BANKING REGULATIONS:

COMPARATIVE ANALYSIS BETWEEN JAPAN AND CANADA

BY

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ABSTRACT

The primary purpose of this thesis is to identify the nature of regulatory problems in the Japanese banking system by a comparative analysis of banking regulations between Canada and Japan. Examining preventive measures in the legal frameworks of both countries has resulted in implied solutions for reforming the bank regulatory regime in Japan. This thesis is based on primary legal evidence, specifically statutes and regulations, as well as on the most recent secondary, scholarly studies. The particular problems that are addressed are: capital adequacy, current business activities, and legal frameworks for bank insolvency.

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Introduction

Bank insolvency can occur in the natural course of any business operation. A regime of banking regulations is designed to minimise risks in order to protect depositor and creditor funds and, to a lesser extent, shareholders' funds. Once a bank is insolvent, the effect could be unlimited contagion, inducing other insolvencies within the financial industry, and spreading into other industries. Is a bank especially vulnerable to insolvency and to the effects of another bank insolvency? What is the nature of banking which makes it riskier than ordinary business? The first chapter will examine the nature and causes of bank insolvency.

The regulatory regime on banking is somewhat stricter than those of other industries because of greater susceptibility to insolvency risks and the quasi-public nature of its business, which includes management of funds entrusted by the general public. In this sense, any failure to meet withdrawal demands from depositors will cause confusion for the public. Thus, it is justifiable that stricter external rules are imposed on the banking industry, along with equally stringent internal supervision by banking agencies. A most significant regulation among many others is the requirement of capital adequacy. Once a bank's capital becomes negative, where the value of assets does not exceed the amount of liabilities, the bank is technically insolvent. In this sense, the bank's capital account provides a safety net for depositor funds, and it also measures the safety and soundness of the bank. Furthermore, it is an obligation nowadays for signatory countries of the Bank for International Settlements to adopt a common criterion for measuring capital adequacy. The critical deficiency of Japanese banking capital has highlighted recent regulatory problems in Japanese banks. Chapter Two examines how Japan and Canada have incorporated the BIS standards of capital adequacy.

The bank regulatory regimes in both nations present distinct and unique characteristics, reflecting the development of banking in each country. The regulatory framework for Japanese banks was originally designed for an efficient allocation of capital resources to corporate activities, while those for Canadian banks aimed at balancing competitiveness and solvency. As opposed to Japanese banks, whose ultimate goal was to enhance the viability of corporations, Canadian banks were supposed to enhance social welfare by accommodating various and low cost financial services to cater to private householder needs. Chapter Three will present the stark contrasts in the two banking systems and legal frameworks; current business activities will also be described.

The last chapter is devoted to describing and analysing the bank insolvency law regimes of the two countries. The legal regime for bank insolvency differs from those for non-banking industries in that it accompanies numerous forms of governmental intervention and financial assistance under the auspices of protecting public interest. Since Japan and Canada have enjoyed stable financial systems for the last quarter of this century, insolvency legislation has not been as firmly established as in U.S. laws. Thus, Chapter Four will examine what can be learned about Japan and Canada by comparing and contrasting U.S. bank insolvency legislation with legislation in these two countries.

CHAPTER I. CAUSES OF BANK FAILURES

A. The Phenomenon of Bank Insolvency and its Effect on an Economy

> If a bank is unable to meet a check drawn upon it, the refusal to pay is an act of insolvency. Its doors are closed, its business is arrested, its affair goes into liquidation, and the mischief takes a wide range. Those who have been accommodated with loans must pay, whatever their readiness or ability to do so. Further advances cannot be obtained. Other banks must call in their loans and refuse to extend credit in order to fortify themselves against the uneasiness and even terror of their own depositors. Confidence is destroyed; business is brought to a standstill. Securities are enforced. Property is sacrificed and disaster spread from locality and locality.[1]

This is an excerpt in the U.S. case of *Schakke v. Dolley* in 1911 describing a disastrous episode of bank failure and its negative consequences on corporate and household sectors.[2] The devastating consequences of bank failures are not much different irrespective of time and place.[3] For example, a large-scale financial panic occurred in Japan in the 1920s, which resulted in numerous bank closures.[4] The immediate causes of this panic were the major Tokyo earthquake of 1 September 1923, as well as world-wide economic depression. In order to assist reconstruction of the damaged area, commercial bills were drawn on banks and discounted by the Bank of Japan. The so-called "earthquake bills" amounted to 2.1 billion yen by 1927, and they were continuously rediscounted by the Bank of Japan. A bank run was triggered by a mistaken

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[1] *Schaake* v. *Dolley*, 118 P. 80, 83 (Kan.1911).

[2] Also, Peter P. Swire, "Bank Insolvency Law Now That It Matters Again" (1992) 42 *Duke Law Journal* 469.

[3] Bank failures, and preventive regulation and supervision of the banking industry are main concerns of governments with advanced, industrialised and technology-based economies. For example, in the U.S., legislation governing the banking sector has seen continuous efforts to prevent a recurrence of the situations that occurred during the Great Depression in the 1930s: an infamous episode accompanied by large-scale bank runs, unemployment, and business bankruptcies. See, William A. Lovett, *Banking and Financial Institution Law*, 2nd ed. (St.Paul, Minnesota: West Publishing Company, 1988) at 16 and 51-53. All economic indicators showed the deteriorating economic condition from 1929 to 1933: the GNP declined to almost half its level during this period; index of industrial production shrank from 100 to 63; monetary supply fell from $26.6 to $19.9 billion; and the unemployment rate was as high as 24 % of the work force. Half of the banks ceased operation by the summer of 1933. The Great Depression in the 1930s created the turning point for United States banking legislation; the enactment of the Bank Act of 16 June 1933, which established the Federal Deposit Insurance Corporation, contributed to the sharp decline in bank insolvency.

[4] Thomas. F. Cargill, Michael Hutchison & Takatoshi Ito, *The Political Economy of Japanese Monetary Policy* (Mass.: MIT Press, 1997) at 21-22.

claim of bank insolvency made by the Ministry of Finance when the stability of the banking system had been questioned by the public. This bank run eventually brought many banks into insolvency in 1927. Banks unable to survive this period mainly held bad assets in the form of earthquake bills and had riskier lending practices. Consequently, the Banking Law was enacted in 1927[5] and it altered the national banking system; consolidation of the banking industry progressed, which brought many small and weak banks into closure or merger. The Japanese banking industry enjoyed relatively long-term stability until the 1990s, when the solvency of the whole financial system was put into question.[6] The direct causes of this banking crisis are the enormous amounts of defaulted loans, produced during the bubble economy period of 1987-89, as well as the significant decline in prices of domestic company stocks, which plummeted to half of their peak market levels.[7] It has become obvious that the Japanese economy has entered into deflationary recession since 1992. However, disposal of non-performing loans has been delayed partly because of the "forbearance policy," where government ordered banks not to call in most substandard loans, with a hope that an economical recovery would restore corporate viability.[8] Most defaulted loans, which banks carried in their assets, were those lent to the seven housing loan companies, called *Jusen* companies during the bubble economy period; when *Jusen*

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[5] *Ginko Ho* [Banking Law], Law No. 21 of 1927.

[6] Gregory A. Root, "What's Next for Japanese Banks?" *Financial Executive* 8:5 (September 1992) 25 at 25-34.

[7] Cargill, Hutchison & Ito, *supra* note 4 at 117; also, Geoffrey P. Miller, "The Role of a Central Bank in a Bubble Economy" (1996) 18:1031 Cardozo Law Review 1053 at 1061-65. The following is a brief summary of the situation of the bubble economy. The Japanese stock and real estate markets during the period of 1987-1989 recorded sharp price increases. Although its boom originated with positive economic fundamentals, such as rapid economic growth since the early 1980s, both markets became increasingly overvalued. Once the trend toward price increases was well established, demand fed on itself and increased because of speculation rather than fundamentals. The Nikkei 225 blue chip stocks doubled from Y20,000. in 1987 to Y40,000. by 1989, and land prices, especially in the Tokyo area, had more than doubled over four years. The stock and real estate market booms were accelerated by many factors: many financial institutions heavily invested in both securities and real estate markets; and the Bank of Japan held to a low-interest rate policy. However, since 1990, partly due to the Iraq invasion of Kuwait in August 1990, which triggered a war in the middle east, the price of Nikkei 225 started to decline rapidly and in only five months, the market fell below Y22,000.

[8] Cargill, Hutchinson & Ito, *ibid.* at 117.

companies failed, their parent companies (the major shareholder), large city banks, securities firms, and life insurance companies, found their assets overvalued with an enormous amount of defaulted loans.[9] They had no choice but to aggressively write off such unrecoverable loans against their capital reserves and that eroded their capital levels seriously.[10] In addition, an enormous decline in the prices of domestic company stocks, which had been the main earning sources of Japanese banks, also accelerated the deterioration of bank assets quality; by 1997, speculation started in international markets that the whole Japanese banking industry was about to be insolvent.[11] Furthermore, a deflationary recession in the Japanese economy has been prolonged partly because of a "credit crunch;" banks started to take more risk-adverse attitudes toward lending practices, refusing to lend to even sound clients or to impose higher collateral for loans.[12] Moreover, their massive selling off of corporate stocks, in an effort to maintain adequate capital levels, further declined the price of corporate equity, further lowering corporate viability. Faced with a difficulty in obtaining sufficient capital to fund business operations, as well as a continuing decline in their stock prices, a number of private corporations became bankrupt, and the unemployment rate soured to a record high:[13]

> ...[b]ankruptcies will raise the amount of bad loans crippling the banks. Banks, in response, will tighten credit, forcing more bankruptcies. Unemployment will produce another round of bankruptcies. Risks of a self-reinforcing deflationary cycle remain high.[14]

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[9] *Ibid.* at 120-21.
[10] Anthony Rowley, "From Bad Loans to Worse in Japan" *The Banker* 148:868 (June 1998) 12 at 12.
[11] Neil A. Martin, "Banking Mess Keeps Dragging Down The Tokyo Market, With No Relief in Sight" *BARRON'S* 77: 5 (March 1997).
[12] "Crunch Time?" *The Economist* 384:8052 (January 1998) 70 at 71.
[13] P. Niemira, "Japanese Bankruptcies Soared in '97" *The Chain Store Age* 74:3 (March 1998) 44 at 44; Tanya Clark, "Restructuing Japan-Style: Is Bankruptcy the Road to Reform?" *Industry Week* 247:15 (March 1998) 9 at 9-10.
[14] Sam Jameson, "Resuscitating Japan's Economy" *Asian Business* 34:6 (June 1998) 26.

Likewise, Canada experienced twelve chartered banks that failed between 1890 and 1923.[15] Some bank failures during this period resulted in major losses to depositors, in the absence of a deposit insurance system and of legal provisions which would have required the government to guarantee deposit liabilities of private banks. Thus, when a bank became insolvent, and their asset value was insufficient to cover all liabilities for depositors and secured creditors, a legal provision of "double liability" was enforced on shareholders; shareholders of defaulted banks were required to compensate for depositors' and creditors' loss from their personal wealth equivalent to the subscribed capital.[16] Consequently, after a voluntarily liquidation of Home Bank in 1923,[17] Yet, a second wave of instability started to emerge with regulatory policy mistakes which incorporated regional banks in the western regions during the 1970s and 1980s;[18] both Canadian Commercial Bank and Northland Bank were established to cater to demands from a booming western economy in the late 1970s.[19]

However, neither of the banks could survive the economic recession in Alberta in the beginning of 1980s because (i) their lendings were narrowly focused on development of the real estate and energy industries, (ii) they did not seek their funding source from depositors, but from wholesale money market, (iii) they were lacking in experienced management skills, and (iv) there were

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[15] J.L. Carr, G.F. Mathewson & N.C. Quigley, *Ensuring Failure: Financial System Stability and Deposit Insurance in Canada* (Toronto: C.D. Howe Institution, 1994) at 20.

[16] *Ibid.* at 20, 24. However, there was a time when financial difficulties of several trust and loan corporations were revealed to the public in the late 1960s. See, Ronald A. Shearer, John F. Chant & David E. Bond, *Economics of the Canadian Financial System: Theory, Policy & Institutions,* 3rd ed. (Scarborough, Ontario: Prentice Hall Canada Inc., 1995) at 458; and also see, Carr, Mathewson & Quigley, *supra* note 15 at 47. Bankruptcy at the Atlantic Acceptance Corporation in 1965 threatened the solvency of the Mortgage and Trust Company, which was closely linked to it. The depositor funds in the Mortgage and Trust Company were guaranteed by the Ontario government until it merged with another trust company. However, in the following year, there was a run on York Trust and Savings Corporation. The depositors run on York Trust and Saving Corporation urged the federal government to create its Deposit Insurance System in Canada in 1967.

[17] *Ibid.* at 22-23.

[18] Canada, *Report of the Inquiry into the Collapse of the CCB and Northland Bank* (Ottawa: Minister of Supply and Service Canada, 1986) (Commissioner: Willard Z. Estey)[hereinafter "Estey Report"].

several flaws in governmental supervision, which failed to detect the financial deterioration of the two banks, hidden behind their overvalued loan portfolios.[20] Consequently, the rescue programs, funded by the Government of Alberta and chartered banks in the form of capital subscription were not successful; both banks were liquidated, and all depositors and insured creditors paid off. This episode of bank failure did not induce systematic insolvency risk to other industries and recession of the entire economy, unlike Japan. However, as a result of this episode, depositors lost confidence in the stability of their financial system and started to withdraw deposits from weaker banks, imposing a liquidity risk on several banks; as a result, in 1986, Mercantile Bank of Canada merged with the National Bank, the Morguard Bank with Security Pacific Bank, Continental Bank with the Canadian subsidiary of Lloyds Bank of London, and Bank of British Columbia with Hong Kong Bank.[21] On the other hand, this event urged the government to reform the bank supervisory framework; in 1987, a governmental investigation was conducted to uncover the cause of the failure of these two banks, which influenced the following legislative revisions in the banking supervisory system: creation of the Office of Superintendent of Financial Institutions (the OSFI) and revision to the *Canada Deposit Insurance Corporation Act* (the *CDIC Act*) in 1987,[22] which granted the CDIC expanded authority. The next turbulence came with a number of troubled trust companies in 1991; their severe losses were mainly due to the poor performance of their commercial real estate holdings.[23] The amendment to the *Bank Act* in 1992, allowed chartered banks to own trust company subsidiaries in order to prevent further insolvencies of financial institutions.[24] A number of legislative changes in 1992 resulted in granting the CDIC more authority in terms of early

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[19] Canada, *Competition and Solvency* (Ottawa: Minister of Supply and Services Canada, 1986) at 5[hereinafter "Competition and Solvency"]. Also, Shearer, *supra* note 16 at 461.
[20] "Estey Report," *supra* note 18 at 1-17.
[21] "Competition and Solvency," *supra* note 18 at 5; also, Shearer, *supra* note 16 at 461.
[22] *Canada Deposit Insurance Corporation Act*, R.S.C. 1985 c. 18 (3rd Supp.).
[23] Shearer, *supra* note 16 at 462.
[24] *Ibid.*

intervention in insolvent banks, in cooperation with the OSFI.[25] Despite no continuous or emerging risks of bank insolvencies since 1992, the Canadian regulatory authorities have been pro-active in ensuring the solvency of the financial system and in initiating continuous reform in banking supervision and regulations.[26]

What are the fundamental causes of insolvency risks which a bank inevitably carries in the very nature of its business?

B. Causes of Bank Insolvency

1. Introduction

Bank failure is so complex that it could hardly be attributed to one specific factor.[27] However, in this section, there is an attempt to analyse the complex causes of bank insolvency and to outline the basic process and pattern of how insolvency risk is induced. First, insolvency risk exists due to the pursuit of profit maximisation on intermediary operations which is a distinctive trait of the banking business. Thus, first an examination will be provided outlining aspects of the banking business which are potentially more susceptible to insolvency. Furthermore, there are more direct causes of insolvency, such as credit risk, liquidity risk, and interest risk. These will be explained with empirical evidence of bank failures from the two countries, in the second part. When bank management is not capable or not skillful in avoiding these risks, a bank will move toward insolvency. In addition, intentionally or unintentionally, insolvency results when a bank

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[25] This amendment also resulted in a more active role for the CDIC in assisting mergers and consolidations for failed institutions. For example, the CDIC provided financial assistance in the following merger cases: First City Trust Company, purchased by North American Life with the CDIC loan of $175 million and guarantees for the assets of the First City Trust Company against losses to a maximum of $300 million; Central Guarantee Trust was taken over by the Toronto Dominion Bank, with CDIC loan support of $1.35 billion and $2.4 billion in loss guarantees. Canada, *CDIC Annual Report,* 1997/1998 (Ontario: Canada Deposit Insurance Corporation, 1998) at 2.

[26] *Ibid.* at 2-4.

[27] George G. Kaufman, "Bank Failures, Systemic Risk, and Bank Regulation" (1996) 16 CATO Journal 17 at 17; also, Shearer, *supra* note 16 at 529.

breaches governing laws and regulations, such rules governing capital adequacy, restrictions on business powers, and portfolio limitations. In addition, when a bank breaches such rules, governmental authorities in charge of the supervision of bank affairs may be implicated in a bank failure; a regulator's failure to detect troubled banks and to deal with their threatened insolvency in a proper manner often results in unnecessary losses to the public.

2. Distinct Nature of the Banking Business

Bank insolvency risk exists in the distinctive nature of the business: certain aspects of banking make banks more susceptible to insolvency risk:

a) low capital-to-assets ratios (high leverage), which provides little room for losses;
b) low cash-to-assets ratios (fractional reserve banking), which may require the sale of earning assets to meet deposit obligations; and,
c) high demand debt and short-term debt-to-total-debt (deposit) ratio (high potential for a run), which may require hurried assets sales of opaque and non-liquid earning assets with potentially large fire-sale losses to pay off running depositors.[28]

(a) Low Capital-to-Assets Ratios

Bank capital comes from two different sources, shareholder equity and retained earnings.[29] When a bank is incorporated, stocks will be issued and subscribed, and funds will be paid by purchasers into their capital account. This is called shareholder equity. In addition, the profits made by the bank from ordinary business operations will be another source of bank capital in retained earning accounts.[30] In the course of retaining or reinvesting profits and capital through lending and investment activities, the amount of the capital account will be reduced.[31] This reduction is partly due to market price fluctuations of stocks and bonds, or to the writing off of

[28] Kaufman, *ibid.* at 20.
[29] Shearer, *supra* note 16 at 329.
[30] Gordon F. Boreham & Ronald G. Bodkin, *Money, Banking and Finance: the Canadian Context,* 4th ed. (Toronto: Holt, Rinehart and Winston of Canada, Limited, 1993) at 98.
[31] Shearer, *supra* note 16 at 285.

defaulted loans from the balance sheet. The smaller the capital accounts, the greater the risk of becoming insolvent.[32] This type of bank insolvency is called balance sheet insolvency. It can be defined as a situation where the value of liabilities exceeds the value of assets; in other words, their capital-to-assets ratio goes below zero.[33] Thus, for the purpose of ensuring the safety of depositor funds, it is crucial for banks to maintain an adequate level of capital accounts. On the other hand, the capital account is also a measure for shareholders to pursue the return on their investment.[34] Thus, managers of banks tend to hold smaller amounts of capital against the assets, since the smaller it is "the larger will be the expected rate of profit (or expected yield) on the shareholder's investment."[35] The other factor that motivates banks to reduce their capital account is the federal deposit insurance system which creates a so-called "moral hazard" problem. This dilemma has two negative effects, (i) eliminating depositors' incentive to closely monitor the risk assumed by their institution's portfolio activities, and (ii) encouraging institutions to take riskier portfolio activities, since institutions are not urged by depositors to develop more diversified and conservative loan portfolios.[36]

(b) Low Cash-to-Assets Ratios

A bank makes profits through a basic intermediary operation: charging borrowers with loan rates and paying interest to depositors. The difference between the lending rate and cost of deposits is called "the spread."[37] In an effort to maximise their return on assets, banks attempt to construct their portfolio from illiquid assets,[38] such as term-loans and mortgages, which produce a higher

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[32] *Ibid.*
[33] Lovett, *supra* note 3 at 133.
[34] Shearer, *supra* note 16 at 285.
[35] *Ibid.* at 286.
[36] Daniel Lang, "Reform of the Canada Deposit Insurance Corporation" (1990) 5 Banking and Finance Law Report 167 at 169-71.
[37] *Ibid.* at 168-69.
[38] *Ibid.* Also, see Jerry White, John Downes & Jordan Elliot Goodman, *Canadian Dictionary of Finance and Investment Terms,* 1st ed. (Hauppauge, NY: Baron's Educational Series, Inc., 1995) *s.v.* "liquid asset" [hereinafter "Finance and Investment Terms"]. Liquid assets are defined as cash or assets easily convertible

yield than liquid investments or cash lying in the vault.[39] In other words, a bank tends to hold less cash, liquid assets and hold more illiquid assets.

(c) High Demands Debt-to-Total Debt Ratio

While a bank tends to hold less cash and liquid assets, their liabilities are mostly comprised of high-demand debts or short-term notice deposits. This causes a mismatch between the maturity of assets and the maturity of liabilities; when a bank has an insufficient amount of cash to meet withdrawal demands from depositors and sudden calls from creditors, the bank will try to convert the assets into cash. However, because of a high volume of illiquid assets, it will be more difficult for banks to liquidate assets in a short period of time. Consequently, efforts to sell off assets quickly will result in losses to the bank.[40] In addition, if it is a bank run, raising funds in money markets becomes more expensive, thus a troubled bank will face further difficulty in meeting current obligations.[41] When a bank cannot meet current obligations because of shortages of cash reserves or liquid assets, it has liquidity insolvency.[42]

For the above reasons, a bank always bears two types of insolvency risks. One occurs when a bank cannot meet current obligations of liabilities because of a preference for holding illiquid assets (liquidity insolvency). Another occurs when bank liabilities exceed assets because of a

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into cash, *e.g.*, money market fund shares or U.S. treasury bills. As opposed to this, illiquid assets are such as real estate, or oil and gas, which are not easily marketable, difficult to convert into cash in the short-term. Normally, "illiquid assets," as a financial term, mean loans secured by mortgages with long-term maturity, but which produce higher yield.

