Default will generally be determined by the Scheme or the Authority by reference to the ability of the firm to pay claims against it and to whether the firm is subject to formal insolvency proceedings (in the UK or another jurisdiction).

Compensation payable under the Scheme is limited. In the case of protected deposits, the level of cover currently extends to 100% of the first £2,000, and then 90% of the next £33,000. The maximum payable to a single depositor is therefore £31,700. In the case of joint accounts, each individual is eligible to receive compensation up to the maximum limit in respect of their share of the deposit. The Scheme will assume that the split is 50/50 unless evidence shows otherwise.

6. Reimbursing Depositors

If the Scheme determines that compensation is payable in respect of a protected deposit, it must pay that compensation to the claimant, or as directed by the claimant.

The Scheme may decide to pay an appropriate lesser sum in final settlement or to make payment on account if it considers that immediate payment in full would not be prudent because:

(a) there is uncertainty as to the amount of the claimant's overall net claim; or

(b) the claimant has a reasonable prospect of recovery in respect of the claim from a third party.

7. Risk Assessment

The Scheme does not itself monitor the risk of a Firm becoming unable, or likely to be unable, to pay claims against it. This role is carried out by the Authority as part of a broader risk assessment framework that monitors risks to the Authority's regulatory objectives.

Using quantitative information provided to the Authority by a Firm, that Firm is given a common impact score across the regulatory objectives. All Firms other than those designated low impact, are subject to an individual risk assessment. This assessment is a high level review to check compliance with the Handbook, identifying external risks, such as political and economic factors, as well as business and control risks. In order to relate the business and control risks to the regulatory objectives, the Authority assess whether these risks affect one or more of seven regulatory risks, including financial failure.

Following this assessment, the Authority will provide a Firm with a risk mitigation plan, which will identify the issues it considers to pose a risk to its regulatory objectives and will propose actions to address those issues. The Authority will monitor the risk mitigation programme to ensure the intended outcomes are achieved within the timeframe set. A Firm is re-assessed on a timetable that depends on its risk profile. Reviews may also take place where there is a change in the external environment materially affecting a Firm, or where there is evidence that a measure has not produced the desired outcome.

If a Firm is designated as low impact it does not have an individual risk assessment or risk mitigation programme, unless the Authority otherwise decides. Low impact Firms are monitored by a combination of: baseline monitoring (that is, the receipt and monitoring of returns and notifications); action in response to risks identified by that information; and, sample exercises to monitor compliance standards in a sector. This monitoring allows the Authority to identify if a Firm moves out of the low impact category, and so requires an individual risk assessment and mitigation programme.

Intervention

The Scheme's powers to intervene where a Firm is in financial difficulty are limited to circumstances where it has already paid compensation or where the Firm is subject to formal insolvency proceedings (see section 10 below). Conversely, the Authority may intervene in a number of ways and has a wide range of enforcement powers and regulatory tools to help it meet its regulatory objectives. These include powers to conduct investigations, which may lead to formal disciplinary action, and powers to intervene and obtain restitution.

The Authority may also withdraw authorisation from a Firm. This is intended to help ensure high standards of regulatory conduct by preventing a Firm from continuing to perform the controlled function to which the authorisation relates if it is not a fit and proper body to perform that function. It is also hoped to demonstrate generally to authorised persons the consequences of failing to comply with appropriate standards of conduct.

The Authority's enforcement powers may be exercised in, or reviewed by, the criminal courts, the civil courts and the Financial Services and Markets Tribunal. For example, the Authority has power to prosecute particular offences in the criminal courts, it may seek to obtain injunctions in the civil courts, and its powers to impose disciplinary sanctions are subject to referral to the tribunal.

The Authority recognises that even where a Firm or other person has failed to comply with the requirements of the Act, the Handbook, or other relevant legislation, formal disciplinary or other enforcement action may not be appropriate.

The proactive supervision and monitoring of Firms, and an open and cooperative relationship between Firms and their supervisors, may lead the

Authority or supervisor to reach an informal settlement with a firm as to the resolution of breaches of its compliance with the requirements of the Act. If the Firm does not act promptly to deal with the Authority's concerns, it is likely that the Authority will revert to disciplinary or other enforcement action.

8. Failure Resolution

Where a Firm faces financial failure, the Authority has a number of powers and rights under the Act to apply to court for orders stopping Firms from carrying on insolvent or unlawful businesses.

The Authority will consider the facts of each particular case when it decides whether to use its powers or exercise its rights. The Authority will also consider the other powers available to it and to consumers under the Act and other legislation, along with the extent to which the use of those other powers meets the needs of consumers as a whole and the Authority's regulatory objectives.

The Authority's principal power in such circumstances is its ability to make an application to court to place a firm into administration or liquidation. The principal ground for doing so is that a Firm is unable, or (in the case of administration orders) is likely to become unable, to pay its debts. The Authority does not have to be a creditor to petition on these grounds.

The Authority will not usually seek to place a Firm into a formal insolvency process solely on the ground of its inability to pay its debts (as provided in the Act). The Authority will only do so if it believes that the Firm is, or is likely to become, unable to meet its obligations. The Authority will look at other methods of resolving the Firm's financial difficulties and will consider various factors surrounding any default, including the relationship between the Firm and its creditors.

Where the Authority decides a Firm is or is likely to become unable to pay its debts, the Authority's approach will be in two stages. It will consider:

(a) whether it is appropriate to seek any insolvency order - this will include, among other things, looking at whether the Firm is taking steps to deal with its insolvency, the effectiveness of those steps and the effect on the creditors of the Firm if an insolvency order is made. The term “insolvency order” means an administration order, a compulsory winding up order, a bankruptcy order or a sequestration order; and

(b) which insolvency order will meet, or is likely to meet, the needs of consumers - having regard to matters such as nature of the business of the Firm and the purpose to be achieved by the insolvency procedure.

Neither the Scheme nor the Authority will take insolvency appointments in relation to a Firm. However, the powers referred to in this section and the next to determine the timing and conduct of any insolvency process give both bodies crucial supervisory and consultative roles in relation to a Firm in financial difficulty. The Scheme and the Authority will discharge these roles through using their power to appear at any court applications in relation to winding-up or administration. The Scheme and the Authority will also work with the insolvency practitioners appointed to a Firm or the proponents of schemes or compositions between a Firm and its creditors to achieve arrangements acceptable to the Scheme and the Authority.

In practice, the Scheme’s role in relation to compositions or arrangements has proven to be the most significant. The Scheme’s consultative function is reinforced by an express power to appear at any court application relating to the proposal or implementation of a scheme of arrangement in relation to a Firm.

9. Claims, Recoveries and Estate Management

Where a Firm has become unable to pay its debts, there are a number of ways in which the Scheme and the Authority can help to ensure the orderly realisation and distribution of that Firm’s assets.

Where the Scheme has paid compensation to a claimant, it may take an assignment of that claimant’s rights against the relevant Firm (or against any third party, or both). This will make the Scheme a direct creditor of that Firm (or third party) and will give the Scheme all rights that are afforded to a creditor under English insolvency law, including the ability to petition for and participate in formal insolvency proceedings in relation to that Firm.

If a claimant assigns any of his rights against a Firm to the Scheme as a condition of payment, any sum payable in relation to those rights will be payable to the Scheme and not to the claimant. The Scheme's right of recovery in these circumstances cannot exceed any right the claimant would have had; and to the extent that an amount recovered exceeds the compensation paid, recoveries must be paid to the claimant.

The Scheme's right to take an assignment of creditors' claims in return for the payment of compensation gives it a major role in either any formal insolvency procedure relating to a Firm or attempts made by that Firm to formulate a composition or arrangement with its creditors. Experience shows that in many cases, the Scheme will become a member of a Firm's formal or informal creditors' committee. Where a Firm has a large number of creditors who are eligible to receive compensation from the Scheme, the Scheme's rights to assignment will be very likely to give it the ability to block a composition or arrangement that contains terms unacceptable to it.

The result is that the proponents of a compromise between a Firm and its creditors will need to work with the Scheme and the Authority throughout the relevant insolvency or composition process. To date, the best known examples of such cooperation have occurred in relation to the participation of the Scheme and its predecessor in relation to insurance compensation, the Policyholders Protection Board, in schemes of arrangement between insolvent insurers and their creditors.

The Scheme is empowered to take such measures as it considers appropriate to safeguard the rights of claimants in respect of certain contracts of insurance where it considers that the cost of doing so is likely to be no more than the cost of paying compensation. The categories of insurance to which these provisions relate include compulsory cover such as employers' liability and motor insurance. The writers' experience, gained in many years, has been that obtaining the Scheme's approval to the terms of a particular scheme of arrangement is one of the key stages, towards achieving its successful implementation, certainly where the Firm has a material number of policyholders eligible to receive compensation under the Scheme.