[39] Lang, *ibid.* Also, see Shearer, *supra* note 16 at 318-22. The author emphasises the incentive of banks to minimise the cash reserve. Banks cannot earn interest on currency in their vaults or on their deposit at the Bank of Canada; those are "sterile assets." For this reason, banks tend to keep their cash holdings and reserves of liquid assets as low as possible "to a minimum consistent with meeting immediate cash needs." However, legal requirements concerning cash holdings have become considerably more permissible over the years. Currently, there is no legal requirement in terms of the amount of cash and liquid assets reserves in Canadian law.

[40] Lang, *supra* note 36 at 169-70.

[41] Yoshio Suzuki, *The Japanese Financial System* (New York: Oxford University Press, 1987) at 52-53.

[42] Lovett, *supra* note 3 at 133.

deficiency in capital (balance sheet insolvency), due to a lower capital-to-assets ratio. These characteristics make banks more vulnerable to insolvency than other industries which deal in tangible products, such as "a steel mill, software manufacturer, or grocery store."[43]

3. Credit Risk, Liquidity Risk, and Interest Rate Risk

Empirical evidence shows that there are more specific risks, as a direct cause of bank failures: credit risk, liquidity risk, and interest rate risk.[44] Following is a definition of those risks:

> (a) Credit risk is the possibility of a reduction of expected earnings because repayment conditions on the asset may not be fulfilled; that is, the loan may be late or uncollectable.
> (b) Liquidity risk is the possibility of a fall in expected earnings that accompanies the need to acquire liquidity in the case of an unusually large call on one's liabilities. For example, in the case of a run on a bank, or inability to roll over funds raised in markets, assets would have to be sold quickly or sources of finance found. In such cases, the cost of raising money would be higher than usual.
> (c) Interest rate risk is the possibility of a fall in expected profits due to unusual fluctuations in interest rates. The traditional risks of the banking business belong here, as do those which accompany fluctuations of the securities market.[45]

Credit Risk

Credit risk occurs when a bank lends to financially unsound borrowers, motivated by potentially higher returns, such as real estate development loans. For example, when a bank suffers profit decline due to less borrowing demand, the bank tends to resort to such riskier lending practices in an effort to compensate for that decline. In fact, such bank activities were seen in both countries

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[43] Kaufman, *supra* note 27 at 20. Many authors emphasise the unique characteristics of deposit taking intermediaries, *e.g.*, "fragility" (Kaufman, *supra* note 27 at 20), "vulnerability" to insider abuse, fraud (Swire, *supra* note 2), and "quasi-public characteristics" (Boreham & Bodkin, *supra* note 30 at 123.) These aspects give justification for a governmental agency to take greater care of banks through stricter regulation and supervision.

[44] Suzuki, *supra* note 41 at 52.

at the time of deregulation of financial markets, which intensified competition among financial intermediaries. Worse, the governments encouraged such bank activities by relaxing legal requirements for sound practices.[46] However, when a bank lowers its standards of credit worthiness for borrowers and lends to unsound borrowers, it constructs a portfolio mostly of higher risk loans which are more likely to end in defaults. Accordingly, when a bank continuously has to write off defaulted loans from the balance sheet, capital will dry up. This is the basic process of credit risk or default risk. For instance, Japanese city banks started to lend to unfamiliar clients, in fierce competition with other financial industries in the late 1970s.[47] Because banks were inexperienced in dealing with such unknown clients outside of their own *Keiretsu*,[48] they failed to evaluate and monitor the risk in such lendings.

In addition, investments in stock and real estate markets often appear to offer higher returns. Thus, a bank, which is having difficulty in raising sufficient capital on its own, becomes attracted to such more speculative investments. However, since such markets can be highly volatile, a bank's loss which is incurred by price declines of stocks and real estates will be less predictable. For example, in the 1980s in the U.S., the Savings and Loan industry (S&L industry), suffering a critical decline in deposits resorted to highly speculative investments in securities and real estate. The U.S. government encouraged such activities as an effort to prop up the near-insolvent S&L industry, hoping that that would provide compensation for capital declines.[49] For instance, the Net Worth Guarantee Act of 1982 allowed any S&L to be engaged in high risk investments. However, this sort of regulatory intervention simultaneously created the government obligation

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[45] *Ibid.*
[46] *Ibid.* Also, Davita Silken Glasberg & Dan Skidmore, *Corporate Welfare Policy and the Welfare State: Bank Deregulation and the Savings and Loan Bailout* (New York: Walter De Gruyter, Inc., 1997) at 21.
[47] Edward Lincoln, "Japan's Financial Mess" *Foreign Affairs* 77:3 (May 1998) 57 at 59.
[48] A term concept more fully defined in Chapter III.
[49] Glasberg & Skidmore, *supra* note 46 at 29-39.

to bail out the entire industry.[50] Likewise, Japanese policy-makers, in the face of bank profit declines, adopted a similar solution:

> ...[i]n the context of liberalization in the 1980s, the removal of binding portfolio constraints permitted banks and other depositories to adopt riskier investment and loan portfolios, including the adoption of high loan-to-value ratios.... Banks also had incentives to adopt riskier loan and investment portfolios.... [and], directly or indirectly, provided imprudent levels of credit to real-estate and equity markets in an effort to offset declining profit margins and declining market shares and to maintain the franchise value of commercial bank charters.[51]

Furthermore, even when a bank is cautious about the client's credit condition, default risk might be induced by other factors, such as an unpredictable economic recession. This feature of credit risk was emphasised in the Canadian literature, pointing out the situation where economic recession induced bank difficulties.[52] Once the national or regional economy entered into recession, many corporations find their markets shrinking. Their payments on loans are delayed and eventually they default the entire debt. As the number of borrowers who default on loans increases, the lending institution will notice that the value of its assets begin to decline. The re-emergence of failures in financial institutions, which happened in Canada in the 1980s, was attributed to "weak business conditions."[53] In addition, the more a bank is connected with a regional economy, the more serious the consequences, once the viability of the regional economy starts to decline. In the U.S., banks located in Oklahoma or Texas, where the dominant economic activity is agriculture or energy based, become seriously damaged at times of industrial recession.[54] Because national banks in the U.S. have been prohibited from inter-state branching

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[50] *Ibid.*
[51] Cargill, Hutchison & Ito, *supra* note 4 at 102.
[52] Shearer, *supra* note 16 at 465.
[53] *Ibid.*
[54] *Ibid.* at 530.

by the McFadden Act of 1927,[55] inevitably, banks have tended to concentrate their lending on specific regional industries in their region. The same aspect of credit risk was identified by the Estey Report of 1987, which emphasised shortsighted governmental policy concerning the incorporation of regional banks, the Canadian Commercial Bank and Northland Bank; these two regional banks were doomed to failure from the outset.[56] The initial purpose in chartering these banks was to cater to growing demands within western Canada's economy. These regional banks embarked on business with a strong dependency on regional economies which was temporally booming at that time.

Interest Rate Risk and Liquidity Risk

As noted, liquidity insolvency occurs when banks cannot meet their debt by a due date, because of a shortage of cash and credit. Liquidity insolvency occurs because of a bank's composition of liabilities and assets; while a bank tends to have smaller amounts of liquid assets or cash, liability is mostly comprised of short-term and high-demand debts. Thus, at a time when interest rates were determined by regulatory restriction or through price agreements among banks, banks were less likely to be exposed to such insolvency risks. However, once the interest rate restriction was removed as part of deregulation, an imbalance between assets and liabilities resulted, precipitating liquidity insolvency.[57] For example, in Canada, the failure of the Atlantic Acceptance Corporation (the AAC) in 1967 was induced by a sudden rise in interest rates in U.S. money markets, which the AAC depended on as a major funding source; at this time the U.S. government started to restrict the outflow of short-term capital in money markets as part of their

[55] *McFadden Act*, 12 U.S.C.A. s. 24 (1989). Also, Maximillan J.B. Hall, *Banking Regulation and Supervision: Comparative Study of UK and USA and Japan* (Brookfield, Vt.: Edward Elgar Publishing Limited, 1993) at 58.
[56] "Estey Report," *supra* note 18 at 1-17.
[57] Suzuki, *supra* note 41 at 52.

monetary policy, which increased the cost of short-term funds for borrowers.[58] Consequently, the AAC became troubled, especially because the return on assets did not rise commensurably. Thus, when the AAC tried to dispose of assets to meet debt obligations, it could not because their assets were long-term and non-marketable; this made it difficult to convert assets into cash. Worse, the asset quality of the AAC was overestimated. Eventually, the AAC failed, and many creditor institutions suffered losses, one of which was threatened their solvency. Such situations are called "interest rate-induced disintermediation episodes."[59]

Similarly, the Savings & Loan dilemma arose from the same situation.[60] Many S&L companies suffered from rising interest rates on liabilities, while burdened with fixed and low interest rates on assets and with long maturity on home mortgage loans. Transformation of financial markets in the 1970s in the U.S. triggered the S&L crisis; innovation of numerous money market instruments enabled commercial banks and non-depository institutions, such as foreign securities companies, to attract more depositors with promises of higher returns and borrowers with less expensive funding sources. Consequently, many S&L institutions found themselves facing a dilemma: if they did not increase interest rates on deposits, they would lose depositors, but if they did increase interest rates, they could end up paying more interest on deposits than they were earning on their mortgage assets.[61] A same type of interest rate risk was predicted for Japan as a result of financial market liberalisation, which heightened the probability of liquidity risk. ...[A]s liberalization of deposit rates progresses, fluctuation of borrowing costs will also

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[58] Shearer, *supra* note 16 at 458. The AAC was a personal and sales finance company, not categorised as a deposit-taking intermediary. However, when it failed in 1966, it swayed public confidence about the health of the entire Canadian financial system. Consequently, it urged the federal government to establish the Deposit Insurance system. Nevertheless, the AAC episode was only tip of the iceberg, as many distressed trust and loan corporations faced increasingly changing markets.

[59] *Ibid.* at 518, 529. "Disintermediation" was a common phenomenon perceived in all three countries in the 1980s. The borrowers, who used to be bank customers, started to prefer money markets to bank borrowing since interest rate payments on loans became relatively more expensive for corporations than direct financing in equity or money markets.

[60] Glasberg & Skidmore, *supra* note 46 at 27-29.

rise, and interest rate risk will rise with it. The increase in the share of funds raised on domestic markets has raised interest rate risk, and this rising dependence on unstable market funds simultaneously implies an increase in liquidity risk.[62]

4. Systemic Risk

In addition to the above-mentioned features of vulnerability in the banking business, there is another distinctive feature of financial institutions: a high degree of interdependence among them. This will greatly contribute to the potentiality of systemic risk. Financial intermediaries, such as banks, trust and loan companies, and securities companies, are closely interwoven with each other through their mutual borrowing-lending relationships.[63] One bank failure can result in a linkage of negative consequences:

> [i]n banking, contagion is perceived to (1) occur faster; (2) spread more widely within the industry; (3) result in a large number of failures; (4) result in larger losses to creditors (depositors) at failed firms; and spread more beyond the banking industry to other sectors, the macroeconomy, and other countries.[64]

For such reasons, banks are inevitably vulnerable to contagious failure, regardless of individual efforts to prevent insolvency.

5. Mismanagement and Breach of Laws and Regulations

Because the vulnerability of banks to insolvency risk is an inevitable aspect of their business, the supervisory and regulatory frameworks for the banking industry are designed to minimise the insolvency risk through stricter laws, regulations, and guidelines. Typical legal requirements for bank solvency are: capital adequacy; sound lending practices, including restriction on insider and affiliates lending; restrictions on portfolio activities; restrictions on business powers and ownership; and stricter liability imposed on bank directors and officers. However, banks

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[61] *Ibid.* at 21. Also, Shearer, *supra* note 16 at 519.
[62] Suzuki, *supra* note 41 at 53.
[63] Kaufman, *supra* note 27 at 21.
[64] *Ibid.*

sometimes intentionally or unintentionally breach laws, regulations, and guidelines, which creates another cause of insolvency. In addition, bank regulators are responsible for immediately detecting unsound and unsafe practices or breaches of laws and regulations, in order to minimise the bailout costs accrued by government or to reduce the losses to depositors and borrowers.

Chapter II. CAPITAL ADEQUACY

A. Introduction

As argued, capital adequacy is an essential factor in precluding bank failure and in minimising losses to the general public. In this chapter, the significance of capital adequacy will be re-examined in the first part. Second, it will overview the guidelines for capital adequacy which were issued by the Bank for International Settlements as a result of the Basle Agreement in 1988.[65] Third, a comparative analysis of the two countries will be presented on how each government has incorporated this international standard of assessment and measurement of bank capital into its own domestic laws. It is common knowledge nowadays that the vulnerability and weakness of Japanese banks are mainly caused by the deficiency of bank capital.[66] Therefore, the ultimate purpose in comparing the two countries' standards of capital adequacy is to identify a defect in the Japanese legal approach to regulating the capital adequacy of Japanese banks.

B. Significance of a Banks' Capital Account

A bank's capital account, composed of common shares, contributed surplus, and retained earnings,[67] serves a crucial function for reducing the risk of bank insolvency and protecting depositor funds. This function is regarded as "a guarantee fund," or "a safety cushion" for depositors and creditors.[68] Additionally, it functions as an indicator to express the financial condition and healthiness of banks.[69] A bank will be considered technically insolvent when the value of assets goes below its liabilities; or when its cash reserve is not sufficient to meet the demands of liabilities, including calls on liabilities from creditors and depositors. Suffice it to

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[65] Hall, *supra* note 55 at 188-217.
[66] Richard Dale, "Japan's Banking Regulation: Current Policy Issues" in Hiroshi Oda & R. Greffrey Grice, *The Japanese Banking, Securities, and Anti-Monopoly Law* (London: Butterworths, 1988) 33 at 40-45.
[67] Office of Superintendent of Financial Institutions Canada, Guideline No. A, *Capital Adequacy Requirements* (October 1995) at 3 [hereinafter "Capital Adequacy Requirements"].
[68] Boreham & Bodkin, *supra* note 30 at 98.
[69] Shearer, *supra* note 16 at 285.

say that despite the incentive of profit maximisation through holding less capital, it is indispensable for a bank to maintain an adequate capital-to-assets ratio in order to prevent balance sheet insolvency. In addition, because there is no contractual obligation to pay dividends to shareholders, failure to pay dividends cannot trigger bankruptcy proceedings, it cannot force the closing of an institution; any shareholder claim will come last in the hierarchy of claims.[70] Therefore, the capital account is one part of bank assets which does not represent claims of shareholders.[71] It establishes the loss of asset values that can be sustained before the safety of the deposits is impaired.[72] In this sense, the primary function of bank capital is to guarantee depositor funds and to give a safety net for the funds of depositors and creditors.[73]

C. Basle Committee of Supervision under the Bank for International Settlements

1. Introduction

Reflecting the growing debt crisis in the developing world in the 1980s, the Basle Committee of Supervision issued a guideline for measurement and assessment of the capital adequacy levels for internationally active banks in December 1987.[74] The principle agreement had been reached by the Group of Ten countries, plus Luxembourg, in July 1988.[75] The interpretation and implementation of rules were left to the discretion of the national supervisory authorities, and full implementation and submission of the agreed package were required for the member countries on 30 December 1992. The purpose of this international agreement was to establish a common framework for capital adequacy measurement and a minimum target capital standard for

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[70] *Ibid.* at 479.
[71] *Ibid.* at 285.
[72] *Ibid.* at 549.
[73] Boreham & Bodkin, *supra* note 30 at 98.
[74] Hall, *supra* note 55 at 188. Also, John D. Wagster, "Impact of the 1988 Basle Accord on International Banks" *Journal of Finance* 51:4 (September 1996) 1321.
[75] *Ibid.* The initial member countries of this committee were Belgium, Canada, France, Germany Italy, Japan, the Netherlands, Sweden, Switzerland, the U.K., and the U.S.A.

internationally active banks.[76] Promulgation of the international agreement of the Basle Committee in 1987 has had significant meaning for Japanese commercial banks, because most of them have been seriously involved in international business activities.

However, this new international standard for the minimum requirement of "risk-weighted capital adequacy" highlighted the vulnerability and weakness of Japanese banks.[77] This is partly because of their problematic accounting standards in commercial law, which were different from western standards,[78] and partly because of problematic practices in traditional portfolio activities. Furthermore, the Japanese approach to capital adequacy standards has been perceived as most permissive, in terms of the definition of capital as asset-risk weighting.[79] In contrast, to incorporate the BIS standard domestically,[80] the Canadian government imposed higher requirements on chartered banks than did Japan and the U.S. This illustrates the regulatory authority's belief that such an approach is needed to demonstrate that the Canadian banking system can continue to have a strong international reputation.[81] In any case, chartered banks generally met this requirement, keeping well above four points of risk-weighted capital adequacy for Tier 1 capital, and some had met the 8% total capital goal by 1992.[82] As of 31 January 1997, the average risk-weighted capital ratio of chartered banks stood at 9.3%, well above the 8% minimum requirement.[83]

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[76] Hall, *supra* note 55 at 394-402.
[77] Dale, *supra* note 66 at 40. The domestic guideline for capital adequacy was issued as a circular by the Ministry of Finance in December 1988 in accordance with BIS standards.
[78] *Ibid.*
[79] Hall, *supra* note 55 at 394-402. Under the Japanese rule for weighting asset-risk, either interest rate or exchange rate risk will not be "captured," which is not case in the U.S. either Canada.
[80] *Bank Act,* S.C. 1991, c. 46, s. 485 (2)(3). The OSFI have authority for issuing guidelines, in which the principle of the Basle Agreement was incorporated.
[81] Boreham & Bodkin, *supra* note 30 at 101.
[82] *Ibid.*
[83] "The Changing Business Activities of Banks in Canada," *Bank of Canada Review* (Spring 1997) 11 at 13 [hereinafter "Changing Business Activities"].

2. Tier 1 and Tier 2 Capital, and Risk-Weighted Assets

Under the new rule for measuring capital adequacy, capital is classified into two types: Tier 1 capital and Tier 2 capital, or primary capital and secondary capital.[84] With subtle difference in the definition among nations, Tier 1 capital is basically defined as shareholders' equity, contributed surplus, and retained earnings. Tier 2 capital is then defined as hybrid (equity/debt) capital instruments (Tier 2A) and subordinate bonds (Tier 2B). The significant difference between the two types of capital is that, unlike primary capital, secondary capital is usually subordinate debt, which cannot absorb losses in order to allow a bank to continue as a going concern.[85] This means that once core capital of a bank is depleted, then, if losses must be written off against subordinated debts, the bank is technically insolvent. Therefore, the function of subordinate debts gives protection to deposits only after a bank is closed. In this sense, the subordinate bonds are called "debt capital."[86] Furthermore, bank assets are assigned to one of four risk categories and weighed according to the relative credit risk of those categories. The requirement ratio can be derived by expressing the adjusted capital base as a percentage of the total risk-weighted assets.[87] The following are major categories of assets:

0% (cash and claims on OECD governments)
20% (claims on Canadian Deposit-taking institutions, OECD banks and non-domestic OECD public sector entities);
50% (residential mortgages); and
100% (all other claims).[88]

Under the Basle Agreement, internationally active banks are obliged to meet the requirement of the minimum risk-weighted capital ratio of 4% for Tier 1 capital, and 8% for Tier 1 and Tier 2 capital in total.

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[84] "Capital Adequacy Requirements," *supra* note 67 at 3.
[85] Boreham & Bodkin, *supra* note 30 at 99.
[86] *Ibid.*
[87] Shearer, *supra* note 16 at 479.

3. Incorporation of the BIS Standard

(a) Japan

Japanese laws prohibit banks from issuing non-perpetual, non-cumulative preferred shares and bank debentures in domestic markets.[89] Thus, those types of shares are issued only by overseas subsidiaries in foreign markets and are calculated as eligible Tier 1 and Tier 2 capital. This domestic restriction has placed Japanese banks at a competitive disadvantage for enhancing capital levels.[90] This is partly why Japanese bank methods for improving capital levels depend on unrealised capital gains from equity holdings. The purpose of this prohibition on banks concerning debenture issues is to separate artificially long-term lending and short-term lending in domestic markets. To be more specific, under Japanese banking laws, city banks raise funds largely from depositors, and they are prohibited from issuing bank debentures. On the other hand, long-term banks depend for their fundings mostly on debenture issues, which account for 70% of their funds, while these banks are prohibited from taking deposits, with a few exception;[91] long-term banks, designated to be specialised in long-term lending for certain industries, are not deemed suitable for raising funds through short-term deposits.[92] These legal restrictions have been eased in the recent past, *i.e.*, sanctioning convertible-subordinated bond issues for city banks since 1987, and removing the associated restrictions concerning debenture issues in January 1990. However, no perpetual-debt issues by Japanese banks have been forthcoming.[93]

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[88] "Capital Adequacy Requirements," *supra* note 67 at 4.
[89] *Choki Shinyo Ginko Ho* [Long-Term Credit Bank Law], Art. 8, Law No. 187 of 1952.
[90] Hall, *supra* note 55 at 216.
[91] The types of bank debenture issued by long-term banks were five year coupon debentures and one year discount debentures. But, they are prohibited from taking deposits except those from the government, public bodies, and their own borrowers. Suzuki, *supra* note 41 at 202.
[92] They are still subject to such restrictions, as a purchaser of such debentures must be financial institutions.

(b) Canada

As opposed to the above restrictions on preferred shares and debenture issues imposed on Japanese banks, Canadian banks have been free from such constraints on fund raising since the 1967 revision to the *Bank Act*. However, prior to this, Canadian banks were prohibited from issuing bank debentures, and their methods for raising funds from external sources were limited to central bank borrowing, through discounts of selected short-term assets or through secured advances on loans such as promissory notes.[94] Revisions to the *Bank Act* in 1967 allowed chartered banks to issue bank debentures which were subject to several rules. Section 77 of the 1967 *Bank Act* stated:

> (1) In this Act, "bank debentures" means instruments evidencing unsecured indebtedness of the bank payable in Canadian currency....
> (2) Subject to this section, the bank may borrow money by the issue of bank debentures.[95]

Furthermore, the 1980 revision of the *Bank Act* permitted banks to issue preferred shares and common shares without par value, subject to several restrictions.[96] Permitting banks to issue debt instruments was intended to provide banks with a method for raising capital at the lowest possible cost and without diluting the value of shareholder equity.[97] More importantly, it serves to preserve the integrity and security of depositor funds.[98] Nevertheless, according to the latest

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[93] Hall, *supra* note 55 at 197.
[94] Boreham & Bodkin, *supra* note 30 at 97.
[95] *Bank Act*, S.C. 1966-67, c. 87, s. 77(1)(2). The restrictions on debenture issues were such that: (i) the maturity of the bank debenture is 5 years, (ii) the bank debentures cannot be called for redemption by the bank before maturity, and (iii) the indebtedness cannot be paid by the bank before the maturity. However, these restrictions on bank debenture issues have become permissive. Under the current *Act*, the only restrictions imposed on bank debenture issues are (i) subordinated indebtedness should be fully paid in money or, with a regulator's permission, in property, and (ii) subordinate indebtedness should not be a deposit.
[96] *Bank Act*, S.C. 1980-81-82-83, c. 40.
[97] Boreham & Bodkin, *supra* note 30 at 97-98.
[98] M.H. Ogilvie, *Canadian Banking Law* (Toronto: Carswell, 1991) at 174.

Guideline of Capital Adequacy, certain types of preferred shares are categorised as Tier 1 capital.[99]

D. A Controversial Matter of Japanese Banks' Capital Adequacy

Japanese banks have distinctive accounting systems which hold that 45% of unrealised capital gains on corporate equity investment can be classified as Tier 2 capital.[100] Again, this type of accounting method is not allowed in Canada or the U.S.[101] The Japanese government won this concession from the Basle Agreement, to give ostensibly the Japanese banks a competitive advantage, helping them to make balance sheets look healthier, if only for accounting purposes.[102] However, this unusual accounting method has been controversial because latent profits are subject to a discount of 55%, which is designed to reflect a potential capital gain tax, as well as to balance stock market volatility.[103] Obviously, those large, undisclosed, and latent reserves in the form of unrealised gains on securities is the distinctive feature of Japan's bank capital structure; if they did not include unrealised capital gains on equity in their eligible capital, Japanese banks could not meet the required capital adequacy at the international standard. By illustration, Japanese city banks, as a group, had a critical shortage of Tier 1 capital components, holding only about 2.5%. This fell below the minimum requirement of 4% in BIS standards.

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[99] "Capital Adequacy Requirement," *supra* note 67 at 3.
[100] Dale, *supra* note 66 at 40-41.
[101] Hall, *supra* note 55 at 196. Hall also introduced the U.K. s' rule for capital adequacy. Since the Basle agreement allowed discretionary policies of regulatory authorities in each nation, unrealised capital gains held by banks were treated differently. While Japanese banks were allowed to include unrealised capital gain on equity investment as a Tier 2 capital component, the U.K.'s banks were allowed to include unrealised capital gains on land holding in the same component.
[102] Dale, *supra* note 66 at 41-42.
[103] *Ibid.* Also, Miller, *supra* note 7 at 1063-64. At the time (1987-89) when Japanese banks had the deadline to meet the BIS standards, the country was in the midst of its historic stock and real estate market booms. As the earnings on stocks and real estate invested by banks increased, bank capital positions were exceedingly strengthened.

However, after incorporating unrealize securities profits, it stood around 4.5% above the minimum requirement of 4% set by the BIS standard for Tier 2 capital.[104] This strong capital position of Japanese banks was reflected in the extraordinary buoyant Japanese stock market during this period.[105] This accounting method and profit gain mechanism of Japanese banks has been criticised because the fragility of Japanese banks arose from their dependency for profitability on this latent profit. Nakao has noted that

> ...[t]hese profits were nothing more than "paper shuffling." This is because the banks would realize taxable gains by selling shares they had for a long time in companies belonging to their *Keiretsu* business groups, but the custom of mutual shareholding within such groups required them to repurchase the shares almost immediately afterward. The result of this was that: (1) the banks could record book profits, although at the cash level the portion paid in tax was a loss, and (2) the average cost of owning stocks increased. This type of operation was possible as long as share prices continued to rise, but it became a major problem for the banks when the stock market went into reverse in 1990.[106]

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[104] Dale, *supra* note 66 at 40-41.

[105] Miller, *supra* note 7 at 1063-64. At the time (1987-89) when Japanese banks had the deadline to meet the BIS standards, the country was in the midst of its historic stock and real estate market boom. As the earnings on stocks and real estate invested by banks increased, bank capital positions were exceedingly strengthened.

[106] Shigeo Nakao, *The Political Economy of Japanese Money* (Tokyo: Tokyo University Press, 1995) at 101.

Figure:1 Capital Adequacy of Requirement of Basle Committee of 1987
[Source: F.Boreham:100-1 for Canadian part and M.Hall:192,194 for Japanese, the United States part]

Country	Japanese approach	US approach	Canadian approach
Tier 1 Capital	Permanent stock holder equity i) common Stock ii) non cumulative perpetual preferred stock (only foreign issues by overseas subsidiaries)	Shareholders equity i) common stock ii) related surplus iii) retained earnings	Common shareholders equity i) common shares ii) contributed surplus iii) retained earning
	Disclosed reserves	Qualifying non commutative perpetual preferred stock	Qualifying non cumulative perpetual preferred shares
	Published retained earning Consolidated subsidiaries minority interests	Minority interest in equity accounts of consolidated subsidiaries	Minority interest in common share holding equity attributable to consolidated subsidiaries

Country	Japanese approach	US approach	Canadian approach
Tier 2 capital A	1. 45% of later revaluation reserves related to securities holdings		
	2.General Loan loss reserves, subject to a limit	1. Allowance for loan and lease losses, subject to a limit	
	3. "Allowable" hybrid capital Instruments (debt/equity capital) i) convertible, subordinate bonds ii) perpetual, cumulative preferred stock and limited life redeemable preferred stock iii. perpetual subordinated bonds(e.g., FRNS) and loan	2. Hybrid capital (debt/equity)instruments and qualifying mandatory convertible debt securities in the form of equity contract notes 3. Perpetual preferred stock	1. Hybrid capital (debt/equity)instrument i) cumulative perpetual preferred stock ii) non convertible preferred shock iii) debenture (minimum term to maturity 99 years)
Tier 2 Capital B	4. Allowable subordinated term debts, subject to limit i) subordinated loans ii) subordinated bonds	4. Subordinated debts and intermediate term preferred stock (with an original weighted average maturity of 5 years or more), subject to limit	4. Subordinated term debt (-conventional unsecured subordinated debt of 5-9 years) - Limited life redeemable preferred shares

CHAPTER III. HISTORICAL DEVELOPMENT OF BANKING SYSTEM AND LEGISLATION

A. Introduction

This chapter will discuss the development of banking legislation in Canada and Japan, with a particular emphasis on different legislative policies underpinning banking law reforms in the past. The banking system in both countries started with a similar regulatory framework which separated financial institutions into different categories based on the so-called "commercial bank philosophy." However, in the course of the system's evolution, the effect of "commercial bank philosophy" has increasingly diminished. In other words, both Japanese and Canadian banks, which used to limit their business to short-term and corposate lending, have increasingly expanded their business areas beyond such conventional business. Now, the systems in both countries are heading toward integration of all financial sectors: Japan is still far behind its Canadian counterparts in terms of the pace of integration. In addition, a difference between the two countries is also obvious, especially in terms of the purposes for legislative reforms. Thus, in this chapter, the background of the major revisions to banking legislation and the outcomes of the reforms will be examined; such a comparison will also aim at illustrating the speed with which both countries have moved toward a consolidation and integration of all financial service sectors.

B. Legislation, Structure, and Major Reforms of Banking Legislation.

1. Japan

Transformations in Japanese banking in this century can be divided into four terms: from 1927 to the 1950s; the second period of high economic growth from the 1950s to the late 1970s; the low growth from the 1970s to the late 1980s; then, the bubble economy of the 1990s. The basic

structure of the modern Japanese banking system was established with enactment of the Banking Law in 1927 and consolidated by legislative reform in the post-war period in the late 1940s.[107] Most provisions in banking laws hardly changed until the late 1970s; since enactment, there was no amendment until 1981.[108] Thus, in order to understand the peculiarity of Japanese banking system and its legislative approach, it is crucial to review its historical background.

1950s-1970s:

As noted, the current legal framework governing Japanese banking was consolidated in the war-devastated period of the late 1940s after national industries and business functions had been near fatally destroyed.[109] Under such circumstances, the most urgent national concern was how to reconstruct the domestic economy in a short period of time. Thus, it was natural that the national priority was to nurture and foster core industries with the goal of achieving rapid economic growth.[110] However, a significant obstacle in achieving this national goal existed: a serious

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[107] J. Robert Brown, "Japanese Banking Reform and the Occupation Legacy: Decompartmentalization, Deregulation, and Decentralization" (1993) 21:2 *Denver Journal of International Law and Policy* 361 at 366-72.

[108] *Ibid.* at 367. However, a distinguishing characteristic of Japanese law is that statutory and regulatory provisions are not necessarily to be revised in order to change the rules governing corporate activities; in most cases, the Ministry of Finance issues administrative guidance, at their discretion, in order to modify such governing rules. This is part of the reason why there was no revision of the Banking Law for more than a half century. Also, Masaki Yagyu, "Securities Activities of Japanese Banks under the 1993 Japanese Financial System Reform" (1995) 15:2 *Northwestern Journal of International Law and Business* 303 at 311. The author states:

> ...[n]otwithstanding this interpretation of the Banking law, it should be noted that the Ministry of Finance has imposed substantial non-statutory restrictions on these activities. In general, the Ministry of Finance often imposes such non-statutory restrictions on bank activities, which are usually published but are sometimes oral. These non-statutory restrictions are called administrative instructions (*Gyo-sei Shido*). It is true that such restrictions make Japan's banking regulations difficult to understand. In considering whether or not, or to what extent, a type of activity is permissible, it is indispensable to look into not only the Banking Law but also the related Ministry of Finance non-statutory administrative rules.

[109] Colin P.A. Jones, "Japanese Banking Reform: A Legal Analysis of Recent Developments" (1993) 3 *Duke Journal Comparative and International Law* 387 at 3-4; and also, Brain W. Semikow, "Japanese Banking Law: Current Deregulation and Liberalization of Domestic and External Financial Transactions" (1985) 17 *Law and Policy in International Business* 81 at 1-3.

[110] Suzuki, *supra* note 41 at 21.

shortage of capital resources.[111] Since all financial resources had been spent on the war effort, the amount of capital left in Japan was too scarce to finance sufficiently any viable corporate activities. A reform of monetary and banking systems was initiated and implemented by the Ministry of Finance, largely influenced by U.S. Occupation Army orders and recommendations.[112] Thus, the outcome of legislative reforms resulted in a compromise with U.S. demand, which had to be adjusted to Japanese governmental policy.[113] The essence of the newly established banking system during this period was their central dominance. Almost as a sole financial intermediary, banks played a key role in transferring funds from the personal sector to the corporate sector.[114] Corporations were encouraged to borrow from banks rather than issue securities for financing business activities. Consequently, money and capital markets in Japan remained undeveloped, even suppressed, until the late 1970s.[115] The governmental policy of developing this type of financial intermediation was embodied by the following legal provisions: (i) interest rates on deposits and loans were much lower than normal, which enabled banks to

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[111] Semikow, *supra* note 109 at 1-3.

[112] Brown, supra note at 107 at 387-94.

[113] Hiroshi Oda, *Japanese Law* (London: Butterworths, 1992) at 32-33. Legal reform in the 1940s was conducted under supervision of the Supreme Commander of the Allied Powers (SCAP), which was mainly the American Forces. Democratisation and demilitarisation of Japan were the central themes of this legislative reform. Consequently, a number of sources of laws governing banking were largely influenced by American models, such as *Sho Ho* [Commercial Code], Law No. 48 of 1899; *Ginko Ho* [Banking Law], Law No. 59 of 1981; *Shoken Torihiki Ho*[Securities and Exchange Law], Law No. 25 of 1948, and *Shiteki Dokusen No Kinshi Oyobi Kosei Torihiki No Kakuho Ni Knausuru Horitsu* [Law on Prohibition of Private Monopoly and Ensuring of Fair Trade], Law No. 54 of 1947 [hereinafter "Anti-Monopoly Law"].

[114] Jones, *supra* note 109 at 3-4.

[115] Both in Japan and Canada, securities markets have been developed with the strong initiative of government, which has also needed to finance their fiscal activities through bond issues. However, at an early time in post-war period, the Japanese government was reluctant to issue government bonds very often, making the volume of flotation of the bonds much smaller. See, Thomas Cargill & Shoichi Royama, *The Transition of Finance in Japan and United States: a Comparative Perspective* (California: Hoover Press Publication, 1988) at 40. Consequently, there was no public offering in the primary market and there was hardly any secondary market for re-selling government bonds to the public until the late 1970s. Also, Allen B. Grankel and Paul B. Morgan, "Deregulation and Competition in Japanese Banking," *The Federal Reserve Bulletin* 78:8 (August 1992) 579 at 580. Thus, the form of flotation of government bonds was not taken in a normal way: government bonds were underwritten by a syndicate group, and it was mostly composed of city banks and other financial institutions. Also, the same syndicate group purchased them above market level and held them for a year. Instead of re-selling them in the secondary markets, the Bank of Japan used to buy them back at lower prices. This method helped the government to minimise the cost for government bond flotation.

raise capital cheaply in order to lend to industrial sectors at lower rates;[116] (ii) payments for interest on loans were tax deductible, and dividends were paid out of profits after tax payments;[117] (iii) there was an artificial separation between short-term and long-term finance for lending to corporations;[118] and (iv) the types of financial intermediaries were classified into seven categories to cater to a specific industrial sector.[119] Thus, each type of bank was subject to numerous restrictions in terms of their sources, uses of funds, as well as maturity and minimum denomination of lending.[120] Those rules are provided by statutes, regulations, and administrative guidance.[121]

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[116] Jones, *supra* note 109 at 3.

[117] *Ibid.*

[118] Suzuki, *supra* note 41 at 36-40. The origin of separation of short-term and long-term finance goes back to enactment of the Banking Law in 1927. The legislative policy was that commercial banks should cater to short-term finances for the working capital and inventory of corporations. As for long-term capital needs, a number of the so-called "Special Banks" were established. Also, Brown, *supra* note 107 at 366-67. Under SCAP supervision for Japanese legal reform, the basic structure of separational banking was not abolished, and special banks re-incorporated as long-term banks. Also, S. Nishimura & L.S. Pressnell, *Money and Banking in Japan* (New York: St. Martin's Press, 1969) at 204-06.

[119] Suzuki, *supra* note 41 at 163. That is: (i) commercial banks, including city banks, regional banks, and foreign banks; (ii) financial institutions for long term lending, including long-term credit banks and trust banks; (iii) foreign exchange banks; (iv) financial institutions for small business, including *Sogo* banks, *Shinkin* banks, and credit co-operatives; (v) financial institutions for agriculture, forestry and fishery; (vi) securities companies; and (vii) governmental financial institutions.

[120] Hall, *supra* note 55 at 91.

[121] Semikow, *supra* note 109 at 3-8. One unique characteristic of the Japanese Civil Code is that the sources of laws governing the banking business are scattered over different statutes. In addition, the Japanese bureaus are legitimately delegated the authority to create regulations as ancillary legislation to supplement statutes. Such regulations issued by governmental officials are legally binding and take the form of Cabinet Orders (*Seirei*), Ministerial Ordinances (*Shorei*), Circulars (*Tsutatsu*), or Directives (*Kunrei*). Furthermore, Administrative Guidance, which is the so-called *Gyo-sei shido,* is also used by governmental officials. But this merely creates administrative pressure, thus it does not have legitimate enforcement power. However, in practice, Administrative Guidance has been as effective as legislation. The governmental agencies often prefer Administrative Guidance to formal regulations as a method to persuade the business sectors to follow governmental decisions on industrial policy in a more flexible or informal manner. There are several types of Administrative Guidance, such as a request, warning, suggestion, and encouragement. See Matsuo Matsushita, *International Trade and Competition Law in Japan* (New York: Oxford University Press, 1993) at 59-62.

In addition, there is an another factor which significantly contributed to the development of bank-dominant intermediation: the *Keiretsu*, a loosely organised, large group conglomerate.[122] But, the *Keiretsu* differs from a financial holding company in that under the *Keiretsu*, no single parent company holds the majority of equity shares of member firms so as to control their management.[123] A member corporation belonging to the *Keiretsu* has strong, friendly relationships with other member corporations;[124] a larger volume of business is transacted within the member firms, and they are also associated with each other in the form of cross-equity holdings and personnel exchange.[125] At the center of each *Keiretsu* group is usually a city bank which constitutes a basis for the "main bank" system. Under the main bank system, a corporation has a single major bank which not only caters to all financial needs but is also active in corporate governance in the member corporation. For example, the main bank consults with managers of a member corporation for their business direction and can intervene in the affairs of a member corporation in times of financial difficulty, through recapitalisation or reorganisation.[126] Such control is not based on equity ownership, since the Anti-Monopoly Law

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[122] The *Keiretsu* is also defined as "a business combination involving interlocking ownership of financial and industrial firms, with a bank acting as one of the dominant firms in the group, holding ownership shares in them as well." Hazel J. Johnson, *Banking Keiretsu* (Chicago: Probus Publishing Company, 1993) at 3; Mark. J. Roe, "Some Differences in Corporate Structure in Germany, Japan, and the United States" in Kenneth L. Port, *Comparative Law; Law and the Legal Process in Japan* (North Carolina: Carolina Academic Press, 1996) at 322-32; and Suzanna C. Miller, "A Double Standard: The United States' Plea For Per Se Illegality of the Japanese *Keiretsu*"(1993) 16:3 *Brooklyn Journal of International Law*. 1101 at 1112-19.

[123] Gregory F.W. Todd & Thomas F. Cargill, "Japan's Financial System Reform Law: Progress toward Financial Liberalization?"(1993) 19 *Brooklyn Journal of International Law* 47 at 54-56.

[124] Johnson, *supra* note 122 at 159-60. For example, Mitsubishi group, one of the largest *Keiretsu*, is composed of Mitsubishi Bank, Mitsubishi Corporation, and Mitsubishi Heavy Industries, plus two insurance companies and a trust company.

[125] *Ibid.*

[126] Ronald J. Gilson & Mark J. Roe, "Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization" in Kenneth L. Port, *Comparative Law; Law and the Legal Process in Japan* (North Carolina: Carolina Academic Press, 1996) at 364-66. The author describes the risk-monitoring function of a main bank as follows:

> ...[t]he main bank required review of a client corporation's business plans and, in the event of poor performance, intervened to impose new management or strategies. It often bailed out a troubled company. Thus, the main bank was said to provide an important substitute mechanism for what in effect is a "missing takeover market" in Japan; or to put

prohibits financial institutions from holding more than 5% equity ownership.[127] However, in practice, banks and insurer groups form a coalition creating a 20% group holding in the *Keiretsu*. This enables one dominant corporation to be active in the corporate governance of their member corporations.[128]

This is one example where real practices contradict the original purpose of laws; originally the Anti-Monopoly Law was aimed at preventing banks from overly controlling other corporations.[129] Nevertheless, this traditional business practice has several merits which played a crucial role for maintaining the stability of the financial system and ensuring stable profit earnings for the business sectors.[130] Those merits are: (i) it eliminates threats of takeover by non-member corporations, and under a hostage-like situation created by cross-shareholding, the

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it somewhat differently the main bank system serves to internalize the market for corporate control."

[127] Anti-Monopoly Law, Art. 11. This is titled as "restriction on stockholding rate by a financial company." It says that no company engaged in financial business shall acquire or hold the stock of another company in Japan if by doing so it holds in excess of 5% (10% in the case of an insurance company) of the total outstanding stock.

[128] "Japan Corporate Governance: a System in the Evolution," *OECD Observer* (February 1997) 204 at 40-41; and Randall Morck and Masao Nakamura, "Banks and Corporate Control in Japan" *Journal of Finance* 53:1 (February 1999) 319 at 320.

[129] Todd and Cargill, *supra* note 123 at 59. : and Roe, *supra* note 122 at 320-32.

[130] Cargill & Todd, *supra* note 123 at 51. The origin of this type of business practice goes back to the late nineteenth century when the *Zaibatsu*, family-owned large conglomerates, started to dominate the Japanese business world. They contributed to industrialisation in the Meiji era and financed war efforts during wartime. The *Zaibatsu* was also a typical holding company where one parent company held 100% equity ownership in many group companies. Thus, they came to control most businesses in Japan from the late nineteenth century to the end of the World War II. After the war, the *Zaibatsu* was blamed for providing armaments and financing war efforts. Under the supervision of the U.S. Army, the groups were ordered to dissolve: the equity shares held by a parent corporation were distributed to the public; the cartels were disbanded; and the executives removed. In addition, the Anti-Monopoly Law was imported from the U.S., which prohibited Japanese financial firms from having holding companies. However, a close relationship between banks and corporations was successfully re-incorporated into the *Keiretsu*. The difference between the *Zaibatsu* while the *Keiretsu* is that the *Zaibatsu* family, as a parent company, owned every type of business unit 100%, and the *Keiretsu* has no single corporation which controls other group companies. Thus, under *Keiretsu* control, the member corporations are given relatively more autonomy.

member corporations mutually secure the positions of the other member corporations;[131] (ii) management is relieved of excessive pressure from the capital market;[132] (iii) it removes pressure to increase the return on dividends to shareholders;[133] (iv) it creates mutual trust and shared expectation enabling members to initiate unwritten contracts;[134] and (v) it serves to monitor the credit conditions of member corporations and ensures solvency.[135] Consequently, Japanese firms were highly leveraged by an enormous volume of bank borrowing, accounting for about 80% of their total liabilities.[136] Thus, Japanese corporations were given a competitive advantage to invest in plants and equipment, as well as to expand export volumes, because of lower funding costs from banks. This enabled Japan to achieve a high rate of economic growth from the 1950s to the 1970s.

All the above observations make us realise that a market mechanism or competitive force among financial institutions and the corporate sector is lacking in the Japanese banking system, which is a fundamental economic factor. In other words, business transactions in Japan have been

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[131] Kuniko Oyama, *Legal Controls on Corporate Management in Japan: Comparison with Common Law Jurisdiction* (Vancouver: University of British Columbia, 1993) at 25 and Morck & Nakamura, *supra* note 128 at 320.