In addition to any rights it may have against an insolvent Firm in its capacity as a creditor, the Scheme has a number of further rights under the Act. If a person other than the Scheme makes an application to court for an administration or compulsory winding up order in relation to a Firm (or an administrator is appointed to a Firm out of court) the Scheme may participate in that insolvency process in a number of ways:

(a) the Scheme is entitled to be heard at the hearing of the relevant application and at any other hearing of the court in relation to the insolvency proceedings;

(b) notices and other documents required to be sent to creditors of the Firm must generally also be sent to the Scheme and the Scheme has a power to inspect certain other documents;

(c) the Scheme is entitled to appoint a person to attend and make representations at any meeting of creditors (or creditors' committees) of the Firm;

(d) where a Firm is in administration, the Scheme may apply to the court to challenge the administrator's conduct where it thinks that the administrator has acted (or is proposing to act) in a way that is harmful to the interests of the Scheme;

(e) if, during the course of an administration or winding up of a Firm, a compromise or arrangement is proposed between the company and its creditors, or any class of them, the Scheme may apply to the court for the arrangement to be made in accordance with statutory rules and sanctioned by the court.

The rights of the Authority to participate in the insolvency proceedings of Firm are broader than those of the Scheme. The Authority has all those rights set out in paragraph10.7 above in relation to administration or compulsory winding up. The Authority will have similar rights where a Firm proposes a voluntary arrangement with its creditors or a receiver is appointed over the property of a Firm. The Authority also has the power to apply to court to set aside transactions that appear to have been entered into for the purpose of defrauding creditors.

The Authority (or the Scheme) will consider a number of issues in deciding whether to participate in the insolvency proceedings of a Firm. These will include, among other things, the extent of claims by consumers upon the Firm and whether the circumstances which gave rise to the insolvency regime might have general implications for others carrying on a regulated business. The Authority and the Scheme will coordinate any participation and will only intervene where doing so is considered appropriate to meet the needs of consumers and further their regulatory or stated objectives.

The Scheme's decision whether or not to participate in and support a particular insolvency or composition will have a far reaching effect on the outcome of the process. The Scheme will not itself be able to determine the extent to which a sale of the business and assets of a Firm to a third party should go ahead. The Authority will have a say in these matters through its powers to regulate and to authorise Firms and their managers to carry on business.

The United States

Deposit Insurance Systems - The United States

1. Objectives, Mandates & Powers

The Federal Deposit Insurance Corporation (hereinafter "FDIC") was established by the United States Congress in 1933 with the passage of The Banking Act of 1933 which was signed into law by President Franklin D. Roosevelt on June 16,1933. The actual insurance of bank deposits became effective on January 1, 1934, when the FDIC began its operations. The initial deposit insurance plan was temporary, but it became permanent with the passage of The Banking Act of 1935. The FDIC was established at the height of the Great Depression in the United States when many banks were unable to meet their obligations.

The FDIC has three basic mandates:

(a) to provide deposit insurance for the vast majority of banks and savings associations in the United States;

(b) to act as the primary federal regulator for some of the banks (state-chartered banks that are not members of the Federal Reserve System) that it insures; and

(c) to serve as the receiver and liquidator of failed banks and saving associations.

These basic mandates are periodically reviewed, although they have not changed over the years.

The FDIC has primary examination authority over state-chartered banks that are not members of the Federal Reserve System. It may also examine other types of banks (by agreement with their primary regulator) when it is determined that the banks present certain risks to the relevant FDIC insurance fund. In addition, the FDIC has primary federal authority to take enforcement actions against state-chartered banks that are not members of the Federal Reserve System and has back-up enforcement authority over all other FDIC-insured institutions.

Although the chartering authority generally makes the decision to close institutions and appoints the FDIC as receiver of a failed institution, the FDIC as receiver determines how to resolve the institution and when to pay depositor claims. The FDIC can also provide open bank assistance, but circumstances under which such assistance can be provided are specified in the law and would rarely be met. It also has the authority to set standards and guidelines for its member institutions, although this is frequently done in conjunction with other regulators.

Further information concerning the FDIC's mission, vision, and values can be viewed at www.fdic.gov/about/strategic/report/2003annualreport/index.html. Statistics about the FDIC's activities, including numbers of insured institutions, total assets and categories of members as of June, 2004 can be viewed at www.fdic.gov/bank/statistical/stats/2004jun/industry.html.

2. Governance

The FDIC is a legally separate organization from other public or private bodies. It is governed by a Board of Directors, whose members are appointed by the President of the United States, but upon their nomination, must be confirmed by the U.S. Senate.

By statute, the FDIC Board consists of five members. Three of these are FDIC Board members (including a chairman and vice chairman); the other two members serve by virtue of their positions as heads of the Office of the Comptroller of the Currency and Office of Thrift Supervision, both bureaus of the Department of Treasury. No more than three Board members can belong to the same political party. One of the five members must have state bank supervisory experience.

The Board of Directors is responsible for all aspects of the Corporation's operations. However, under the U.S. system, the FDIC is a regulator and supervisor as well as deposit insurer. The FDIC is the primary regulator and supervisor of state-chartered institutions that are not members of the Federal Reserve System. The Comptroller of the Currency and the Director of the Office of Thrift Supervision are ex-officio members of the FDIC Board of Directors, only the central bank, which is the Board of Governors of the Federal Reserve System, nor the insured institutions are represented in FDIC management.

3. Information Sharing and Interrelationship Among Safety-Net Players

Depending upon how an insured institution is chartered, it may be subject to examination by the FDIC, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve, and the state chartering authority, or some combination thereof. The FDIC performs safety-and-soundness examinations of state-chartered, insured institutions that are not members of the Federal Reserve System. It also performs examinations to ascertain compliance with the Community Reinvestment Act. In its role as the deposit insurer, the FDIC also is empowered to conduct examinations as deemed necessary to protect the insurance funds.

The FDIC and the other regulators conduct periodic on-site examinations of all federally insured institutions. These institutions are also monitored through an off-site examination process. In addition, all insured banks are required to file quarterly Reports of Condition and Income (Call Reports). Insured thrifts are required to file quarterly Thrift Financial Reports.

The FDIC coordinates with the other federal banking regulators and with its supervisory counterparts at the state level. The FDIC also is an active member of the Federal Financial Examination Council (“FFIEC”), which is made up of representatives of the four federal regulators. In addition, the FDIC regularly contacts other deposit insurance authorities such as the Canada Deposit Insurance Corporation, and through the International Association of Deposit Insurers (IADI).

As an independent agency, the FDIC is not required to consult with other agencies on deposit insurance issues. The agency must follow federal rule-making guidelines that require extensive public notification and solicitation of comments whenever regulations are instituted or materially changed. The rule-making process for regulations pertaining to examination and supervision are coordinated with the other regulators through the FFIEC.

4. Membership

The FDIC insures a wide variety of banks and savings associations headquartered in the United States that operate under bank or thrift charters (licenses) obtained from either the federal government or one of the fifty state governments. At the federal level, the most common types of institutions are national banks, federal savings associations and federal savings banks. At the state level, some of the more common types of institutions are commercial banks, savings and loan institutions, savings banks and industrial loan companies. Credit unions in the United States are not insured by the FDIC but are insured by a separate government agency called the National Credit Union Association ("NCUA"). As of June 30, 2004 there were 9,079 FDIC-insured institutions.

FDIC insurance is mandatory for all depository institutions that accept retail deposits in the United States. This is because national banks and federally-chartered savings institutions are required by law to have FDIC insurance, and most state laws require retail depository institutions to have FDIC insurance. In a few states, the law may not expressly require depository institutions to have FDIC insurance but the banking regulator may require it as a condition for approval of the banking charter. All FDIC-insured institutions are required to abide by all applicable laws, regulations and any orders issued by the FDIC.

Any institution that wishes to be insured by the FDIC must file an application with the FDIC. The factors considered in the application process are specified in section 6 of the Federal Deposit Insurance Act., 12 U.S.C. 1816, and include the following: (1) the financial history and condition of the depository institution; (2) the adequacy of the depository institution's capital structure; (3) the future earnings prospects of the depository institution; (4) the general character and fitness of the management of the depository institution; (5) the risk presented by the depository institution to the insurance fund; (6) the convenience and needs of the community to be served by the depository institution; and (7) whether the depository institution's corporate powers are consistent with the purposes of the Federal Deposit Insurance Act.

The FDIC is solely responsible for making the determination concerning deposit insurance applications. However, newly formed institutions generally apply for a banking charter (license) at the same time they apply for deposit insurance. The two applications are submitted simultaneously, one to the state or federal chartering authority and the other to the FDIC. The FDIC communicates and coordinates the approval of the deposit insurance application with the relevant chartering authority.