[132] Oyama, *ibid.*

[133] Cargill & Royama, *supra* note 115 at 47. The primary objective in the main bank system is to achieve "long term and stable economic performance for their members," not to seek higher profit in the short term. Jim Rohwer also points out that the corporate culture of Japanese firms places first priority on commitments to workers and social goals, but is hardly interested in increasing the return to shareholders. See, Jim Rohwer, "Japan's Quiet Corporate Revolution" *Fortune* 137:6 (March 1998) 82 at 82. The author provides his opinion of the Chairman of Mitsubishi Heavy Industries: "...Mitsubishi management values jobs before profit.... I openly brag that I don't cater to shareholders.... If shareholder do not like us, they should hurry up and get rid of us." This represents a philosophical view of the traditional corporate culture in Japanese firms.

[134] Oyama, *supra* note 131 at 25.

[135] Cargill, Hutchison & Ito, *supra* note 4 at 104.

[136] Semikow, *supra* note 109 at 9. The dependency of Japanese corporations on banks was significant. For example, in March 1980, corporate liabilities were composed of bank borrowing (86.45 %), equity securities (7.8%), and debt securities (4.7%). Compared to corporations in other countries, such as the U.S., U.K., West Germany and France, the financial leverage ratio of Japanese firms is double. Also, Cargill & Royama, *supra* note 115 at 40. In fact, during the high economic growth period, the increased capital demands from corporations, which heavily invested in plants and equipment created a situation called the "overborrowed phenomenon."

conducted by negotiation, not by market mechanisms.[137] A competitive market force, especially among financial sectors, has been regarded as detrimental to a stable financial system in Japan during the high-growth period.[138] This is partly why money and capital markets, based on the philosophy of "free competition,"[139] had been suppressed until the late 1970s. In fact, Japanese business preferred indirect negotiable finance to direct finance through money and capital markets because of the number of advantages noted. The securities markets would have offered efficient funding sources for corporations at lower costs than loan rates. However, in Japan the function of the securities markets had been fully pre-empted by the long-term credit banks and trust banks.[140] A number of provisions concerning corporate securities issues were designed to discourage corporations from turning to money and capital markets for funding sources, *i.e.*, (i) eligibility standards for prospective issuers was higher, (ii) the size of issues was limited, (iii) collateral requirements were imposed, and (iv) the amount of new issues was subject to the

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[137] Cargill & Todd, *supra* note 123 at 49. The author presented his view of the fundamental nature of Japanese commercial law as follows:

> ...a major characteristic of Japanese finance from its beginnings in 1868 has been the role played by negotiated, rather than market, transactions. Japan's financial structure has accordingly not relied on market-oriented transactions, open markets, financial disclosure, or a legal system that codifies permissible and impermissible activities to the same extent as many western financial systems.

[138] Suzuki, *supra* note 41 at 41. The author noted that one obvious example of elimination of a competitive market force was artificially determined interest rates. Whereas free interests rates were not introduced until the late 1980s in Japan, the Canadian *Bank Act* of 1967 removed interest rate ceiling on deposits and lending: in Japan, it has long been believed that price competition of interest rates among banks was detrimental rather than efficient, for encouraging the better business performance of financial firms.

[139] "Finance and Investment Terms," *supra* note 38, *s.v.* "capital market."

[140] Cargill & Royama, *supra* note 115 at 40-41. The securities markets in Japan remained underdeveloped until the late 1970s: even prior to 1945, the markets were under an oligopoly control by the *Zaibatsu* which held majority shares of corporations; and during a high growth economic period, the *Keiretsu* dominated securities markets in the same manner as a *de facto* sole participant in the markets. Furthermore, member groups did not often make the new issues because their securities were held by the *Keiretsu* for a long time period. Thus, in spite of the rapid growth of the Tokyo Exchange, which became a center of international capital and money markets in the 1980s, domestic corporations were still not active participants in securities markets.

decision of an underwriter organisation, *Kisaikai*, composed of trust banks and underwriting syndicates of securities firms[141]

1970s-1980s

Eventually, transformation emerged in the late 1970s when the Japanese economy entered a new era characterised as a low rate economic growth period. Major episodes during this period started to slow down economic growth: two oil price shocks, inflation, and the floating exchange rate. As a major oil consuming country, Japan experienced "the triple problems of inflation, recession, and balance of payment deficit."[142] The old financial structure, designed to ensure an efficient allocation of funds to corporations, became obsolete; corporations could not sustain high levels of production because of the sudden hike in oil prices, and they started to become cautious about expanding production capacity and to adjust their investment, employment, and finance to lower levels.[143] Thus, the corporate sector depended less on banks for financing their operations. This sector also needed more flexibility to raise capital in securities markets and new methods for asset management. In addition, low economic growth affected wealth management in the personal sectors, which had accumulated savings during the high-growth period, but now faced the shrinkage of income growth and a decline of asset values, due to inflation. The personal sector started to demand new methods of management for their savings which would promise higher returns on their savings.[144] In contrast, the government became more heavily burdened by excessive fiscal expenditure's, which subsequently accumulated deficits by bond

[141] Hall, *supra* note 55 at 90. Also, Cargill & Royama, *supra* note 115 at 154 and Suzuki, *supra* note 41 at 135.
[142] Suzuki, *ibid.* at 4.
[143] *Ibid.* at 8.
[144] *Ibid.* at 26.

issues. Therefore, the emergence of new markets to absorb the government's deficits was inevitable in order for government to manage its fiscal activities.[145]

The changing circumstances in the three sectors, corporate, personal, and government, necessitated reform of banking regulations. A first step was deregulation of secondary markets for government bonds in 1977, which permitted both banks and securities companies to participate in government bond underwriting and primary distribution to the public.[146] Aggressive participation of banks and securities companies in bond markets contributed to the further deepening of government bond markets; the volume of new issues, as well as of secondary trading on government bonds increased. Subsequently, the government also had to respond to domestic demands from corporate and household sectors, as well as to external pressure from foreign governments: (a) corporations needed access to less expensive funding sources and to investment channels for their asset management; (b) household sectors demanded higher returns on their saving; and (c) foreign governments sought entry for their financial institutions into Japanese financial markets. To meet these demands, further deregulation in

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[145] Jones, *supra* note 109 at 8. Likewise, Canadian secondary markets for Canadian Treasury Bills were underdeveloped from 1935 to 1953. See, W.T. Hunter, *Canadian Financial Markets*, 2nd ed. (Ontario: Broadview Press, Ltd., 1988) at 68-79. However, a turning point came in 1953-54 when the money and capital markets started to develop with federal government supports. It was partly because the government wanted the securities markets to absorb Treasury Bills, which were important for the government to finance their fiscal activities and to carry out monetary policy. For example, the federal government granted market makers, money market dealers, or jobbers, access to the Bank of Canada as a last resort and encouraged them to carry inventories. The government provided the liquidity support to the market makers through purchase and resale agreements (PRA) in which market makers sold their securities to the Bank of Canada, in the promise that those securities would be bought back by the market makers in a short time at higher prices.

[146] Jones, *ibid.* The Japanese government, suffering through an economic recession in the late 1970s, excessively increased the volume of bond flotations. On the other hand, banks, which were forbidden from re-selling government bonds to the public, started to be reluctant to hold government bonds, which produced lower yield rates; after all, it was undesirable for banks to hold a large volume of low yield assets in their portfolios for time periods as long as one year. This is why the government had to allow banks to re-sell government bonds to the public, by making an exception for provisions of the Security Exchange Law. After this deregulation, because of a rapid increase in the volume of government bond trading, new issuing prices became close to the market-determined price. Since 1983, issuing prices have become the same level as, or below, market price. Also, Cargill & Royama, *supra* note 115 at 152.

financial markets was necessary, *i.e.*, removing interest rate restrictions, easing the segmentation of the financial sectors, allowing development of securities markets, and relaxing governmental control over capital outflows and international transactions conducted by domestic institutions. The following are outcomes of deregulation in the 1980s.

First, once interest rate controls became less restrictive, it changed the old regime of banking laws characterised by the banking system, between long-term and short-term finance. Second, separation between the banking business and securities business became blurred because of the rapid growth of money and capital markets, where both banks and securities companies started to deal with newly introduced short-term securities instruments.[147] Third, requirements for corporate bond and stock issues in domestic markets became less strict; *i.e.*, the "collateral rule" was removed for corporate bond issues. Furthermore, a new trend in corporate finance and asset management brought them to foreign securities markets, which is more liberal than domestic markets; *e.g.*, corporations which wished to issue securities in the Euromarket were not subject to any similar restrictions in their domestic markets, such as capital and collateral requirements. Conversely, banks, in order to keep corporate clientele, wanted to cater to client needs in foreign markets. Thus, banks demanded deregulation on their activities in foreign financial markets. Consequently, taking advantage of cheaply raised funds from domestic markets, banks started to be major lenders in foreign securities markets.[148] In addition, provided with equal footholds for competing with securities firms overseas,

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[147] Those instruments are negotiable certificates of deposit, commercial papers, and the banker's acceptance.

[148] K. Osugi, *Japan's Experience of Financial Deregulation Since 1984 in an International Perspective* (Basle: Bank for International Settlements: Monetary and Economic Department, 1990.) at 41-45. Also, Jim Powell, *The Gnomes of Tokyo* (NY: AMACOM, a division of American Management Association, 1989) at 117-18. Both Japanese banks and securities firms became major participants in the Euromarket, such as London and New York. For example, in 1987 five of the top ten managers of security issues for borrowers in the Euromarket were Japanese financial institutions. Also, Wagster, *supra* note 74 at 1322. The author states:

Japanese banks increasingly intensified their competition with securities firms in foreign markets.[149]

This is a unique outcome of disintermediation and deregulation which has not been seen in Canada. From the perspective of financial stability which was continuously tested by gradual deregulation, the rapid growth of short-term money and capital markets made corporations shift their funding sources from indirect finance to direct finance. Consequently, banks resorted to numerous survival tactics in an effort to compensate for losses due to disintermediation, *i.e.*, paying a higher interest rate on deposits, and starting to lend to new borrowers outside their *Keiretsu,* including small and medium size companies.

However, this caused instability in the banking system, which similarly occurred in the U.S. and Canada;[150] as noted, it triggered S&L debacles in the U.S., and in Canada sent many trust and loan companies into a situation of systemic risk from the 1970s to the 1980s. Likewise, financial

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> ...[i]n 1981, only one of the ten largest banks in the world in terms of total assets was Japanese. By 1988, the seven largest were Japanese. This phenomenal growth occurred because Japanese banks were underpricing their competitors. Even through the value of international banks' market share varies according to how loans are treated that are booked offshore, it appears that by the end of the decade, Japanese banks had captured 38 % of all international lending including 12 percent of the U.S. banking market and 23 % of the U.K. banking market.

[149] Semikow, *supra* note 109 at 35-36. Deregulation of the Japanese financial markets also started with the Financial Accord between the U.S. and Japan in 1984. The U.S. government, in an effort to curb its mounting trade deficits, initiated internationalisation of the yen as a primary goal. Consequently, the Foreign Exchange and Foreign Trade Control Law, which used to strictly regulate domestic companies engaged in international transactions and control the capital outflow, was repealed. The Japanese government made a commitment to its U.S. counterpart to accelerate the internationalisation of the yen, as well as to speed up the opening of domestic financial markets. The result was: (i) forward exchange transactions deregulated; (ii) financial institutions of foreign countries were permitted entry into Japanese markets; (iii) insurance of foreign currency-denominated bonds was allowed; (iv) the yen-denominated banker's acceptance market was open; (v) the minimum unit of the yen denominated CD was lowered, while its ceiling was enlarged; (vi) issuance of Euro bonds by residents was allowed; and (vii) the withholding tax for interest earnings on financial instruments, which used to be imposed on non-residents, was abolished.

[150] Cargill, Hutchison & Ito, *supra* note 4 at 102. The authors noted that the liberalisation of financial markets in the U.S., JAPAN and other industrialised countries, removed constraints imposed on a bank's portfolio activities, and caused the asset inflation. For banks and other deposit intermediaries suffering from their profit declines because of disintermediation in the 1980s, the securities and real estate market boom appeared to be suitable solutions to compensate for profit decline.

disintermediation created agony in the Japanese city banks with unprecedented profit declines. Given that Japanese banks depended on lending to their customers for as much as 80% of their profit earnings, the damage was obvious.[151] However, unlike Canadian chartered banks, Japanese banks still tried to keep profitable corporate clientele, instead of diversifying their business patterns, *i.e.*, expanding consumer credit and mortgage loan markets. Thus, Japanese banks intensified competition with securities firms in foreign markets instead of amalgamating, as Canadian chartered banks did. However, this failure to successfully diversify business patterns was largely due to a lack of governmental initiatives encouraging banks to cater more to household needs. This regulatory mistake was in stark contrast to U.S. banks as well, for U.S. banks had been designated to cater to the needs of the household sector long before this.[152]

Such an imbalance in Japanese banking business patterns did not leave them much room in compensate for profit declines: once legal constraints on bank portfolio activities were removed in the late 1980s, Japanese banks vigorously invested speculatively in securities and real estate during the bubble economy period, casting aside prudent business practice. Furthermore, their diversification efforts to reach customers outside the *Keiretsu* did not produce any successful results; such being the case, Japanese banks failed to appropriately evaluate the credit conditions

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[151] Nevertheless, there were several efforts made by banks to attract depositors, such as combining mid-term government bonds into time deposits. Among this type of deposits, there are so called *Chukoku* funds and *Rikin* funds. *Chukoku* funds are "open-ended public and corporate bond investments" with the minimum unit of Y10, 000. and such fund holders are usually individuals or small corporations. The characteristics of *Chukoku* Funds are (i) free withdrawal after a month, (ii) higher rates of return than notice deposit and 3-6 month time-deposits, and (iii) *Maruyu*, a type of tax exemption. Suzuki, *supra* note 41 at 89-90.

[152] Cargill & Todd, *supra* note 123 at 52 and 55-57. For example, the U.S. "Regulation Q" differentiated the ceiling of interest rates on deposits between commercial banks and thrifts. This differentiation was designed to protect thrift industries in order to provide affordable mortgages to less wealthy clients. The similar protection is granted to credit unions in the form of a tax advantage, so that credit unions were able to supply lower cost funds for low-income households. Furthermore, the rights of households have been well guarded by numerous laws, such as *Consumer Credit Protection Act*, 15 U.S.C.A. s. 1601(1989), *Fair Housing Act*, 42 U.S.C.A. s. 3601 and s. 3619 (1968), and *Equal Credit Opportunity Act*, 15 U.S.C.A. s. 1691(1974). In contrast, such initiatives for enhancing service quality of consumer credit and mortgage credit have never been taken by the Japanese government. The high savings rate of households in Japan is largely attributed to this unfavorable treatment of the savings sector by legislation.

of unfamiliar client corporations, because the main banking system prevented development of market mechanisms which would monitor the credit condition of corporations. As a result, banks ignored the basic pattern of risk-induced insolvency, while engaging in such unprecedented business transactions from 1987 to 1989.

Revision of the Banking Law in 1992[153] came in the midst of the largest banking crisis in post war history; many banks and depositories were riddled with defaulted loans from the bubble economy period.[154] Thus, deregulation by the 1992 Financial System Reform Law can be interpreted as a governmental effort to solve this bank insolvency crisis. The reform laws encouraged more mergers and consolidations of insolvent or near-insolvent financial institutions, as a counteractive measure to the deterioration of the Japanese banking system. Major amendments were made to the Law Concerning Amalgamation and Conversion of Financial Institutions of 1968.[155] In addition, the government provided almost all types of financial institutions, except insurance companies, with broader powers of business activities. Consequently, several amendments were made to the Banking Law and the Securities and Exchange Law. In summary, noticeable outcomes of the Financial System Reform Law were: (i) all types of banks were allowed to participate in the private placement of securities markets; (ii) banks and other depository institutions were allowed to establish their own securities or trust subsidiaries by holding more than 50% equity ownership in their subsidiaries; (iii) securities firms were allowed to establish trust or banking subsidiaries; and (iv) all types of depository institutions were allowed to merge with other institutions. However, several conditions were left to the discretion of the Ministry of Finance to implement this reform. Those provisions prevented

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[153] *Kinyu Seido Oyobi Shoken Torihiki Seido No Kaikaku No Tame No Kankei Horitsu No Seibi Nado Ni Knasuru Horitsu* [Law Concerning the Realignment of Relevant Laws for the Reform of the Financial System and Securities Trading System], Law No. 87 of 1992[hereinafter "Financial System Reform Law"].
[154] Jones, *supra* note 109 at 19-20.

banks from taking full advantage of newly granted business powers.[156] A more comprehensive legislative reform for banks did not take place until the Japanese *Big Bang*, which started in 1997 and is slated for completion by 2001.

This review of transformations in the legislative history of Japanese banking for a half century may imply an answer as to why the Japanese banking system has become stigmatised as "weak," "fragile," and "vulnerable," and considered to belong to a group of the weakest banking systems in the world.[157] The vulnerability of Japanese banks may derive from too little diversification and too strict a regulatory framework. Without diversification, banks were sticking to wholesale markets in an effort to keep the same large corporations as major clients, depending on corporate lending as the main source of earnings. In addition, the "strict" regulatory framework caused an excessively protective environment for financial sectors, where long-stable profit earnings were secured for financial firms. This was achieved through elimination of market forces and competition among corporations. Consequently, there was little necessity for financial institutions to initiate prudent management by internal governance and self-discipline.[158] Even when shifting demands in the markets prompted legislative reform, a deeply-rooted illusion prevented banks from becoming cautious in their business practices: banks believed they possessed immunity to insolvency risks because of an unwritten guarantee from the government

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[155] Law Concerning Amalgamation and Conversion of Financial Institution, Law No. 86 of 1968.

[156] After the Financial System Reform Law was modified by the MOF on 17 December 1992, the Law became effective in April 1993. Several restrictions were added to the original draft, such as, (i) a prohibition on securities subsidiaries of banks being involved in any new issue, distribution, and brokerage of equity securities, and (ii) a limitation on activities of trust bank subsidiaries.

[157] See "Canada Leads G7 in Banking Strength," *Canadian Banker* 105:5 (September 1998) 8 at 8. It presented Moody's Investor Service's national ranking of the financial strength of banks in the world. The rankings were made on the basis of the possibility that foreign countries' assistance might be needed for a country's banks. In addition, financial fundamentals, franchise value, and business and asset diversification were considered. According to the rankings, the Canadian banking system is the strongest among G7 nations, the sixth strongest among all nations. In contrast, the Japanese banking system was ranked 48th, followed by China (61), Russia (64), and Mexico (69).

[158] Suzuki, *supra* note 41 at 41.

for their solvency, which eventually led banks to eagerly participate in the bubble economy boom.[159]

In summary, overly excessive protection of financial intermediaries is detrimental not only to their viability but also to their stability. In this sense, the Japanese banking system, framed by the extreme conditions of the post-war era, inherited self-induced defects which the bubble economy period revealed. This is why a system which greatly contributed to high economic growth until the 1970s became a defective factor in the economic structure during the decades that followed.

As a preview to the following chapters, the above conclusion has implications for the deposit insurance system, as imported to Japan. This system is typically vulnerable to moral hazards because depositories are given incentives to undertake riskier business operations, and depositors become less cautious for their bank's prudent management due to governmental guarantees on insured deposits. The Japanese deposit insurance system has been under tremendous reforms in recent years. And it will increase its importance in the future when market forces will become the dominant power over governmental regulations; intensified competition among financial institutions will lead Japanese finance toward amalgamation and consolidation. However, a question remains: how to apply and transplant a different deposit insurance system into the Japanese setting? Japan is still unfamiliar with market mechanisms, where "out-of-business" is an everyday occurrence, and there is neither stability nor guarantee of a long business life in the corporate sector.

[159] Lincoln, *supra* note 47 at 59-60.

2. Canada

The regulatory framework of Canadian banking used to be characterised by "four pillars" which divided the financial industry according to business power and ownership restrictions. Under the four-pillar system, financial institutions were categorised into banks, trust companies, securities companies, and insurance companies. Thus, each was prohibited from engaging in the business activities of the others.[160] This separated system was similar to the Japanese, but the legal purpose was different in that Canada was intended to ensure the stability of its financial system. Nevertheless, numerous changes in Canadian financial markets have transformed the banking system gradually toward mergers and integration over the past thirty years. Such changes are assumed to be the result of "interest rate volatility, globalization of financial markets, technological innovations, changing demographics, rising household wealth, and adjustments within the financial sectors to shifting business prospects."[161] During the past three decades, legislative reforms have focused on a balance between "competition and solvency."[162] In other words, competition among financial institutions was encouraged in order to innovate financial products and services in a way that would benefit users; at the same time, financial stability and solvency, which might be endangered in an intensified competition, would be minimised.

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[160] "Competition and Solvency," *supra* note 18 at 1. Under the pillar system, the main activities of chartered banks are limited to collecting short-term funds, such as demand deposits and financing for inventories and account receivable. The trust companies are confined to the management of estate and trust funds such as pension funds, as well as accepting term-deposits and offering mortgage financing. The securities companies dealt with underwriting, distributing, and dealing in stocks and bonds. Insurance companies offered several types of insurance products, including life insurance, property insurance, and casualty insurance.

[161] "Changing Business Activities," *supra* note 83 at 11-12.

[162] "Competition and Solvency," *supra* note 18 at ix. This was the title of the government report issued in 1986, which addressed several agendas for banking legislation, such as "banking and monetary system and institutions and operations of the capital market." Emphasis was placed on increasing competition among financial institutions by making their activities more overlapping. In addition, all governmental reports recommending legislative banking reform in the following years had the same emphasis on competition and solvency.

In the course of the legislative development of the Canadian banking system, there are noticeable aspects in governmental policy which assigned chartered banks special mission, for the development of national industries: chartered banks played active roles in developing national industries, primarily in the area of manufacturing and producing natural resources such as agriculture, aquaculture, fishing, forestry, mining, and petroleum. Chartered banks established their dominant position as commercial lenders, especially to those industries, at the beginning of this century.