Foreign banks are now generally required to have separately capitalized subsidiaries to conduct retail deposit-taking activities in the United States, although it is possible for a foreign bank to operate a branch that maintains only wholesale deposits. They are subject to the same assessments and their deposits are entitled to the same insurance coverage that is provided for domestic banks.

5. Coverage

Section 3(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(1)) defines the term “deposit” as follows:

(a) the unpaid balance of money or its equivalent received or held by a bank or savings association in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the bank or savings association, or a letter of credit or a traveler’s check on which the bank or savings association is primarily liable: Provided, That, without limiting the generality of the term “money or its equivalent”, any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable, or for a charge against a deposit account, or in settlement of checks, drafts, or other instruments forwarded to such bank or savings association for collection,

(b) trust funds as defined in this Act received or held by such bank or savings association, whether held in the trust department or held or deposited in any other department of such bank or savings association,

(c) money received or held by a bank or savings association, or the credit given for money or its equivalent received or held by a bank or savings association, in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including without being limited to, escrow funds, funds held as security for an obligation due to the bank or savings association or others (including funds held as dealers reserves) or for securities loaned by the bank or savings association, funds deposited by a debtor to meet maturing obligations, funds deposited as advance payment on subscriptions to United States Government securities, funds held for distribution or purchase of securities, funds held to meet its acceptances or letters of credit, and withheld taxes: Provided, That there shall not be included funds which are received by the bank or savings association for immediate application to the reduction of an indebtedness to the receiving bank or savings association, or under condition that the receipt thereof immediately reduces or extinguishes such an indebtedness,

(d) outstanding draft (including advice or authorization to charge a bank's or a savings association's balance in another bank or savings association), cashier's check, money order, or other officer's check issued in the usual course of business for any purpose, including without being limited to those issued in payment for services, dividends, or purchases, and

(e) such other obligations of a bank or savings association as the Board of Directors, after consultation with the Comptroller of the Currency, Director of the Office of Thrift Supervision, and the Board of Governors of the Federal Reserve System, shall find and prescribe by regulation to be deposit liabilities by general usage, except that the following shall not be a deposit for any of the purposes of this Act or be included as part of the total deposits or of an insured deposit:

  (i) any obligation of a depository institution which is carried on the books and records of an office of such bank or savings association located outside of any State, unless:

    (a) such obligation would be a deposit if it were carried on the books and records of the depository institution, and would be payable at, an office located in any State; and

    (b) the contract evidencing the obligation provides by express terms, and not by implication, for payment at an office of the depository institution located in any State;

  (ii) any international banking facility deposit, including an international banking facility time deposit, as such term is from time to time defined by the Board of Governors of the Federal Reserve System in regulation D or any successor regulation issued by the Board of Governors of the Federal Reserve System; and

(iii) any liability of an insured depository institution that arises under an annuity contract, the income of which is tax deferred under section 72 of the Internal Revenue Code of 1986.

In addition section 3(m) of the Federal Deposit Insurance Act (12 U.S.C. 1813(m)) defines the term “insured deposit”, “uninsured deposits” and “preferred deposits” as follows:

(a) In General

Subject to paragraph (2), the term “insured deposit” means the net amount due to any depositor for deposits in an insured depository institution as determined under sections 7(i) and 11(a).

(b) In the case of any deposit in a branch of a foreign bank, the term “insured deposit” means an insured deposit as defined in paragraph (1) of this subsection which:

(i) is payable in the United States to:

(a) an individual who is a citizen or resident of the United States;

(b) a partnership, corporation, trust, or other legally cognizable entity created under the laws of the United States or any State and having its principal place of business within the United States or any State, or

(c) an individual, partnership, corporation, trust, or other legally cognizable entity which is determined by the Board of Directors in accordance with its regulations to have such business or financial relationships in the United States as to make the insurance of such deposit consistent with the purposes of this Act; and

(ii) meets any other criteria prescribed by the Board of Directors by regulation as necessary or appropriate in its judgment to carry out the purposes of this Act or to facilitate the administration thereof.

(c) Uninsured Deposits

The term “uninsured deposit” means the amount of any deposit of any depositor at any insured depository institution in excess of the amount of the insured deposits of such depositor (if any) at such depository institution.

(d) Preferred Deposits

The term “preferred deposits” means deposits of any public unit (as defined in paragraph (1)) at any insured depository institution, which are secured or collateralized as required under State law.