Since enactment of the *Bank Act* of 1890,[163] chartered banks had been allowed to lend money to manufacturers and producers by taking the security of their products and equipment. Suffice it to say that these sections reflected the legislative purpose of encouraging manufacturing and commercial enterprise in Canada, even with the acknowledgment that it was not as beneficial for banks as for manufacturers and producers.[164] In addition, while the lending policy of chartered banks used to be based on "real bill doctrine,"[165] this permissive provision had been the exception to the doctrine from the outset. The following years witnessed the significant erosion of this doctrine, in the lending practices of chartered banks: for example, the 1944 revision of the *Bank Act* permitted banks to make loans on the security of ships, ship equipment, fishing vessels,

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[163] *Bank Act*, S.C. 1890, c. 31, s. 72, and 74.

[164] [1935] 4 D.L.R. 483 (Ont. C.A.); and *Landry Pulpwood Co.* v. *Banque Canadienne Nationale.* [1928] 1D.L.R. 493 (S.C.C.), per Mignault J. at 499.

[165] *Taking Security Under Section 177 and 178 Bank Act* (Toronto: Davies, Ward & Beck, 1990) at 1. This provision has also served to safeguard liquidity for chartered banks and contributed to the maintenance of prudent lending practice of banks. See Shearer, *supra* note 16 at 313. At the start of this century, the basic lending policy of chartered banks can be represented by the so-called "real bill doctrine." The essential argument of the real bill doctrine is: as far as the loans of chartered bank are used to finance the production and distribution of goods, the nature of a loan is to be self-liquidating, because such a loan is supported continually by the existence of goods. Hence, when goods are ready to be sold, borrowers will be given the means for repayment of the loan. Thus, the volume of bank credit can be adjusted automatically to the needs of trades. Subject to this doctrine, chartered banks were not allowed to lend on the security of fixed and non-negotiable assets, such as real estate, or personal property. It was not until the revision of the *Bank Act* in 1967 that chartered banks started to be allowed to lend on personal property or real estate.

and agricultural equipment.[166] In the same year, the *Farm Improvement Act* was enacted with the purpose of providing finances to farmers by permitting banks to make long-term loans to farmers on various types of security, such as a mortgage on a farm.[167] In addition, at the time of the major oil discoveries in the west in the late 1940s, petroleum products were added to the list of special security provisions.[168] Similarly, minerals and mineral rights became an eligible security in the revision of the 1980 *Bank Act*.[169]

Under the current *Bank Act*, eligible recipients are manufacturers,[170] aquaculturers,[171] farmers,[172] fishermen,[173] or any forestry producers,[174] and the types of eligible security provided by Section 427(1) are products of those eligible recipients. That is: agricultural products, including "grain, hay, roots, vegetables, fruits, other crops, and all other direct products of the soil," as well as "honey, livestock, dairy products, eggs and all other indirect products of the soil;"[175] (ii) aquaculture products, including "all cultivated aquatic plants and animals;"[176] (iii) forestry

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[166] *Bank Act*, S.C. 1944, c. 30, s. 85.
[167] *Farm Improvement Loan Act*, S.C. 1944-45, c. 41, s. 7.
[168] *Taking Security Under Section 177 and 178 Bank Act* (Toronto: Davies, Ward & Beck, 1990) at 1.
[169] *Ibid.* at 2. Also, *Bank Act*, S.C. 1980-81-82-83, c. 40, s.177.
[170] *Bank Act*, s. 425(1) gives the definition of "Manufacture" as;

> ...any person who manufactures or produces by hand, art, process or mechanical means any goods, wares or merchandise and... a manufacturer of logs, timber or lumber, a maltster, distiller, brewer, refiner and producer of petroleum, tanner, curer, packer, canner, bottler and a person who packs, freezes or dehydrates any goods, wares, and merchandise.

[171] *Ibid.* An "aquaculturist" is defined as "the owner, occupier, landlord and tenant of an aquaculture operation," which is the cultivation of aquatic plants and animals.
[172] *Ibid.* A "farmer" is defined as "owners, occupiers, landlord, and tenant of a farm. The farm is defined as "land in Canada used for the purpose of farming, which term includes livestock raising, dairying, bee-keeping, fruit growing, the growing of trees and all tillage of the soil."
[173] *Ibid.* A "fisherman" is defined as "a person whose business consists in whole or in part of fishing." Fish includes shellfish, crustaceans, and marine animals.
[174] *Ibid.* A "forestry producer" is defined as "a person whose business consisted in whole or in part of forestry" and includes "a producer of maple product." A forest means "land in Canada covered with timber stands or that, formally so covered, is not put to any use inconsistent with forestry, and includes a sugar bush." Forestry means "the conservation, cultivation, improvement, harvesting and rational utilization of timber stands and the resources contained therein and obtainable therefrom, and includes the operation of a sugar bush."
[175] *Ibid.*, s. 425(1).
[176] *Ibid.*

products, including "logs, pulpwood, piling, spars, railway ties, poles, pit props and all other timber," as well as "boards, laths, shingles, deals, staves and all other lumber, bark, wood chips, sawdust, and Christmas trees," and also, "skins and furs of wild animals, and maple products;"[177] (iv) products of quarries and mines, including "stone, clay, sand, gravel, metals, ores, coal, salt, precious stones, metalliferous and non-metallic minerals and hydrocarbons;"[178] and (v) products of the sea, lakes, and rivers, including "fish of all kinds, marine freshwater organic and inorganic life and any substances extracted or derived from any water."[179] Furthermore, the *Bank Act* now provides that certain equipment of those producers and manufacturers will also be eligible security, such as agricultural equipment, agricultural implements, farm electronic systems, crop growing or produce on the farm, grain and livestock, fishing equipment and supplies, and fishing vessels.

As argued, it was not only manufacturers and producers of natural industry but also household sectors which benefited from the permissive banking legislation that allowed banks to expand their lending and business powers: (i) since 1937, banks were permitted to make unsecured home improvement loans with government guarantees; (ii) the 1954 revision to the *Bank Act* granted chartered banks permission to make loans to individual by taking household property, such as motor vehicles and any personal or movable property in lands and building;[180] (iii) since the enactment of the *National Housing Act* of 1954,[181] chartered banks started mortgage lending on the security of land and buildings, as far as those mortgages are insured by the Government of Canada; and (iv) finally, the revision of the 1967 *Bank Act* removed all restrictions concerning

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[177] *Ibid.*
[178] *Ibid.*
[179] *Ibid.*
[180] The collateral for personal lending which chartered banks used to take, prior to this revision, were largely stocks or bonds. Shearer, *supra* note 16 at 316.
[181] *National Housing Act*, S.C. 1953-1954, c. 23.

mortgaged lending; since then, banks have been free to make loans by taking the security from any real and personal, immovable or movable property.[182]

The 1967 revision to the *Bank Act* was a significant transition in the Canadian banking system. Besides removal of all restrictions on mortgage lending, numerous amendments to the previous *Act* added more flexibility to bank activities, as well as increased competition within and among financial sectors:[183] (i) the 6% rate ceiling, which chartered banks imposed on lending, was removed and interest on deposits and loans became free rates;[184] (ii) cash reserve requirements were reduced from 8% to 4%;[185] and (iii) banks were allowed to issue bank debentures to raise capital.[186] Consequently, banks, free from heavy cash reserve requirements and interest rate restrictions, started to increase earnings on their assets by offering competitive interest rates with other depositories.[187] This established a trend that made chartered banks major participants in

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[182] *Bank Act,* S.C. 1966-67, c. 87, s. 75. Also, Ogilvie (1998), *supra* note 98 at 304. Statutory restriction on bank's lending on real estate used to be more strict, to the extent that it was totally prohibited to chartered banks with two notable exceptions:

> (i) where the security was a corporate debenture which included a charge on land; and,
> (ii) where a mortgage was subsequently taken as an additional security for a loan made in the course of banking business which was shaky.

Although this prohibition was removed by the revised 1967 *Bank Act*, restriction on residential mortgages has remained.

[183] Shearer, *supra* note 16 at 430. The revision of 1967 *Bank Act* is based on numerous recommendations in a governmental report, the so-called "Porter Commission." The central theme of this report was "the flexibility of banks and free competition both among banks and between banks and near banks." This Commission was appointed in 1962 with a mission of "enquir[ing] into and report[ing] on the structure and methods of operation of the Canadian financial system." The same emphasis was expressed in the Regulation of the Financial Institutions in 1992, a Finance Ministry paper which accompanied the public release of the bill. Ogilvie interprets this as "it is to provide for enhanced consumer protection domestically and to create a Canadian financial services sector able to compete globally." M.H. Ogilvie, "What's Really New in the New Bank Act" (1993) 25:2 *Ottawa Law Review* 385 at 387.

[184] *Bank Act,* S.C. 1966-67, c. 87, s. 91. Shearer, *ibid.* at 434 and 437-38. Prior to 1967, interest rates on deposits and loans were decided by pricing agreements among chartered banks; the revision of the 1967 *Bank Act* prohibited such price agreements among chartered banks.

[185] *Bank Act*, S.C. 1966-67, c. 87, s. 72(1)(b).

[186] *Ibid.*, s. 77.

[187] See, "Changing Business Activities," *supra* note 83 at 13-18. The expansion of chartered bank shares in residential mortgage markets over the years was remarkable. Between 1971 and 1996 their stakes in

residential mortgage and consumer loan markets. On the other hand, the separation between chartered banks and other corporations remained. For example, banks were restricted in their ownership and business activities; more than 10% equity ownership of a bank cannot be held by any single owner, while banks were prohibited from acquiring more than 10% ownership in other companies, except small companies and corporations which provide ancillary business to the bank.[188] It should also be noted that chartered banks inevitably experienced a serious decline in demand for business lending, partly due to the disintermediation phenomenon: the development of equity finance and the introduction of numerous money market instruments made corporations less dependent on bank borrowing.

The revision to the *Bank Act* in 1980 made an impact on the Canadian financial system. Business powers of the chartered banks were further expanded, *i.e.*, data processing, leasing, and factoring businesses were newly admitted as being legitimate banking practices;[189] and as part of the legislative policy of increasing competition among banks and near-banks, regional banks and foreign bank subsidiaries were permitted in Canadian financial markets, as so-called Schedule B Banks. They were expected to enhance the efficiency of Canadian financial markets by competing with chartered banks, or Schedule A Banks. Furthermore, the "little bang" that occurred in Canada in 1987 permitted any Canadian financial institution to own a securities subsidiary.[190] Now, 80% of securities firms have become subsidiaries of the chartered banks.[191]

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residential mortgage markets increased from 10% to over 50%, and relative to their assets, the volume of residential mortgage loans increased from 7% to 30 % during the same period.

[188] *Bank Act*, 1966-67, c. 87, s. 76(1).

[189] *Bank Act*, S.C. 1980-81-82-83, s. 173, 174.

[190] Hunter, *supra* note 145 at 199. It is named after the large-scale deregulation of the British financial system, which happened in October 1986, called the "Big Bang." A "little bang" Canadian version of financial deregulation came relatively on a smaller scale on 30 June 1987. It allowed all Canadian financial institutions to own up to 100 % of securities firms. All Canadian chartered banks, except one, gained substantial equity shares in major Canadian securities dealers: the 75% equity shares of Dominion Securities were purchased by the Royal Bank; 65% of Wood Gundy by the Canadian Imperial Bank of Commerce.

[191] Boreham & Bodkin, *supra* note 30 at 300.

Moreover, revision of the 1992 *Bank Act* showed a radical trend to integration of all financial sectors under chartered bank umbrellas: chartered banks were permitted to conduct almost all financial activities through networking arrangements with affiliated companies, or their subsidiaries;[192] and a 10% ceiling on bank holdings of stocks in other companies was no longer applied to certain financial institutions. Also, chartered banks were allowed to establish or own separate trust and loan companies. This aimed at encouraging chartered banks to capture many distressed trust and loan companies during the real estate market recession in the early 1990s.[193] Consequently, most trust and loan companies became part of the chartered banks and came to constitute one of their major business lines. Trust and loan companies are now associated with large trust companies or have become parts of financial holding companies.[194] Thus, chartered banks in Canada, which took advantage of their national branch systems, now successfully cater to all financial needs: from the corporate sector, large or small, to the household sector in domestic markets. In this sense, the primary objective of regulatory reforms, which was to integrate all financial intermediaries into one sector, has been accomplished in marked contrast to Japan.[195]

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[192] M.H. Ogilvie, *Canadian Banking Law*, 2ed (Toronto: Carswell, 1998) at 402-03. Also, the current *Bank Act* provide, in s. 468 (a)-(n), that chartered banks are allowed to acquire and increase substantial investments in certain financial firms including, among others, a factoring corporation, financial leasing corporation, information services corporation, investment counselling corporation, portfolio management corporation, mutual fund corporation, mutual fund corporation, real property brokerage corporation, real property corporation, service corporation, specialized financing corporation, and financial holding corporation.

[193] "Changing Business Activities," *supra* note 83 at 22.

[194] Shearer, *supra* note 16 at 354.

[195] Also see, Ogilvie (1998), *supra* note 192 at 401.

Chapter IV. Current Business Activities: Main, Additional, and Prohibited

A. Introduction

One similarity between Japanese and Canadian banking law regimes is the concept of a separated banking system. This section will briefly explain the origins and justifications of legal structures, which divide financial sectors according to business powers and ownership.

As seen in the previous section, early Canadian banking legislation was based on the "real bill doctrine," which emphasised that banks should lend on a short-term basis to safeguard liquidity.[196] In other words, the "real bill doctrine" required banks to finance only seasonal working capital, such as the production and distribution of goods. It also required those loans to be secured by only "a corresponding value of real goods in the final stages of production."[197] In fact, the separated banking system, which prohibited banks from conducting securities or trust business, originated with this traditional concept of commercial banking. This system aimed at preventing banks from carrying undesirable assets in the balance sheet, such as real estate and corporate equities. Those assets are highly volatile and vulnerable to price fluctuation, which can be easily affected by economic, social, and market conditions.[198] Considering that bank liabilities are mostly short-term demand deposits, it is risky to carry a large amount of illiquid assets, such as real estate or loans secured by real property, which are difficult to convert into cash in order to meet withdrawal demands from customers. Based on this idea, Canadian financial institutions were separated by a four-pillar system, and chartered banks were subject to stringent restrictions on business powers and ownership for ensuring their solvency. In short, banks were prohibited from conducting non-financial and commercial activities, making substantial investments to commercial firms, and from dealing in real estate and mortgage

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[196] Shearer, *supra* note at 313. Also, see, "Finance and Investment Terms," *supra* note 38, *s.v.* "Commercial loan."
[197] Shearer, *ibid.*

transactions.[199] Thus, it can be said that the fragmented structure of the financial industry was the major regulatory tool utilised for minimising risks of bank insolvency in Canada: solvency and stability in the financial system were achieved by dividing financial sectors according to function and ownership.

Similarly, separating financial intermediaries into various categories was the traditional Japanese way for defending bank solvency.[200] In Japan, when commercial banks began business in the late nineteenth century, the legislative policy regulating commercial bank activities was based on the following "commercial banking philosophy:" [201] there should be a clear line of "distinction between commercial funds used in the sale of commodities on the one hand and agricultural or manufacturing funds used in promoting production on the other."[202] Based on this "commercial banking philosophy," Japanese banks at the beginning of century conducted prudent management even without legal requirements.[203] Thus, lending on long-term debt instruments, real estate, or mortgages, or dealing in equity securities was normally avoided by prudent management.

Another justification for the separated banking system was to prevent self-dealing and conflict-of- interest, which might arise when banks conducted different business operations, such as commercial lending on the one hand and securities dealing and trust business on the other. In such a situation, for example, banks would be inclined to promote the sales of securities of companies to which they also provided loans. In the long process of deregulation, such a "non-arm's length" issue has been frequently discussed in Canada because such activities sometimes

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[198] *Ibid.* at 547-48.
[199] *Ibid.*
[200] Suzuki, *supra* note 41 at 36-40.
[201] *Ibid.* 36
[202] *Ibid.*
[203] *Ibid.*

caused risk of abuse by employees, which also led to insolvency.[204] Likewise, Japan's legislative requirement for separating financial sectors was also originally aimed at prevention of conflict of interest and self-dealing.[205] However, this ceased to be the primary justification in Japan after World War II. Under the banking law framework in the post-war period, the segmentation of financial industries served to allocate capital resources efficiently for the corporate sector, rather than to encourage the prudent management for protecting depositor funds.

A third justification for this functional separation was to prevent banks from unfairly enhancing their business powers over other financial sectors, such as other deposit-taking institutions or securities firms. As already observed, this last reason became increasingly dominant for preserving an overall policy of preventing banks from gaining excessive controls over other industries. Especially in Canada, it is expressly stated that this is a major reason for restricting bank securities business.[206]

The above-examination into the origin and justification of separated banking indicates one fact: whereas banks have increasingly expanded their business scopes by affiliating with other types of financial institutions, it is inevitable that provisions artificially separating financial sectors become obsolete and need to be phased out. Confining financial institutions to specific business operations then no longer serves to ensure bank solvency. Sometimes, it might even be an

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[204] "Competition and Solvency," *supra* note 18 at 6, and 21-22.
[205] Suzuki, *supra* note 41 at 37.
[206] Ogilvie (1993), *supra* note 183 at 402. The author notes that prohibition for banks to engage in certain types of business activity was a reflection of the overall policy of "protecting the core activities of particular pillars of the financial services industry from competition with other pillars." Also, Guy David & Louise Pelly, *The 1997 Annotated Bank Act* (Toronto: Carswell, 1997) at 293. The legislative purpose of the provision for restrictions on securities activities by banks is expressed in the following:

> ...[t]his section prevents banks from dealing in securities in Canada, to the extent restricted by the regulations. The purpose of this restriction is not functional or prudential but jurisdictional in that it reflects the 1987 agreement between the federal government and certain provisional governments as to the regulation of the securities activities of banks.

obstacle for enhancing viability and diversifying business operations, which has been the case in Japanese banking law.

There is another reason why governing rules on the banking business became permissive: new types of instruments in the securities market, which have contributed to relieve liquidity risk from banks.[207] For example, while mortgages used to be considered illiquid and a non-marketable asset, this is no longer the case. Because the maturity of mortgages has become shorter, advanced techniques of securitisation have allowed banks to repackage some mortgages into units to be sold in the open market.[208] Thus, there is less necessity to regulate banks strictly concerning their mortgage lending. In addition, the development of money market instruments greatly contributed to relieve banks from default risks. Money market instruments, such as negotiable certificates of deposit, commercial paper, and banker's acceptances are commonly liquid, short-term, and safe instruments. These significant factors for innovations in corporate finance help to explain the decline of the traditional form of bank lending; banks became expert at dealing with these short-term instruments.

Nevertheless, preservation of demarcation lines can still be observed in both countries, no matter which justification is emphasised. The following sections will examine the current business activities: main, additional, and prohibited activities under Japanese and Canadian laws. Also, it will highlight the difference in classifications between both countries about what constitutes "main business" and "additional business." It will also distinguish the gap in concepts between two different legal frameworks for the business of banking. Additionally, banks have increasingly tended to engage in non-traditional banking business through affiliated financial firms. Thus, relationships with their affiliated firms will also be a key issue. The following

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[207] Shearer, *supra* note 16 at 547-48.
[208] Hunter, *supra* note 145 at 81.

section will examine the permissible securities business activities conducted by banks in both countries.

B. Japan

1. Overview

Under Japanese Banking Law, there are four categories:[209] main (*Hongyo*), ancillary (*Fuzui Gyomu*), other ancillary business (*Sonata Fuzui Gyomu*), and fringe business (*Tagyo*).[210] Article 10(1) of the Banking Law provides the definition for the main business activities which are exclusively permitted to banks as a prerogative right and from which other types of financial institutions were strictly prohibited. The ancillary business activities are those supposed to be accompanied by the traditional banking business in the normal course of operations.[211] They are articulated by Article 10(2). Under the provision of ancillary business activities, limitations on certain operations, such as securities dealing and trust businesses, are also stipulated. Other ancillary business and fringe businesses were added and defined by Notification of the Director of the Banking Bureau in the Ministry of Finance. This notification was issued on 3 July 1975, and it was a typical administrative rule, entitled "Regarding Relationship between Financial Institutions and Their Affairs."[212] However, banks are prohibited from directly engaging in other ancillary and fringe businesses: banks are required to be affiliated with other companies if they wish to conduct these types of business.

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[209] Banking Law, Art. 10.

[210] Masabumi Yamane, "Financial Transactions in Japanese Law" in Charles Albert, Eric Goodhart & George Sujita, *Japanese Financial Growth* (Basingstoke: Macmillan, 1990) 17 at 19-20. Also, Yagyu, *supra* note 108 at 310-13. The author categorises banking business as follows: core banking business (*Hongyo*), incidental banking business (*Fuzui Gyomu*), non-listed incidental business (*Sonota Fuzui Gyomu*), and other banking business (*Tagyo*).

[211] Suzuki, *supra* note 41 at 189.

[212] *Kin' yu Kikan to Sono Kanrengaisha No Kankei Ni Tsuite* [Regarding Relationships Between Financial Institutions and Their Affiliates], *Jimu Renraku* [Administrative Notice] (July 3, 1975), as amended [hereinafter "MOF Domestic Administrative Notice"].

2. Main Business

Main business activities defined by Article 10(1) are deposit taking, lending, and exchange activities.[213] Deposit taking operation means accepting deposits and installment savings.[214] Lending activities include making loans and discounting bills of exchange or promissory notes. As for domestic exchange transactions, banks act as intermediaries for payment or collection of funds from various parts of the country.

3. Ancillary Business

As articulated in Article 10(2),[215] ancillary business activities are: (i) guarantee of liability and acceptance of notes;[216] (ii) lending securities;[217] and (iii) agency services for banks and financial institutions for money transactions.[218] Article 10(2) also covers limited business activities in

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[213] Banking Law, Art. 10(1).

[214] Also, Suzuki, *supra* note 41 at 174 -48.

[215] Banking Law, Art. 10(2). It lists all ancillary activities as follows:

1) the guaranteeing of debts or the acceptance notes,
2) the buying and selling of securities...,
3) the lending of securities...,
4) The underwriting of national government bonds, local government bonds or government guaranteed bonds or the handling of flotation in relation to the said national bonds...,
5) the acquisition or negotiation of monetary claims,
6) handling of private placement of securities,
7) trust service related to the flotation of local government bonds, corporate bonds or other bonds,
8) representation of banks and other parties conducting financial business,
9) the handling of the receipt of money or other matters related to money of the national government, local bodies, or corporations, etc...,
10) safekeeping of securities, precious metals or other articles,
11) money exchange,
12) financial futures transactions, etc, and
13) trust of financial futures transactions, etc.