The types of accounts that are eligible for coverage by the FDIC are savings accounts, checking accounts, certificates of deposit, travelers checks on which the institution is primarily liable, money orders for those in which the institution is primarily liable, certified drafts of checks, foreign currency deposits, and inter-bank deposits. Annuity contracts are not insured, although certain bank accounts maintained in connection with annuity contracts can be insured by the FDIC. In addition, any type of deposit liability is insured if it comes within the above definition of “deposit” and is entitled to coverage pursuant to the FDIC’s deposit insurance regulations, 12 C.F.R. Part 330. Developers of new financial products often seek a legal opinion from the FDIC confirming the eligibility of their products for FDIC coverage and specifying the manner and extent to which the product will be covered.

Insurance coverage is per depositor per institution. The basic coverage limit is $100,000 per depositor. However, depositors can obtain separate `insurance-coverage for their interests in individual-accounts, joint ownership accounts, certain types of revocable and irrevocable trusts accounts, pension and other employee benefit accounts, etc. Consequently, a depositor can have far in excess of $100,000 insured at a single bank if he/she has funds owned in different manners and satisfies the FDIC’s regulatory requirements for the separate coverage provided for different types of accounts.

The initial deposit insurance limit (when the FDIC first commenced operations in January 1934) was $2,500. Over the past 70 years, this basic limit has been raised by the United States Congress on an incremental basis. The last time it was raised was in 1980 when the U.S. Congress set the limit at $100,000, with the passage of the Depository Institutions Deregulation and Monetary Control Act. The amount of coverage is not indexed, but the FDIC has proposed legislation that, if enacted, would provide for indexing of the coverage limit.

The basic coverage levels are the same regardless of the resolution method employed at a particular depository institution. However, in resolution transactions where all of an institution's deposits (as opposed to just its insured deposits) are transferred to an assuming depository institution, the coverage rules are not applicable. In those situations the net result is as if there had been full coverage of an entire deposit regardless of amount.

When one insured depository institution merges with another insured institution, the deposits assumed continue to be separately insured for 6 months from the date of the assumption or, in the case of time deposits, until the first maturity date after the end of the six-month period. If a time deposit matures during the six-month period and is rolled over on the same terms and conditions as the initial deposit, the separate insurance continues until the first maturity date after the end of the six-month period. If it is rolled over on any other terms, the separate insurance ceases. See 12 U.S.C. 1818(q) and 12 C.F.R. 330.4.

6. Reimbursing Depositors

The FDIC reimburses insured depositors—pays deposit insurance—in one of two ways. The first option is by transferring the insured portion of a depositor's account to another FDIC-insured financial institution. The second option is by a pay out of the insured portion of the deposit accounts in the form of checks sent directly to the depositors. By law, the FDIC is required to pay deposit insurance proceeds as soon as possible. The FDIC typically is able to fully reimburse insured depositors on the first business day following the bank failure.

Depositors are not typically required to file a claim in order to receive deposit insurance payments. However, if a depositor has a deposit in an amount that may exceed the deposit insurance limit, the depositor may have to complete paperwork and/or submit documentation to the FDIC to complete the deposit insurance determination process. In return for making a payment of deposit insurance, the FDIC receives the depositor's rights to the liquidation proceeds of the closed financial institution, up to the amount of the payment.

The standards for determining the proper amount of deposit insurance coverage have been established by law and FDIC regulation. Deposit insurance limits are set for various ownership categories (individual, joint, trusts, etc.) for deposit accounts. These ownership categories can qualify for separate deposit insurance coverage.

The FDIC uses a competitive bidding process to determine if other insured financial institutions are interested in acquiring the deposits of a failing insured financial institution. Such bidders frequently agree to accept these deposits at a discount that is usually less than ten per cent. This discount, commonly referred to as a bid “premium,” helps to lower the FDIC’s overall cost of resolving the failed institution. Bidders typically will pay this premium to expand their own deposit base and market, to gain access to additional customers for cross-selling opportunities, and/or to acquire or consolidate branch locations. If an acceptable bid is not received for acquiring the insured deposits, the insured balance in each account is paid directly to the accountholder in the form of a check drawn on the FDIC.

Insured institutions that have capital below 2 percent of assets can be closed at the end of 90 days unless they can secure additional capital to cure their capital deficiency. The primary regulator formally issues this notice in the form of a prompt-corrective-action letter to the Board of Directors of the potentially failing institution. The FDIC’s resolutions staff is typically given access to the institution’s financial and depositor records shortly thereafter.

A failing financial institution typically is closed as of the close of business on Friday evening. The insured deposits are determined and transferred, over the course of that weekend, to the acquiring insured financial institution so that the insured portion of these accounts are available for transactions on the next business day. Access to insured deposits is virtually uninterrupted for most depositors. Payments to depositors are funded by FDIC resources, which are replenished through the collection and/or sale of the failed bank assets.

Deposit insurance payments include account principal and interest accrued up to the date of the institution failure. Depositors with uninsured deposits will periodically receive check payments representing their share of the distribution of proceeds from the collection and/or sale of the failed financial institution’s assets. These distributions generally do not include any interest payment for the time taken to collect and distribute this type of payment.

Each accountholder receives a formal notice of the deposit insurance payment process through the mail for each deposit account. Notices also are posted at each deposit taking office of the failed financial institution. Press releases are sent to local media outlets, are made available on the internet, and are published in local newspaper.

7. Risk Assessment & Intervention

The FDIC uses a system of assigned case managers to monitor risk at all insured institutions. The case manager of an institution has access to all FDIC data as well as the correspondence files. Each quarter, some institutions are identified for additional review by off-site models, and the case managers are responsible for reviewing the risk profile of these institutions. In addition, case managers are responsible for reviewing the risk-related premium classification of selected institutions. The case manager is also responsible for monitoring any concerns that arise during the course of an on-site examination.

The FDIC regularly examines certain insured institutions, and it has the legal authority to examine any insured institution. Much of the examination responsibility is delegated to other federal banking agencies as well as to state agencies. The examination activities of the federal agencies are coordinated by FFIEC, and most states have adopted standards similar to the federal standards. The FDIC has access to all examination ratings as well as to the examination reports of the other federal regulators as well as the state agencies.

The FDIC receives quarterly financial reports from all insured institutions, either directly or from the primary federal regulator. In addition, bank examinations conducted every twelve to eighteen months generate data on the quality of the loan portfolio. This information is transmitted to the FDIC by the examining agency. At larger institutions, the larger loans are reviewed annually by a team that includes FDIC examiners.

On-site examinations are the basis for the fundamental risk assessment at the FDIC. As a result of each examination, banks are rated on each of the components of the CAMELS system (Capital adequacy, Asset quality, Management, Earnings, Liquidity, and market Sensitivity) are given a composite rating, as well. The composite rating summarizes the strength of the institution; there is no formal relationship between composite ratings and component ratings. A rating of 2 is considered sound while a rating of 1 is considered strong. Institutions with ratings of 3 have clearly identified weaknesses, and those with ratings of 4 are in some danger of failure. Institutions with ratings of 5 are in imminent danger of failure. Institutions with ratings of 3 or worse are subjected to more intensive and more frequent on-site examinations. Off-site systems and the case manager system are considered supplements to examinations.

The other federal agencies as well as the state agencies work closely with the FDIC when an institution is in trouble. The FDIC can use a variety of possible enforcement actions. Actions can be informal, such as a resolution by the board of the insured institution to remedy a list of specific defects that were identified in the last examination. Actions can also be formal, such as cease-and-desist order which is enforceable in court. Enforcement actions can concern almost any aspect of bank operations that threatens the safety and soundness of the institution. Almost all institutions that have composite ratings of 3 or worse are subject to some sort of enforcement action. In the most extreme case, the FDIC can revoke an institution's deposit insurance.

8. Failure Resolution

It is the primary regulator that determines whether a member institution has failed or is "insolvent." If such a determination is made, the primary regulator of a problem bank or thrift can close a member institution and appoint the FDIC as its receiver. The most common reasons for closing an institution are: being "critically undercapitalized," (as defined by law) having assets insufficient to meet obligations, engaging in unsafe or unsound banking practices, willful violation of a cease-and-desist order, concealment or tampering with books and records, money laundering, or the voluntary cessation of insured status.

The FDIC also has the authority appoint itself as receiver or conservator. This can be done in the event the institution's primary regulator is unwilling or unable to close a financial institution whose continued operation is viewed as increasing the potential loss to the deposit insurance fund.

After its appointment as receiver, the FDIC has full power to marshal and sell assets, determine liabilities, and operate the institution in a manner consistent with its role as receiver. As receiver, the FDIC has a number of special powers that have been granted by federal law to promote the efficient resolution of a failed institution’s affairs. The receiver has the power to void certain transfers made to an institution’s obligors within five years of the receiver’s appointment if made with an intent to hinder, delay or defraud the institution, the Corporation, or any other federal banking agency. Unless an agreement is properly documented in the institution’s records, it cannot be enforced against the receiver, either to make a claim against or to defend against, a claim by, the receiver. As receiver, the FDIC may repudiate contracts of the depository institution that it deems to be burdensome.