Roderick H. Seeman (1999) "1981 Banking Law" online: Japanese Law Cite <http://www. japanlaw.com/banking /article.htm> (last modified: September, 1999).

[216] *Ibid.*, Art. 10(2)(i).

[217] *Ibid.*, Art. 10(2)(iii). Securities lending operation is: when banks lend securities to a customer who holds the securities and uses them as collateral for borrowing from a third party. In return for this lending, banks are paid a fixed lending fee by the customers. Suzuki, *supra* note 41 at 180.

[218] Banking Law, Art. 10(2)(viii).

securities dealing[219] and trust operations.[220] Banks are permitted to engage in certain types of securities business operations, such as underwriting, distributing, and dealing in securities in the same manner as investment bankers do. These types of securities are: (a) government bonds, regional bonds, and governmental guaranteed bonds, as stipulated in Article 10(2)(iv) of the Banking Law; and (b) foreign certificates of deposit, commercial paper, and certain kinds of trust beneficial certificates backed by residential mortgages or other loans.[221] However, as for equity securities, bank involvement is limited under certain conditions: banks may purchase and sell equity securities of corporations only for investment purposes and at the written request from customers.[222] In addition to purchasing and selling corporate securities, banks are also permitted to deal in major index securities futures, securities options, and foreign securities futures; and the legal condition is the same as those for dealing with government securities.[223] As for the trust business, Article 10(2) states that banks are allowed to engage in certain trusteeship operations for bonds issued by governments and corporations: to be specific, within a permissible trusteeship capacity, banks are permitted to implement the issue, to pay interest, and to redeem bonds. In addition, in relation to bond subscription, banks are also allowed to engage in certain clerical works, such as preparation of the certificate of application and receipt of funds.[224] All banks are permitted to conduct these types of trust activities concerning the subscription of securities on their own, as ancillary business.[225] On the other hand, Article 12 of the Banking Law gives specific provisions about what types of trustee operation banks are prohibited from engaging in; a trusteeship in relation to valuation, management, and liquidation of collateral for

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[219] *Ibid.*, Art. 10(2)(ii), (iv), (v), and (vi), and (3)-(7), and Art. 11.
[220] *Ibid.*, Art. 10(2)(vii) and Art. 12.
[221] Banking Law, Art. 10(2)(v); *Ginko Ho Shiko Kisoku* [Banking Law Administrative Ordinance], *Okura Shorei* [Ordinance of MOF], Art. 12, No. 10, Mar. 3, 1982, as amended [hereinafter "BL Administrative Ordinance"].
[222] Banking Law, Art. 10(2)(ii).
[223] *Ibid.*, Art. 10(2)(xii).
[224] Suzuki, *supra* note 41 at 180.
[225] Banking Law, Art. 10(2)(vii).

issued bonds,[226] which is a so-called Mortgage Debentures in Trust.[227] In Japan, all banks, except trust banks and a few city and regional banks, are prohibited from engaging in these trust activities with the purpose of protecting investors;[228] since a mortgage debenture trust needs specialised knowledge to conduct its operations, banks are also required to obtain permission from the Ministry of Finance. Thus, banks otherwise would not be permitted to deal in mortgage debentures in trust unless through affiliated companies.

4. Other Ancillary Business and Fringe Business [229]

As noted, there are other ancillary and fringe businesses which Japanese banks are allowed to conduct, but only through bank affiliates.[230] Other ancillary business, also called "non-listed incidental business services," is stipulated in the Administrative Guidance issued in 1979, as

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[226] Suzuki, *supra* note 41 at 206.

[227] *Ibid.* at 206 and 210. Mortgage debenture trust is a business: when a corporation issues the bonds, it becomes the trust owner, entrusting to the trust banks either corporate collateral rights or physical collateral rights. Collateral will be land, ship, railroad, factories, or mine. Trusteeship of trust banks will include management of the collateral rights on behalf of the creditors of issued bonds.

[228] *Ibid.* at 207 and 210. There are seven trust banks, which are the Mitsubishi, Sumitomo, Mitsui, Yasuda, Toyo, Chuo, and Nippon banks, nine foreign banks, Daiwa Bank, the Bank of Ryuku, and the Bank of Okinawa.

[229] Other ancillary business is also called "non-listed incidental banking business," and fringe business is also called "proximate non-banking business." See, M. Yagyu, *supra* note 108 at 367.

[230] "MOF Domestic Administrative Notice," *supra* note 212. Besides those other ancillary and fringe businesses, there are two more categories of business activities conducted by bank affiliates: agency business, and administration services in relation to banking business. Agency business is defined as that which will be provided by banks incidental to their "banking business." However, this is only limited to deposit taking, consumer credits, and domestic exchange transactions. Administration services for a bank's business include:

a) cash or other calculation services;
b) collateral appraisal and inspection services;
c) bank premise maintenance services;
d) fringe-benefit-related services for bank employees;
e) operation and maintenance services of automatic teller machines;
f) services of cash collection or other routines;
g) consulting and brokerage services of consumer credit;
h) advertisement services;
i) brokerage services of part-time workers; and
j) Computer-related services, such as developing computer systems, selling computer software and hardware as necessary to use such software, safekeeping back-up data and data processing.

noted.[231] These are (a) credit card financing, (b) guaranteeing residential or other consumer financing, (c) factoring, (d) selling asset-banked certificates, and (e) selling commodity-fund certificates.[232] Furthermore, fringe business is (a) property leasing, (b) venture capital, (c) management consulting, (d) investment advisory activities, and (e) electronic communication services.[233] The electronic communication services include information network services for banking, business or trade account settlements and data processing services in relation to accounting, tax, and fund management.[234]

5. Relationship with Affiliates:

The definition of an "affiliated company" in the context of Japanese law is somewhat different from its western counterparts. Japanese administrative rules define "affiliated company" as "a company to which a bank has made and or has maintained capital contributions and which has close relationships to such bank, by virtues of circumstances of its establishment, financial and personal relationships, etc."[235] However, given the fact that banks, like other financial institutions, are subject to a 5% ceiling on acquiring outstanding stocks of other corporations,[236] bank relationships with their affiliates in Japan are based on personal exchange and management control, not on capital contribution.[237] This aspect of bank relations with affiliates contrasts with U.S. and Canadian law: under U.S. laws, unless a bank has more than 25% voting shares in a corporation, it will not be considered a "bank affiliate;"[238] and likewise, Canadian laws permit banks to have substantial investments in other financial institutions in order to engage in other

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[231] *Ibid.*
[232] *Ibid.*
[233] *Ibid.*
[234] *Ibid.*
[235] Yagyu, *supra* note 108 at 365-66.
[236] Anti-Monopoly Law, Art. 11.
[237] Yagyu, *supra* note 108 at 366.
[238] 12 U.S.C.A. s. 1841.

business. Substantial investment is defined as a bank acquisition of more than 10% voting shares or beneficial ownership in more than 25% of shareholder's equity.[239] Thus, it can be assumed that capital contribution or acquisition of voting shares is a more important element for U.S. and Canadian banks, to engage in non-core banking business.

C. Canada

1. Main business

There are more differences and fewer similarities between the two countries regarding the legal definition of main business, additional business, and prohibited business activities. First, under the Canadian *Bank Act*, there is no statutory definition of "what is the business of banking,"[240] which would constitute "main business" activities, as defined under the Japanese Banking Law. In other words, the definition of banking business in the Canadian *Bank Act* only serves to differentiate permitted and prohibited business activities, because of the wide range of business lines offered by Canadian banks nowadays. In addition, normal business operations of banks are easily acknowledged to be part of traditional and customary practices.[241] Nevertheless, in the absence of a statutory definition of the "business of banking" in Canada, courts have had to interpret it as follows: "the business of banking" is "the conduct of current accounts, the payment and collecting of cheques,[242] dealing in credit,[243] dealing in money, precious metals, discounting, lending and issuing letter of credit."[244] Notably, these court definitions are almost identical to the Japanese law's categorisation of "main business activities."

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[239] *Bank Act*, s. 10.
[240] Ogilvie (1991), *supra* note 98 at 294-95.
[241] *Ibid.*
[242] *United Dom. Trust Ltd.* v. *Kirkwood*, [1966] 2 Q.B. 431 (C.A.)
[243] *Ref. re. Alta. Legislation*, [1938] S.C.R.100; affd (*sub nom. A.G. Alta.* v. *A.G. Canada*), [1939] A.C. 117 (P.C.).
[244] *Re Bergethaler Waisenamt*, [1949] 1 D.L.R. 769 (Man. C.A.).

Moreover, "main activities" are defined by Section 409 of the current *Bank Act* as:

> (i) providing any financial service;
> (ii) acting as a financial agent;
> (iii) providing investment counselling services and portfolio management services; and
> (iv) Issuing payment, credit or charge cards and, in cooperation with others including other financial institutions, operating a payment, credit or charge card plan.

The wording of "any financial service" seems too vague to define what a "financial service" is, in the absence of statutory definition. However, in the previous *Bank Act*, each business activity was listed in detail in Section 173(i)(a)-(p): *i.e.*, opening branches; borrowing money; dealing with securities, bills of exchange, promissory notes and other negotiable instruments, precious metals; lending with and without security; guaranteeing payment and repayment; acting as a financial agent; acting as a factor; engaging in financial leasing business; selling tickets; selling tax deferral plans; and engaging in certain trust activities.[245] In contrast to this previous provision, some business activities, which used to be listed in Section 173, are now implicitly incorporated into the broad category of "financial services" in Section 409(1) and (2) under the current *Act*.[246] For example, such businesses as factoring,[247] guaranteeing,[248] and selling tax

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[245] *Bank Act*, R.S.C 1985, c. B-1, s. 173.
[246] Ogilvie (1998), *supra* note 192 at 302.
[247] *Ibid.* at 327-8. The business of factoring is recognised as: collecting and administering accounts receivable on behalf of a business; granting credit on the security of an assignment of account receivable; and raising and lending money while acting as factors. The previous *Act* permitted banks to conduct factoring business only through a subsidiary: likewise, the current *Act* only allows banks to invest in a factoring corporation in order to act as its factor.
[248] *Bank Act*, S.C. 1980-81-82-83, c. 40, s. 173. The "guarantee business" under the Canadian *Bank Act* has different meanings from those under Japanese Banking Law. Under Japanese Banking Law, the guarantee business is: with the good name of a major city bank, a corporation can borrow from another lender. See, Suzuki, *supra* note 41 at 189. Thus, the actual function of guarantee services is similar to lending money. Instead of directly lending to corporations, banks guarantee the payment of client corporations to other financial institutions. These services were convenient in the time of tight monetary policy, where the Ministry of Finance restricted the lending volume. On the other hand, Canadian banks conduct a broader range of guarantee services for payment, such as;

> ...guarantees to cover irregularities in documents such as letters of credit, performance guarantees in relation to performance by a customer, guarantees to transportation companies to release goods to customers prior to the surrender of bills of lading, guarantees to cover tolls payable by customers on the St. Lawrence Seaway and guarantees to cover payments of transportation charges.

deferral plans are no longer mentioned as banking business in the current *Act*, but are assumed as a part of financial services under Section 409.

Interestingly, most of the main business activities of chartered banks, listed in section 409 of the current *Act*, would constitute the other ancillary business activities categorised by the Japanese Banking Law. For instance, the business operation such as investment counselling, portfolio management, and credit cards are all regarded as part of other ancillary business in Japan. However, in practice, banks' involvement in such quasi-securities business as investment counselling and portfolio management is subject to similar legal or administrative requirements. In short, in order to conduct these businesses, both the Canadian *Bank Act* implicitly[249] and Japanese Banking Law explicitly require banks to be affiliated with securities firms. The same requirement is also applied to the factoring business in both countries; banks in both countries are allowed to engage in factoring business as long as such business is conducted by their affiliates. In Canada, since the factoring business started to be recognised as a legitimate banking business by the revision to the *Bank Act* in 1980, banks were expressly required to be affiliated with a factoring company if they engage in factoring business.[250] This provision continues in the current *Bank Act* which implicitly requires banks, wishing to perform factoring operations, to have substantial investments in factoring corporations.[251] Likewise, under the Japanese banking law, factoring business is considered a non-listed incidental activity: in order for a bank to act as a factor, it is required to have relationships with other companies through capital contributions, as well as management and personal exchanges.

However, such business used to be beyond the power of banks until 1980. Also, Ogilvie (1991), *supra* note 98 at 315-6.

[249] Ogilvie (1998), *supra* note 192 at 327.

[250] *Ibid.* at 327- 28.

2. Additional Business

When it comes to examining additional business activities conducted by Canadian banks under Section 410, we see how extensively Canadian banks have come to be permitted to engage in such business directly, as well as indirectly. Additional business activities under Section 410 are real estate business, information services, and some trust activities. However, Canadian laws, unlike Japanese, do not distinguish between main activities and additional activities according to whether each must be conducted as a bank's own business or through subsidiaries. In other words, Canadian bank involvement in certain additional businesses is subject to the implicit or explicit requirement that they acquire a substantial amount of stock in other companies. On the other hand, there are other types of additional business which are not subject to such a requirement.

Furthermore, although not defined explicitly, one can assume from Section 412-422 that non-banking financial business, such as leasing, insurance, securities, and fiduciary business, is also permitted as additional banking business. These are permitted to a limited extent for the purpose of preventing banks from being excessively competitive with other financial institutions. The following is an overview of additional business activities by Canadian banks.

(a) Real Property:

Banks are now permitted to acquire, manage, and deal in real property, as well as to hold other interests in real property, including leasehold interests under Section 410(1)(a) of the *Bank Act*. As opposed to the previous *Bank Act*, the current *Bank Act* removes such constraints, that bank holdings of real property are only permissible for actual use and occupation.[252] Yet, the current *Act* still assumes that such real property of a bank will be acquired and managed by their

[251] *Bank Act*, s. 468. Also, see, Ogilvie(1998), *supra* note 192 at 328.

affiliates, but this is not an explicit requirement, as in the previous *Act.*[253] The only restriction placed on a bank's involvement in any real estate business are: (i) the aggregated value of real property held by a bank should not exceed 70% of its regulatory capital; and, (ii) the aggregated interests in real property should not exceed 100% of its regulatory capital.[254]

(b) Information Services:

Communications technology and electronic commerce has rapidly advanced, and it is inevitable that financial intermediaries have extended the scope of their information services in order to cater to various demands from customers. This broadening of scope has also been encouraged by the more permissive attitude of government. Now information service is a core part of incidental business activities, whether exclusively used for bank business or for providing services to bank customers. This holds true for both countries. Yet, certain differences between the two countries can be found in the definition of information services or the electronic communications business. Under the current Canadian *Bank Act*, information services which banks are allowed to engage in consist of:

> (a) providing information processing services;
> (b) providing advisory or other services in the design, development or implementation of information management system; or,
> (c) designing, developing or marketing computer software, and the activities of which may include, as an ancillary activity, the design, development, manufacture or sale of special purpose computer hardware.[255]

Unlike Japanese banks, Canadian banks are allowed to engage in such services on their own, as long as their activities remain in Canada and banks obtain ministerial approval for it. On the

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[252] *Bank Act*, S.C. 1980-81-82-83, c. 40, s. 199.
[253] Ogilvie (1998), *supra* note 192 at 330-31.
[254] *Bank Act*, s. 476 and s. 479(d).
[255] *Bank Act*, s. 464 (1), "information service corporation."

other hand, banks which wish to operate information services outside Canada are required to be affiliated with and work through their subsidiaries.[256]

(c)Trust Business Activities:

Canadian banks are also permitted to engage in certain trust business activities, while "core" fiduciary business is strictly banned by Section 412. In other words, Section 410 permits a bank to act as a custodian of property, or receiver, liquidator, and sequestrator to the extent that these activities are incidental to the business of banking; Section 412 prohibits banks from engaging in certain fiduciary services, such as acting as:

> (a) an executor, administrator, official guardian, or a guardian, tutor, curator, judicial adviser, or committee of a mentally incompetent person; or
> (b) a trustee for a trust.

However, in the absence of any explicit prohibition, banks, in practice, provide certain trust services in their fiduciary capacity, *i.e.*, offering registered retirement savings plans and registered education plans.[257]

(d)Insurance, Lease Business:

As noted, banks are prohibited in principle from engaging in insurance and lease operations. As for the insurance business, their limited involvement is even "framed as an absolute prohibition."[258] In fact, banks are not allowed to act as an agent for any person in the placing of insurance and to lease or provide space in any branch in Canada to any person engaged in the placing of insurance.[259] However, Section 416(3) of the *Bank Act* and the *Insurance Business Regulations*[260] make exceptions to these prohibitions, stipulating the extent to which banks are allowed to be involved in any insurance business. First, Section 416(3)(a) and (b) articulate that

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[256] *Bank Act*, s. 410 (1)(c).
[257] Ogilvie (1998), *supra* note 192 at 343.
[258] *Ibid.* at 345.
[259] *Bank Act*, s. 416 (1)(2).

such insurance activities are permissible only with insurance companies, insurance agents, and brokers. In addition, the *Insurance Business Regulations* provide that administration and counselling on insurance products are also permissible activities, but limited only to the authorised types of insurance as follows:

(a) credit or charge card-related insurance,
(b) creditors' disability insurance,
(c) creditor's life insurance,
(d) creditors' loss of employment insurance,
(e) export credit insurance,
(f) mortgage insurance, and
(g) travel insurance.[261]

As for leasing activities, banks are allowed to offer leasing services only to the extent that financial leasing corporations are. Thus, needless to say, personal property leasing activities, in which financial leasing corporations are prohibited from engaging, are also prohibited to banks.

3. Ownership Control:

The extensive scope of the additional business activities by Canadian banks defines the law's role in the close relationship between banks and other financial corporations: most additional business activities conducted by banks are only permitted through subsidiaries, in which banks have substantial investments. In Japan, as noted already, corporate relationships between banks and their affiliates are framed by personal and management involvement in their affiliates, not by capital involvement and contributions. As opposed to this, under the current Canadian *Bank Act*, a bank affiliate is defined as "a corporation to which banks make substantial amount of capital contribution."[262] This is partly because Japanese banks are still subject to explicit legal restrictions under the Anti-Monopoly Law.

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[260] *Insurance Business (Banks) Regulations*, SOR/ 92-330(1995).
[261] *Ibid.*, s. 2.
[262] *Bank Act*, s. 10.

However, there was a time when Canadian banks were subject to the same type of ownership restriction as the Japanese counterparts. In other words, it had been a long-standing policy in the Canadian *Bank Act* that banks should be prohibited from holding more than 10% voting shares of another Canadian corporation:[263] in Canada, not only has such statutory provision set a ceiling on stock holdings by banks, but also case law has stated that banks cannot actively manage other corporations, for this would enable banks in other business operations directly or indirectly.[264] The same type of preventive measures for statutory loopholes is not seen in Japan.

Nevertheless, the current *Bank Act* allows bank ownership in other corporations to be more liberally constructed; since the 1992 revision to the *Bank Act*, banks are permitted to have substantial investments in authorised types of corporations. In fact, Section 468 of the current *Act* stipulates that banks may make "substantial investment" in other firms by acquiring more than 10% of the voting rights or beneficial ownership of more than 25% of shareholder's equity.[265] Authorised types of corporations are: financial institutions, factoring corporations, financial leasing corporations, information services corporations, investment counselling and portfolio management corporations, mutual fund corporations, mutual distribution corporations, real property brokerage corporations, real property corporations, service corporations, specialised financing corporations, and financial holding corporations.

Furthermore, among the aforementioned corporations, banks are also required to obtain "control" in order to make substantial investments to factoring corporations, financial leasing corporations, specialised financing corporations and financial holding corporations. Such controlling powers

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[263] *Bank Act*, S.C. 1980-81-82-83, c. 40, s. 193.
[264] *Nor. Crown Bank* v. *Great West Lumber Co.* (1914), 17 D.L.R. 593 (Alta. C.A.); *While* v. *Bank of Toronto*, [1953] O.R. 479 (C.A.).

can be obtained through a bank's acquisition of 50% of corporate equity attached with voting rights to elect the majority of directors.[266] It should also be noted that directors have a duty to establish investment and lending policies, standards, and procedures. Banks adhere to these policies and procedures in order to "avoid undue risk of loss and obtain a reasonable return."[267]

D. Limitations on Securities Activities

1. Introduction:

Securities activities conducted by banks in Japan have been less extensive than in Canada because the current provisions ostensibly look a little more restrictive and stringent under the Japanese version of a U.S. model "Glass-Steagall Act."[268] However, careful observation of the gap between the laws and the real practices of Japanese banks reveals significant loopholes. Therefore, in this section, a focus will be placed on the extent to which governing rules permits banks to be involved in the securities business, from the comparative perspectives of the two countries. In order to explain the complicated process of securities operations, the first part of this section will overview basic securities operations. The second part will investigate the securities activities conducted by Japanese and Canadian banks respectively.

2. Basic Securities Operations

Generally speaking, financial securities are defined as public bonds, company stocks and debt obligations, commercial papers, and monetary claims such as loans and other securities backed by various kinds of property. A securities business operation is basically an intermediation of

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[265] *Banking Act*, s. 3.
[266] *Ibid.* Also, Ogilvie (1998), *supra* note 192 at 399.
[267] *Ibid.* at 396. Also, *Banking Act*, s. 157(2)(g).
[268] 12 U.S.C. A., s. 16, 20, 21, and 32. In addition, they are scattered over sections in 12 U.S.C.A. and collectively referred to as the Glass-Steagall Act. Cargill & Todd, *supra* note 123 at 62. This prohibits banks from; (i) investing in securities firms or from underwriting corporate securities; (ii) affiliating with

fund transfers between a borrower, who needs to raise funds from the general public, and a lender, who seeks a profit from interest and dividends in investments. Securities business activities consist mainly of underwriting, distribution, and brokerage operations.[269] In underwriting the issued securities, investment banks will assume a risk in buying the securities and selling them to the public, which includes sophisticated investors such as financial institutions and the usually less sophisticated general public.[270] The margin between a price the investment bankers pay to the issuing company and a price underwriters re-sell to the general public by public offering is called the "underwriting spread."[271] This is the major source of profit for investment bankers participating in stock issues.[272] Usually, underwriting operations involve many investment bankers in a group, in order to pool the risk and achieve successful distribution.[273]

The group chooses a managing underwriter who is usually an originating investment banker who organises the purchase and distribution of a new issue of securities.[274] The contents of a purchase contract, which is signed by the issuer and the managing underwriter on behalf of the underwriter group, include an agreement on the offering price, the underwriting spread, and the settlement dates.[275] During the offering, the managing underwriter is responsible for stabilisation of the market price and for the appointment of a selling group, which is comprised of the dealers and underwriters themselves for the purpose of distributing the issue.[276] A selling group will market both new issues and secondary issues to the public. Under the selected dealer agreement

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securities firms; and, (iii) having bank directors, officers, and employees to serve as directors, officers or employees of securities firms.