As receiver, the FDIC is substituted as a party in any litigation pending against the failed bank or thrift. The court must stay the litigation at the request of the receiver to allow the receiver time to evaluate the facts of the matter and decide how best to proceed. The receiver also has the right to remove litigation from state court to federal court. Courts are prohibited from issuing injunctions or similar equitable relief to restrain the receiver from completing its resolution or liquidation activities.

The methods of failure resolution used by the FDIC include the following types of transactions: (1) purchase and assumption transactions, which can have many variations depending on the mix of assets and liabilities transferred; (2) a insured-deposit transfer; (3) a direct payout ; and (4) open-bank assistance. In the past ten years, the FDIC has arranged 11 payouts and 89 purchase and assumption transactions.

By law, the FDIC must employ the method of resolution that is judged to pose the least cost to the deposit insurance fund, unless the bank’s failure has been determined to present a systemic risk to the U.S. economy. A systemic risk determination must be made and approved by the Board of Directors of the FDIC, The Board of Governors of the Federal Reserve, and the U.S. Secretary of the Treasury (in consultation with the President of the United States). There has never been a determination of systemic risk in connection with a failure since this standard was adopted in 1991.

Private companies may become involved in the resolution process in a number of ways. FDIC-insured financial institutions are among the primary targets of the FDIC’s efforts to sell the deposits and assets of failing FDIC-insured financial institutions. In addition, other private companies are commonly approached as prospective purchasers of failed-bank assets. Private companies also may become involved in the resolution process as contractors for the FDIC. The FDIC has significantly reduced its bank resolution staff in recent years with the intention that resources from private-sector contractors be added as needed to support the resolution process. Private-sector companies may be used to assist the FDIC in the valuation and sale of failing-bank assets, as advisors for developing and implementing sales strategies, for securing and servicing financial institution assets and liabilities, and for other needs and services identified as critical to the success of the resolution process.

The following is a list of the number of failures handled by the FDIC in recent years:

Year	**Number of Failures**
2004 as of March 12	4
2003	3
2002	10
2001	4
2000	7
1999	8
1998	3
1997	1
1996	6
1995	6
1994	13

9. Claims, Recoveries & Estate Management

The FDIC as receiver is required to maximize the return on the assets of the failed bank or savings association and to minimize any loss to the deposit insurance fund that may result from closing the institution. A receivership is designed to market the institution's assets, liquidate them, and distribute the proceeds to the institution's creditors. The FDIC as receiver succeeds to the rights, powers, and privileges of the institution and its stockholders, officers and directors. A receiver also has the power to merge a failed institution with another insured depository institution or to form a new nationally chartered institution, known as a bridge bank. The receiver is not subject to the direction or supervision of any other regulatory authority.

Private-sector assistance may be sought to assist in the valuation, servicing, marketing, sales and/or collection of failed bank assets on behalf of the receivership.

The FDIC works to dispose of the assets of a failed institution in a timely manner through a variety of methods. The FDIC prefers to sell as many assets as possible at resolution as part of the purchase-and-assumption transaction. The remaining assets are liquidated through whatever is determined to be the most efficient form of commercial transaction. The FDIC gauges the effectiveness and efficiency of its claims and recovery work through assessments and reviews that are conducted internally and by other audit and review organizations.

The assets that are the most difficult to recover are those having the greatest amount of uncertainty. This would include assets having major environmental problems, assets involved in significant legal proceedings, assets involving fraud and/or assets affected by major market dislocations. Market reaction and acceptance is a primary determinant in selecting the type of strategies that will be used to recover different assets. In general, performing and sub-performing loans can be sold in loan pools or through securitization. Real estate assets can be sold through auction or by local brokers.

The priorities of claims paid by the failed bank receivership are as follows:

(a) Administrative expenses of the Receiver

(b) Depositors (both the FDIC as subrogee of the insured depositors and any uninsured depositors)

(c) Unsecured General Creditors

(d) Subordinated debt holders

(e) Stockholders.

Claimants in a higher priority class have their recognized claims reimbursed in full before any monies are paid to the claimants of a lower priority class. Set-off by a depositor is allowed, but mutuality must exist (i.e., the owner of the deposit and the loan must be the same party) for a “set-off” to be considered. The FDIC may compel set-off in the case of a delinquent debt.

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