[269] Yagyu, *supra* note 108 at 313.

[270] "Finance and Investment Terms," *supra* note 38, *s.v.* "underwrite."

[271] *Ibid.*

[272] Suzuki, *supra* note 41 at 266.

[273] "Finance and Investment Terms," *supra* note 38, *s.v.* "underwrite."

[274] *Ibid. s.v.* "managing underwriter."

[275] *Ibid. s.v.* "underwriting agreement."

[276] *Ibid. s.v.* "underwrite."

between selling groups and the lead manager, the commission, which is the so-called selling concession, will be determined. This will not be higher than the public offering price.[277] In addition, termination of the selling group will be decided.[278]

The investment bankers will provide services for the newly issued securities, either through public offering or private placement. Public offerings and private placements are two different types of distribution. Through private placement, new securities will be sold to specific investors by direct negotiation,[279] usually with a small group of sophisticated investors, *i.e.*, insurance companies, securities firms, banks, trust companies, pension funds, and venture capital companies.[280] As for a public offering, there are two types of offers, firm commitment underwriting and best effort offering.[281] Under the contract of firm commitment underwriting, the investment banker will purchase outright all available securities from the issuers.[282] As opposed to this, the contract of best efforts offering enables banks to agree to buy only a part of the issues, in case they are not completely subscribed.[283] The above process for primary distribution is different from secondary distribution. In the secondary distribution of issued securities, usually held by corporations or affiliates of issuers, an investment banker will act alone or as a syndicate to purchase the shares from primary holders and sell them to the public at a higher price than the public offering.[284] In the secondary markets, the issued securities will be sold, purchased and exchanged in a stock exchange or an over-the-counter markets. Securities dealers or brokers will conduct this operation and will act as a principal for trading them for their own account and at their own risk.

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[277] *Ibid. s.v.* "selling concession."
[278] *Ibid. s.v.* "selling group."
[279] Suzuki, *supra* note 41 at 135.
[280] "Finance and Investment Terms," *supra* note 38, *s.v.* "private placement."
[281] *Ibid. s.v.* "underwrite." Also, Yagyu, *supra* note 108 at 324.
[282] *Ibid. s.v.* "firm commitment."
[283] *Ibid. s.v.* "bought deal."

3. Japan

(a)Underwriting, Distribution, and Brokerage

As mentioned already, permissible securities activities in Japanese banks are mainly underwriting, distributing, and dealing in certain securities, provided by Article 10(2) of the Banking Law and Article 12 of the Banking Law Administrative Ordinance. These are: (a) government bonds, government-guaranteed bonds, regional government bonds,[285] and (b) certain monetary claims,[286] which include: (i) domestic certificates of deposit, (ii) certain kinds of trust beneficial certificates backed by residential mortgages or other loans, and (iii) other residential mortgage-backed certificates.[287] As far as the aforementioned securities are concerned, banks are allowed to offer full securities services in the same manner as investment bankers do.

(b) Private Placement

In principle, Japanese banks are prohibited from participating in any primary distribution by acting as an underwriter or acting as a distributor for any types of securities except the above listed ones. In other words, banks are strictly prohibited from underwriting and distributing new issues and dealing in corporate equities and bonds in secondary markets. To be more specific, the types of securities prohibited to banks also include debentures, debentures with rights of conversion into stock or with warrants, and beneficial interests in securities investment trusts and loan trusts; in western countries, the latter will be categorised as mutual funds. However, since the 1993 revision to the Banking Law, for the first time, banks are allowed to engage in private placement for almost all kinds of securities. Now banks are allowed to participate in primary distribution of securities as a placement agent. However, this permissive provision comes with

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[284] *Ibid. s.v.* "secondary distribution."
[285] Banking Law, Art. 10(2)(ii).
[286] *Ibid.*, 10(2)(v); and BL Administrative Ordinance, *supra* note 221, Art. 12(1).
[287] BL Administrative Ordinance, *ibid.*, Art. 12(1).

notable restrictions.[288] In order to act as a placement agent for new securities, banks have to comply with the rules under the Security Exchange Law[289] and Securities Exchange Law Administrative Ordinance.[290] Both clarify the condition for private placement, *i.e.*, what types of activities will be considered the permissible "private placement." Thus, a bank's failure to meet any of these requirements will be considered against the rules. First, there are two categories of private placement: professional private placement[291] and small number private placement.[292] For each type of private placement, three conditions are established by administrative ordinance. Professional private placement should be: (i) all offerees are qualifying institutional investors, which include banks, securities firms, and insurance companies; (ii) such securities to be offered are not equity securities, which are stocks, warrants, and debentures with rights of conversion into stocks or with warrants; and (iii) any transfer of such securities to non-qualifying institutional investors is restricted in certain ways.[293] The conditions for small number private placement are: (i) the total number of offerees (qualifying and non-qualifying institutional investors) is less than fifty;[294] (ii) when such offered securities are equity securities, they should be unmarketable stocks or other equity securities; and (iii) any transfer of non-stock securities and debt securities to fifty or more people is restricted in a certain way.[295] Thus, while in principle the private placement is a permissible securities activity for banks, equity securities are excluded from permissible categories.

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[288] Note that securities operations in primary issues is conducted in the form of public offerings and private placement: both are different ways of distribution. Under Japanese law, banks are prohibited from engaging in public offerings, either through a firm commitment agreement or a best efforts offering, because both activities construct "underwriting," which Securities and Exchange Law prohibits banks from participating in.

[289] Securities Exchange Law, Art. 2(3), (8).

[290] *Shoken Torihiki Ho Shikorei* [Securities Exchange Law Administrative Ordinance] *Seirei* [Cabinet Order] as amended, Art. 1-5, No. 321 (Sept. 30, 1965)[hereinafter "SEL Administrative Ordinance].

[291] Securities Exchange Law, Art. 2(3)(ii)(a), 8(vi).

[292] *Ibid.*, Art. 2(3)(i), (ii)(b), (8)(vi).

[293] SEL Administrative Ordinance, Art.1-5.

[294] *Ibid.*, Art. 1-4, 1-6.

(c) Secondary Markets

Securities brokerage takes place when investment bankers purchase from and sell to general public issued securities in their own account. Under Japanese law, banks are not permitted to engage in such brokerage activities with any type of securities, except those allowed by the Banking Law and the Banking Law Administrative Ordinance, as noted already. Exceptional cases are : (a) a purchase is based on a written request from a customer; or (b) the purchases are only for the bank's investment purpose. Under Japanese law, "trading" and "dealing" are separate concepts; the former is permissible for banks, and the latter is not. In other words, when banks sell and purchase securities frequently, it would constitute "dealing," which is prohibited to banks. On the other hand, if the securities purchased for their trading accounts are held for a longer period, it would be considered "trading," which is permissible.[296] Thus, besides the 5% ceiling of bank holdings of stocks in other corporations, there has been no other statutory limitations on banks trading in their own account until 1988. This permissive provision regarding bank involvement in securities trading under the Japanese laws is in a stark contrast with the Glass-Steagall Act of the U.S., which prohibits banks from engaging in the same type of trading, with limited exceptions.[297]

(d) Issues behind Japanese Bank Securities Operations:

The provisions prohibiting banks from dealing in securities business activities did not originate in Japan. It was an imposed provision due to the strong U.S. influence in post-war legislative reform in the later 1940s. Prior to this, there was no such restriction prohibiting banks from engaging in securities business throughout wartime. The underlying "commercial bank philosophy" led banks to be cautious about excessive exposure to securities business risks.

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[295] *Ibid.*, Art.1-7.
[296] Yagyu, *supra* note 108 at 319.

However, banks used to monopolise the underwriting business for government securities and corporate bonds in the pre-war period.[298] To circumvent risks involving securities transactions, such as dealing in equity securities, banks left that type of business to their securities subsidiaries.[299] Even at the time of the financial panic of 1927, the creation of laws similar to the Glass-Steagall Act was not urged because bank involvement in some securities activities was not seen as a contributory factor to that panic in 1927. Rather, the major cause was seen to be in the fact that banks concentrated and engaged in risky lending to one company.[300] Therefore, neither policy base nor historical background necessitated a Glass-Steagall Act in Japan.[301] Furthermore, the Glass-Steagall Act was primarily designed to promote prudent management and defend depositors' funds. However, there was no potential risk that bank solvency would be threatened by a bank's active participation in the securities markets, because these securities markets were not significantly developed in Japan. In this sense, the U.S. imposed provision did not fulfill its originally intended purpose.[302] Rather, it served another purpose well: by separating commercial banking and investment banking, it greatly prevented banks from gaining control over other financial sectors, notably securities firms. Consequently, although the Japanese securities markets were underdeveloped, securities firms were completely protected from intense competition with banks. Under this secured environment, the securities firms

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[297] 12 U.S.C.A. s. 24. This provision permits banks to purchase their own account investment securities under such limitations and restrictions as the Comptroller of Currency may by regulation prescribe.
[298] Suzuki, *supra* note 41 at 39.
[299] *Ibid.*
[300] Brown, *supra* note 107 at 365-67. In 1927 the large number of bank runs was accelerated by the collapse of an industrial company, Suzuki & Co. The situation was made worse because public confidence in the financial system was already eroded after the government's blunder in delaying payment of "earthquake bills" in the 1920s. A number of Japanese banks having lent to Suzuki. & Co. were fatally damaged. They called in short term loans to the central bank. When such liquidity support was unavailable, the banks failed.
[301] Cargill & Todd, *supra* note 123 at 59.
[302] *Ibid.*

continued to impose high commission fees on issuing companies and preserve their competitive position against banks.[303]

However, negative aspects cannot be ignored as a result of Japan' failure to achieve the primary purpose of a Japanese version of a Glass-Steagall Act; despite the existence of such provisions in Japanese laws, Japanese banks gave priority to their own stable profit earnings, instead of protecting depositor funds. The lack of any policy basis of prudent management for protecting depositor rights in the Japanese banking system made an infamous exception which gave a way for banks to reap their majority profits from selling and purchasing equity ownerships.[304] Ostensibly, Japanese banks have been restrained from underwriting, distributing and brokerage activities in equity securities. However, as noted, since Japanese banks were permitted to "hold" their same group companies' stocks, partly for stabilising the market price, they have consequently monopolised securities markets within certain group firms.[305] Furthermore, in practice Japanese banks usually affiliate with one securities firm, contrary to the purpose of the Anti-Monopoly Law.[306] As noted, under the *Keiretsu*, the cross-shareholding maximum of 5% equity shares by financial firms in the same group makes it possible for one dominant entity, which is usually a bank, to control the management of the companies. Furthermore, there have not been any restrictions on the amount of securities that banks could hold on their investment portfolios, until the issue for an administrative guidance in May 1988.[307] With all these factors together, the provisions for prohibiting banks from securities transactions has been meaningless

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[303] *Ibid.*
[304] For example, in 1989, city banks reported that 42% of their profits came from securities trading, and in the case of the largest banks, it accounted for 60%. Nakao, *supra* note 102 at 101.
[305] *Ibid.* at 104-05.
[306] Cargill & Todd, *supra* note 123 at 63. The authors point out that main banks have been seriously involved in the management of securities firm: *i.e.*, banks officers are appointed as top officers of securities firms; bank employees are transferred to securities firms for training; and banks direct their brokerage orders through such securities firms, or solicit securities services to banks clients.
[307] Dale, *supra* note 66 at 38.

in Japan, while the originally intended purpose of such provisions has not been achieved. Suffice it to say that the most recent crisis of Japanese banks has been greatly affected by their large holdings of corporate securities, accumulated for a long time under the main bank system. Eventually this threatened the solvency of banks on the balance sheet, because of their increasingly declining prices after the burst of the bubble economy.[308]

4. Canada

a. Introduction

In the modern history of Canadian chartered banks, participation in securities markets was active until the 1970s.[309] However, because of the sudden expansion of the securities industry in the 1970s, legislative reform began to restrict bank involvement. Despite those restrictions, the current Canadian banking law regime has become even more permissive for chartered banks engaging in securities business activities; and this is another aspect of the erosion of the separated banking system in Canada. Although numerous provisions restricting securities business activities by banks are still observed, the purpose is no longer considered prudential or functional. Rather, it is a jurisdictional reason which mitigates the long-outstanding issue of jurisdictional conflict between federal and provincial governments, notably Ontario.[310] The current provisions governing the securities business activities of chartered banks are based on an agreement between the federal and Ontario governments in April 1987. This is known as the "Hockin-Kwinter Accord."[311] The principles of this accord are now incorporated in the *Securities Dealing Regulation*. The following is a summary of the banks' securities activities which are currently permitted by these Regulations.

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[308] When the Tokyo Stock Price Index hit bottom at 1,523 in October 1990, Japanese city banks and long-term credit banks lost about half of their unrealised profits in securities. Nakao, *supra* note 102 at 100.
[309] Ogilvie (1991) *supra* note 98 at 381.
[310] Ogilvie (1998) *supra* note 164 at 345.

b. Underwriting and Distribution:

First, similar to the Japanese laws, the *Regulations* expressly permit banks to participate in the primary distribution of public bonds. To be specific, the public bonds are federal, municipal, and provincial bonds, as well as public utility bonds, sovereign bonds, and debt obligations of international agency.[312] Second, banks in the two countries deal with public bonds differently. Japanese laws permit banks to engage not only in underwriting and distribution operations, but also brokerage activities; on the other hand, under the Canadian *Regulations*, banks securities operation for the above-listed public bonds are restricted only to primary distribution, which consists of underwriting activities and acting as a selling group. In addition, in terms of primary distribution, the *Regulations* allow banks to participate in primary distribution for (i) their own equity securities,[313] (ii) their own debt obligations,[314] and (iii) debt obligations of their affiliates.[315] Similar provisions regarding bank dealings in their own equity securities, or debt obligations are not found in Japanese laws. Above-mentioned provisions in Canadian laws, which permissibly allow banks to engage in the primary distribution of public bonds, their own equity securities and debt obligations, and debt obligations of their affiliates, are continued from the previous *Act*.[316] Thirdly, the similarity in terms of permissible activities in primary markets between both countries' laws can be found in their dealings with short-term debt obligations, such as "money market securities." In the absence of a statutory definition of "money market securities" in the *Regulations*, it can be assumed that such money market instruments include certificates of deposit, Eurodollar certificates of deposit, commercial paper, banker's

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[311] For detail see, *Consolidated Bank Act and Regulations 1998*, 10th ed. (Scarbough, Ontario: Carswell, 1998) at 759-66.
[312] These are the World Bank Group, the Inter-American Development Bank, the Asian Development Bank, the Caribbean Development Bank, the European Bank for Reconstruction and Development and any other international regional banks. See, *Securities Dealing Restrictions Regulations*, s. 3 (2)(a).
[313] *Ibid.*, s. 3(2)(d).
[314] *Ibid.*, s. 3(2)(c).
[315] *Ibid.*
[316] *Bank Act*, S.C. 1980-81-82-83, c. 40, s. 190(4).

acceptances, and Treasury bills.[317] In Japanese law and administrative rules, these same types of instruments are also considered as eligible securities, which banks can underwrite, distribute, and deal in.

(c) Brokerage Activities

The legal framework of both countries for bank dealings in issued securities, such as purchasing and selling issued securities on the Stock Exchange, or over-the-counter markets, is similarly constructed. For example, Japanese laws permit banks to purchase and sell equity securities in a secondary market, as long as it is based on a written request from a customer or it is for their investment purpose. Similar to this, the Canadian *Regulations* permit banks to purchase and sell equity securities only if (i) such transactions are not solicited by banks to their customers and it is done through authorised brokers, (ii) such a transaction is for its own account administered and managed by the bank. These two provisions have existed for a long time, while trading in equity securities in general has been prohibited for banks only since the previous *Act*.

[317] "Finance and Investment Terms," *supra* note 38, *s.v.* "money market."

CHAPTER V. Bank Insolvency Legislation

A. Introduction

As seen in the previous chapters, numerous restrictions and requirements are imposed on banks to ensure their sound practices and prudent management. Many of them are only applicable to banks, not for ordinary corporations. Likewise, governmental approaches to bank insolvency have unique characteristics, *e.g.*, the vigorous intervention by regulators at an early time in an insolvency problem, exclusive regulator's control as a receiver, and their initiation for maximising asset realisation in an insolvent bank. Therefore, this chapter offers a comparative analysis of the legal, administrative framework for bank insolvency in each country: how will bank regulators intervene in the affairs of an insolvent bank and dispose of such a bank in order to minimise the exposure of depositor funds to loss? To answer this question, we must compare bankruptcy legislation and bank insolvency legislation in Canada to highlight the distinctive features of bank insolvency problems. As well, common and different aspects in bank insolvency rules in the two countries will be described. Finally, since numerous emulation from U.S. model can be found in the current regimes of bank insolvency laws in the two countries, comparison with U.S. laws will also be presented in the last section.

B. Comparative Views

1. Bankruptcy Proceeding and Dissolution

Bankruptcy legislation primarily serves to relieve debtors from their burden of excessive debts and to enable them to make a "fresh start" under court supervision.[318] It also provides protective jurisdiction for creditors to secure their interests or investments, which would otherwise be vulnerable to damages caused by conflicting claims among creditors. The *Bankruptcy and*

[318] E. Bruce Leonard, *Guide to Commercial Insolvency in Canada* (Toronto: Butterworths, 1988) at c. 1 at 3, and c. 11 at 3.

Insolvency Act[319] and *the Companies' Creditors Arrangement Act*[320] are structured to serve such purposes.

The *Bankruptcy and Insolvency Act* will become relevant in the following two situations: where debtors are not able to pay their obligation when it comes due because of his excessive debt obligations exceeding their assets; or where they can not do so because of their inability to liquidate their assets to discharge their obligation by a given due date. Generally, this financial condition is refereed to as "insolvency," which is different from "bankruptcy."[321] "Bankruptcy" is description of a legal status, for which the *Bankruptcy Act* must be invoked. Under the *Bankruptcy and Insolvency Act,* a bankruptcy proceeding may be commenced by either two parties: (a) creditor of an insolvent person (business) applying to the court for a bankruptcy order (receiving order) on the basis that the debtor is insolvent; (b) a voluntary assignment in bankruptcy by an insolvent debtor. In both case, a trustee in bankruptcy will be appointed to administer the affairs of the bankrupt. The purpose of the appointment of the trustee is to gather in all the assets of the bankrupt, liquidate them and distribute the net liquidated value amongst the creditors of the bankrupt in accordance with the priorities and rights set out in the *Bankruptcy and Insolvency Act.*

In addition, the *Bankruptcy and Insolvency Act* also allow insolvent person to continue their business by making a proposal to the creditors to restructure its affairs. The administration of the proposal will be subject to the court supervision until the corporation is once again solvent, while the management of business is normally left in the hands of the existing management.

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[319] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.
[320] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36.
[321] Leonard, *supra* note 318 at c. 1 at 4.

Besides above-mentioned bankruptcy procedures, there is another proceeding in which a secured creditor will privately appoint a receiver under the security agreement once the debtor default their debts. The receiver will be responsible for proceeding to liquidate the assets and to discharge the obligation under the secured debt and, if there is any excess, to pay it to the creditors who are next entitled. In addition, the section 243-252 of the *Bankruptcy and Insolvency Act* require that once a receiver is appointed, notice be given to the superintendent of bankruptcy and final report of the receivership be given to the superintendent as well. However, there is no direct supervision by the superintendent or any court regarding the administration of such a receivership.

2. Bank Insolvency Rules

Primarily, the legislative policy of bank insolvency laws is different from those of bankruptcy laws. Bank insolvency rules focus on guaranteeing depositors' entrusted funds, which would be in danger if their bank becomes insolvent. For this purpose, a government-run deposit insurance corporation plays a crucial role in preventing bank failures, so as to minimise costs to insured funds. In addition, bank insolvency legislation purpose is to maintain public confidence in the stability of the financial system by providing a governmental guarantee to insured funds. In this way, the risk of a "run" on a sound bank will be reduced. Otherwise, one case of bank failure may unnecessarily bring healthy institutions into insolvency.[322] Thus, when a bank is about to be insolvent or becomes insolvent, it comes under the "special regime"[323] of bank insolvency legislation; this is comprised of the *Bank Act,* the *Canada Deposit Insurance Corporation Act,*[324] and the *Winding Up and Restructuring Act.*[325] In other words, neither the *Bankruptcy and*

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[322] See, Chapter 1, above, for more on this topic.
[323] Swire, *supra* note 2 at 476.
[324] *Canada Deposit Insurance Corporation Act*, R.S.C. 1985, C-3 [hereinafter "*CDIC Act*"].
[325] *Winding-up and Restructuring Act*, R.S.C. 1985, c. W-11 [hereinafter "*WURA*"].

Insolvency Act nor the *Company's Creditors' Arrangement Act* are applicable to the financial institutions in Canada.[326]

This indicates several aspects of the unique characteristics of bank insolvency legislation in Canada. First, unlike bankruptcy legislation, bank insolvency legislation does not provide creditors and debtors with a right to commence a bankruptcy proceeding or to petition receivership control; it is only primary regulators who will decide to suspend the business operation of a troubled bank. Also, it is the Minister of Finance who will issue the vesting and receivership orders at the request of the regulators under the *CDIC Act*. Once orders are issued, the CDIC will exclusively undertake receivership over the bank, having all assets, properties, and ownerships vested in the CDIC.

Second, a legal definition of "insolvency," or such condition which warrants a receiver to control an institution, is different under normal insolvency laws and bank insolvency laws. As noted, there are two cases in which financial conditions construe "insolvency:" (i) a debtor's asset value becomes lower than the value of liabilities (absolute bankruptcy) or (ii) a debtor becomes unable to meet its liabilities because of insufficient liquidity (practical bankruptcy).[327] Thus, under bankruptcy legislation, "insolvency" is defined based on the "theoretical status of the balance sheet".[328] As an illustration, Section 2 of the *Bankruptcy and Insolvency Act* defines an insolvent person as "a person ...whose liabilities to creditors provable as claims under this *Act* amount of one thousand dollars" and

> (a) who is for any reason unable to meet his obligations as they generally fall due,
> (b) who has ceased paying his current obligations in the ordinary course of business as they generally become due, or

[326] Leonard, *supra* note 318 at c. 1 at 3, and c. 11 at 3.
[327] I.F. Fletcher, *Law of Bankruptcy* (Plymouth: Macdonald & Evans Ltd., 1978) at 2.
[328] *Smith* v. *Witherow*, C.A. Pa. 1939, 102 F.2d 638 [hereinafter "*Smith*"].

(c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient
to enable payment of all his obligations, due and accruing due.[329]

On the other hand, the *CDIC Act* does not provide a specific definition of "insolvency" for banks, and the legal grounds for CDIC's receivership to be effective is subject more to the regulators' discretion. Section 39.1 of the *CDIC Act* articulates the statutory grounds which warrant CDIC's receivership, as follows:

> Where the Superintendent is of the opinion that (a) a federal member institution has ceased to be viable, and (b) the viability of the federal member institution cannot be restored or preserved by the exercise of the Superintendent's powers....

Furthermore, the Superintendent will consider the following matter when making the above judgments:

(a) the federal member institution is dependent to an excessive extent on loans, advances, guarantees or other financial assistance to sustain its operations;
(b) the federal member institution has lost the confidence of depositors and the public;
(c) the federal member institution's regulatory capital...is about to become substantially deficient; or
(d) the federal member institution has failed to pay any liability that has become due and payable or will not be able to pay its liabilities as they become due and payable.[330]

This comparison illustrates a difference in the legislative definition of "insolvency" between the *Bankruptcy and Insolvency Act* and the *CDIC Act*. The difference is that any legal ground for CDIC receivership is not based on "theoretical status of its balance sheets."[331] Rather, it is based on a regulator's judgment of insolvency risks in a troubled bank, in consideration of significant elements: capital and liquidity adequacy, and public confidence. Consequently, commencement of receivership for an insolvent bank will tend to be earlier than for ordinary corporations.

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[329] *Bankruptcy and Insolvency Act*, s. 2.
[330] *CDIC Act*, s. 39. 1(2).

Thirdly, unlike normal bankruptcy cases, insolvent banks will not be allowed to restructure their financial affairs under court-supervised arrangements in order to continue the business as a going-concern. Such restructuring is not considered an appropriate solution for an insolvent bank; bank insolvency legislation is based on enhancing public interest, not corporate welfare.[332] This is another unique aspect of bank insolvency legislation which treats the public interest as the primary concern, while treating creditor and shareholder rights as secondary and tertiary, respectively.

Lastly, a most distinctive characteristic of bank insolvency legislation is CDIC receivership, which is made effective by vesting and receivership orders issued by the Ministry of Finance. The orders under the *CDIC Act* are only designed to arrange the merger of an insolvent bank in order to minimise the damage and loss to the general public; it is not so concerned with ensuring creditor's remedies, nor restructuring financial affairs by allowing the institution to continue its business as a going-concern. Furthermore, any merger arrangement will accompany CDIC expenditure, because the CDIC has to compensate an acquiring bank for any loss. Thus, the CDIC is granted more extensive authority for maximising cost recovery, which is not subject to the courts, but remains under the supervision of the Minister of Finance. However, when it comes to liquidation and dissolution, the process of liquidating insolvent banks will be subject to the *Winding Up and Restructuring Act*, as applicable to all financial institutions in Canada.

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[331] *Smith*, *supra* note 328 at 638. While this is a U.S. case, the same reasoning allowing regulator's discretion is applicable to any Canadian case.

C. Governmental Procedure: Common to Canada, Japan and the U.S.

Generally speaking, in Canada, Japan, and the U.S. governmental interventions for an insolvent bank take the forms of either administrative procedure or legal enforcement, or both. First, regulators will suspect some violation of laws and regulations, when an institution is found to be in financial trouble. This is based on an assumption that a bank in trouble, or in an unsafe and unsound condition, might not be strictly complying with legal requirements. If this is the case, regulators will immediately order the bank to remedy its undesirable affairs and behaviours. In other words, regulators will require the bank to comply with governing statutes and regulations, which include: capital adequacy, liquidity level in the asset portfolio, quantitative and qualitative limitations on lending and investments, and establishment of an internal policy for risk management.

However, despite such warnings and instructions by regulators, if the bank still fails to meet the requirement of remedying its affairs, the deposit insurance corporation will commence termination of deposit insurance. This is a common practice in the U.S. and Canada, but not in Japan. There is no provision under Japanese legislation that grants the Japan Deposit Insurance Corporation (hereafter, "the JDIC") to terminate an insurance policy in order to penalise an institution in breach of laws and regulations. In other words, a termination of deposit insurance is said to be the "death penalty of banks,"[333] this being synonymous with an insolvency declaration. In Japanese laws, where even new legislation still stands on a long-preserved "no-failure" policy, regulators are less willing to wind up troubled banks, even though they are technically insolvent.[334] Nevertheless, in the U.S. and Canada, the receiver will be immediately

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[332] Bradley Crawford, Q.C., "Restructuring Financial Institutions under the Winding-up Act" (1994-95) 10 *Banking and Finance Law Review* 87.
[333] Swire, *supra* note 2.
[334] Cargill, Hutchison & Ito, *supra* note 4 at 135-36. The Japanese deposit insurance system is not designed to wind up insolvent banks, as a primary purpose. The authors state:

appointed to take over the business affairs upon termination of the insurance policy of the bank.[335]

What if the viability of a bank is further decline despite its strict compliance with legal requirements. The statutory and regulatory requirements no longer impose detailed guidelines for safe and sound practices to eliminate the possibility of bank failure. To put it another way, since many restrictions on banks for solvency have recently been removed, the regulatory regime has become more permissive. This suggests that strict compliance with governing rules alone is not enough to prevent its insolvency. Thus, it might not be fair for regulators to penalize the bank by terminating the insurance policy when no breach of governing rules is identified in their practices. In such a case, more flexible approaches, such as remedial orders will be taken by regulators. This is a second stage of governmental intervention. Remedial orders vary widely, depending on the situation. Among such remedial orders, improving assets-weighed capital level is a most common type of affirmative action. This can normally be achieved either by company sales of its own stock, a restriction on asset growth, or a suspension of payments of dividends to shareholders. This illustrates the importance of capital adequacy, as a "guarantee fund," as well as a "safety cushion" for depositors and other creditors, which is emphasised in the banking law frameworks of all three countries.[336]

In addition, other types of affirmative action include liquidity level improvements, which is often accompanied with temporary support from the central banks. The bank may also be required to

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> ... Japanese financial regulation has historically been predicated on a "no-failure" policy and has not relied on a deposit-insurance system framework that explicitly recognizes the possibility of failure.

[335] 12 U.S.C.A. s. 1818; *CDIC Act*, s. 30 and s. 31.
[336] Boreham & Bodkin, *supra* note 30 at 98.

change securities and loan assets portfolios. Also, regulators can require the bank to draft, within a specific time period, an acceptable remedial plan.

Finally, despite remedial orders by regulators and recovery efforts of the corporation, the result is not always success; asset value might decreased to the point that it is insufficient to cover all deposit liability, or the corporation may still be in breach of contract with the regulators, regarding the remedial order. In such cases, continuation of business under the same management will result in increasing the cost of disposing the bank in the end. Consequently, the bank will be forced to have its operations suspended by regulators and be placed under receivership control. This will more likely happen, especially when the bank has insufficient assets remaining to cover all deposit liabilities, or when it breaches the contract with the regulators that it will follow remedial orders. While statutory criteria for suspending insolvent banks vary among the three nations in question, these two elements are common for granting the regulator right to take over insolvent banks. On the other hand, notwithstanding these statutory established criteria for insolvency, a distinctive line separating "troubled" and "insolvent" institutions is not delineated for banks. Thus, traditionally regulators have been allowed to determine the timing of any suspension order at their discretion. Since the regulator's decision has been based on technical criteria, courts have traditionally refrained from intervening in any such decision.[337]

[337] 12 U.S.C.A. s. 1821(j)(1989) for the U.S. laws. Also, Robert O. Sanderson, "Legal Issues Specific to Insolvent Financial Institutions," *The Regulations of Financial Institutions: Issue and Perspectives* (Toronto: Carswell, 1996) 1 at 5. The author noted that in the previous *CDIC Act,* financial institutions were provided with the appeal right to the Federal Court of Canada. However, such provisions were repealed in order to avoid delays of the process of dealing with insolvency issues, and to ensure early closure of an insolvent institution. The judicial authority will be more likely to accept the regulator's decision in case of bank insolvency.

As noted, there are no provisions under bank insolvency laws that allow an insolvent bank to negotiate payment arrangements with creditors in order to continue operations as a going-concern. Therefore, once a bank comes under receivership control, basically two solutions will be available: liquidation, or merger with another bank. In most cases, simply liquidating the bank is less desirable, due to higher costs for paying off those who are insured. In addition, its negative effects and consequences on the corporate and household sectors will be uncertain.[338] Therefore, liquidation is usually avoided unless other solutions are not available or unless liquidation is viewed as a less costly solution. Hence, when a bank becomes insolvent, or is about to be insolvent, the regulators will try to merge it with a healthier, more stable bank, which is financially supported by regulators in most cases.[339] Both in the United States and Canada, it is called a purchase and assumption transaction (hereinafter, the P&A transaction).[340]

Besides the above two solutions, there is another alternative in the U.S. and Japanese statutes which allows insolvent banks to continue operations under governmental administration and recapitalisation. This technique for nationalising a defaulted institution is called the bridge bank scheme in Japan, based on Section 1821(n) of U.S. law, referred to as "Bridge Banks." Under the bridge bank scheme, an insolvent bank will be able to continue to provide ordinary banking services to the community for a limited time period. However, because of the enormous expenditures to be incurred by a deposit insurance corporation, this solution will be applied in limited situations; whereas merging insolvent banks is not forthcoming, the immediate liquidation of defaulted banks would be detrimental to the public or the community in which

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[338] R.M. Rosenberg & Ronald B. Given, "Financially Troubled Banks: Private Solutions and Regulatory Alternatives" (1987) 104 Banking Law Journal 284 at 8. The merits of the P&A transaction are (i) it minimises the negative effect or inconvenience for the depositors by keeping the bank open at its same location, and (ii) all liabilities to depositors and most liabilities to creditors can be transferred to acquiring banks.

[339] 12 U.S.C.A. s. 1821 and s. 1823(1989); *CDIC Act*, s. 39.2; *Yokin Hoken Ho*[Deposit Insurance Law], Art. 59, Law No. 34 of 1971.

such banks are located. In spite of excessive expenditure for funding such a program, this has become a core policy under new bank insolvency legislation in Japan, in order to deal with the 1998 banking crisis.[341]

Furthermore, when the P&A transaction is not substantially completed, or the allowable period in a bridge bank scheme ends, regulators will terminate the legal existence of the insolvent banks. Consequently, the assets will be liquidated by a court-appointed liquidator, and the depositors and creditors will be paid off.

In the following sections, each country's legal framework for bank insolvency will be examined.

D. Canada

1. Introduction

Bank insolvency legislation in Canada comprises a part of its bank supervisory regime. Thus, it is identified in numerous banking-related statutes, such as the *CDIC Act*, the *OSFI Act*,[342] the *Bank Act*, and the *Winding Up and Restructuring Act*. The legal and administrative frameworks for bank supervision have been strengthened over the years, necessitated by regulatory liberalisation in the banking sector and an increased number of bank failures. However, bank insolvency legislation and the deposit insurance system have a short history. Since enactment of the *CDIC Act* in 1967, the CDIC has continued its operation as a deposit insurer for all federally incorporated banks, trust and loan companies. However, for the first two decades, the CDIC was

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[340] *CDIC Act*, s. 39.
[341] *Kinyu Kino no Saisei no Tame no Kinkyu Sochi Ni Kansuru Horitsu*, [Emergency Measures for Financial Stabilization], Law No. 132 of 1998[hereinafter "Emergency Measures Law"].
[342] *Office of the Superintendent of Financial Institutions Act*, R.S., 1985, c. 18 (3rd Supp.)[hereinafter "*OSFI Act*"].

"essentially a paying agency and a collection agency;" prior to 1980, the CDIC was involved in the failures of only two trust companies.[343] In those days, the CDIC was not assigned the role of ensuring the stability and soundness of the whole banking system, which would have rendered the CDIC more active and extensive role. This started to change with the failure of two regional banks in 1986, which created a turning point in the development of bank insolvency legislation and a deposit insurance system. For example, a notable change after this episode was the establishment of the Office of Superintendent of Financial Institutions (the OSFI). It was a result of the amalgamation of the Department of Insurance with the Office of the Inspector General of Banks in 1987. Now, the OSFI assumes the supervision of banks, insurance companies, trust and loan companies, investment companies, and co-operative credit associations. On the other hand, the function of the CDIC has been enhanced, and now it is given a mission of ensuring the solvency of their member institutions. This was achieved by continuous revisions to the *CDIC Act*, including Bill C-42 in 1987, and Bill C-48 in 1991.[344] Bill C-42 authorised the CDIC to take the initiative in developing a model for sound business and financial practices, which started to be enacted as by-laws in 1993.[345] Bill C-48 legitimated the Financial Institutions Restructuring Program by granting the CDIC a role as a receiver in assisting any merger between an unhealthy institution and a healthier one.[346] Furthermore, the introduction of the *Guide to Intervention for Federal Financial Institutions*, issued by the Ministry of Finance in 1995, provided a more detailed, clearer task division between the OSFI and the CDIC.[347] This improved efficiency in

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[343] These are the Commonwealth Trust Company in 1970 and Security Trust Company Limited. See, Canada, *CDIC Annual Report 1994/1995* (Ontario: Canada Deposit Insurance Corporation, 1995) at 14 [hereinafter "Annual Report 95"].

[344] *Ibid.* 20-22.

[345] Canada, *CDIC Annual Report 1995/1996* (Ontario: Canada Deposit Insurance Corporation, 1996) at 16 [hereinafter "Annual Report 96"]. On August 17, 1993, the following by-laws came into force: Liquidity Management, Interest Rate Risk Management, Credit Risk Management, Real Estate Appraisals, Foreign Exchange Risk Management, Securities Portfolio Management, Capital Management, and Internal Control.

[346] Canada, *CDIC Annual Report 1992*, (Ontario: Canada Deposit Insurance Corporation, 1992) at 9-10 [hereinafter "Annual Report 92"].

[347] Canada, *Enhancing the Safety and Soundness of the Canadian Financial System* (Ottawa: Department of Finance, 1995) [hereinafter "Safety and Soundness"].

the two agency coordination for intervening in the affairs of troubled institutions.[348] It should be noted that OSFI and CDIC intervention during this decade has been primarily related to insolvent trust companies. This is because trust companies became more vulnerable to insolvency risks due to increasing competition from the large chartered banks, as well as from the depression of real estate markets in the early 1990s. The following is a summary of intervention processes undertaken by the OSFI and the CDIC from early warning stages to liquidation process.

2. Pre-insolvency

The OSFI and the CDIC will intervene in the affairs of a troubled institution once they recognise that there is condition and circumstance which could deteriorate the viability of an institution.[349] In this early phase of trouble, the OSFI will enlarge the scope of their examination in to the financial affairs through external auditors. Based on the result of an examination conducted by the OSFI, the CDIC will levy a premium surcharge pursuant to Section 25.1 of the *CDIC Act*; the CDIC will levy the surcharge on any institutions which show a:

a) failure to follow CDIC's standards of sound business and financial practices,
b) failure to comply with its governing statute,
c) failure to fulfill the terms of an undertaking provided to CDIC, and
d) failure to maintain records and information pursuant to provisions of the policies of deposit insurance.[350]

When the result of the examination reveals that the institution has a "[s]ituation or problems, that could deteriorate into serious problems, if not addressed promptly...,"[351] the institution will be

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[348] "Annual Report 95," *supra* note 345 at 16. The *Guide*, published by the Department of Finance in 1995, was considered a significant milestone for streamlining the early intervention system for bank insolvency matters for the OSFI and the CDIC. It prescribes measurement for the agencies with respect to: how and when to step into the business affairs of a troubled bank; how to instruct risk management; how to efficiently allocate and coordinate the intervention functions of the OSFI and the CDIC. Although the *Guide* merely plays an administrative role, it in essence has a similar function and effect as U.S. statutes. In other words, the administrative actions under the *Guide* are aimed at providing effective supervisory tools for directing banks away from undesirable business practices and towards solvency, before the situation becomes prejudicial to the public interest.

[349] "Safety and Soundness," *supra* note 347 at 29.

identified as being in the second stage of insolvency. In this stage, financial viability or solvency will be tested on the following factors: the institution's ability to meet its capital requirements, the asset values, profitability, earning and cost performances; the validity of the reported earnings or expenses; sufficient liquidity; and adequacy of control or management policies.[352] In this stage, the OSFI will require the institution to submit its business restructuring plan. It should reflect remedial measures that will rectify problems within a specified time frame.[353] Additionally, various restrictions will be imposed on the institution. These include restrictions on the following: payment of dividends, management fees, lending or investment powers, amount of deposits and other indebtedness, and interest rate payments on deposits. In addition, other business restrictions will be tailored for each circumstance.[354]

In contrast to the OSFI, the CDIC will take action by terminating the insurance policy in pursuant to Section 31 of the *CDIC Act*. The legal ground which warrants the CDIC to terminate an insurance policy is as follows: (i) the institution violates any CDIC by-laws, and (ii) it is unable to remedy such situations within thirty days.[355] Once their insurance policy is terminated, the OSFI takes over their assets. The purpose of such OSFI control is to preserve the assets of the insolvent bank before liquidating its assets, pursuiant to Section 538 of the *Bank Act*, and Section 6 of the *Winding Up and Restructuring Act*.

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[350] *Ibid.* For details, *Canada Deposit Insurance Corporation Prescribed Practices Premium Surcharge By-law*, SOR/94-142, s. 2 (1994).
[351] "Safety and Soundness," *supra* note 347 at 30.
[352] *Ibid.*
[353] *Ibid.* at 31.
[354] *Ibid.*
[355] *CDIC Act*, s. 30, s. 31.

3. Post-Insolvency

(a) Financial Institutions Restructuring Program:

If the institution has problems which "pose a material threat to future financial viability and solvency"... "in the absence of mitigating factors such as unfettered access to financial support from a financially strong financial institution parent...,"[356] the institution is said to be in the next insolvency stage. Thus, in this stage, the CDIC will provide temporary financial assistance or will commence restructuring transactions. Financial assistance takes the form of the CDIC purchasing the assets, and making or guaranteeing loans to the institution under Section 10 of the *CDIC Act*. It is aimed at reducing risk to or avoiding a threatened loss to the CDIC.[357]

In this stage, the OSFI will insist increase the capital requirement of the institution. In addition, the OSFI will pressure the institution to restructure their business or find a prospective buyers. Additionally, the CDIC will commence the Financial Institutions Restructuring Program, pursuant to Section 39.1 of the *CDIC Act* when statutory conditions are met. As noted earlier, the Financial Institutions Restructuring Program is also known as the P& A transaction. Under this program, the CDIC will acquire ownership and assets under their receivership for the purpose of transferring the assets, ownership, liabilities, and business to another institution. The types of ownership which the CDIC will acquire are only preferred shares and subordinate debts. The preferred share will be attached with a conversion or exchange privilege, which is convertible

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[356] "Safety and Soundness," *supra* note 347 at 32.
[357] *CDIC Act*, s. 10 provides that the CDIC will,

> (i) acquire assets from a member institution,
> (ii) make or guarantee loans or advances, with or without security, to a member institution, and,
> (iii) making or guaranteeing a deposit with the institution.

into common stock at any time. A characteristic of subordinated debts is that they are subordinated to all depositors in the right of payments when the bank is insolvent.[358]

Furthermore, there are other effects of CDIC receivership, such as CDIC powers to carry out any business transactions necessary to its receivership, *i.e.*, dealing with any claim of the institution, or executing all receipts and other documents in the name of the institution.[359] Furthermore, the powers, duties, functions, rights, and privileges of the directors and officers will be suspended and transferred to the CDIC. The CDIC will exercise or perform all these in the receivership role out of court supervision.[360]

In order to conduct the restructuring program, the CDIC will have to enter into numerous transactions with any acquiring institution. Such transactions include the organisation of the workout company,[361] which has a sole purpose in disposing of assets not purchased by an acquiring bank under the P&A transaction. For this arrangement, Section 10 of the *CDIC Act* provides the legal basis for the CDIC to incorporate such a company as a subsidiary.[362] Another

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[358] *Ibid.*, s. 2.
[359] *Ibid.*, s. 39.13(3)(b).
[360] *Ibid.*, s. 39.13(5), s. 39.14(1).
[361] Canada, *CDIC Annual Report 1996/1997* (Ontario: Canada Deposit Insurance Corporation, 1997) at 24 [hereinafter "Annual Report 97"]. The notable example of the workout company is Adelaide Capital Corporation (the ACC). The ACC was established to work out the realisation of some assets of the Central Guarantee Trust, which were not purchased by Toronto Dominion Bank in 1992. Provided $1588 million by the CDIC, the ACC was mandated to complete realisation on all assets by 2001 in order to pay back the CDIC for its financing support.
[362] Section 10(2) of the *CDIC Act* provides;

> ... For the purposes of facilitating the acquisition, management of disposal of real property or other assets of a member institution that the Corporation may acquire as the result of its operations, the Corporation may...
>
> a) procure the incorporation of a corporation, all the shares of which, on incorporation, would be held by, on behalf of or in trust for the Corporation; or
> b) acquire all of the shares of a corporation that, on acquisition, would be held by, on behalf of or in trust for the Corporation.

device is the deficiency coverage agreement.[363] In the course of carrying out a restructuring program, the CDIC can shift to an acquiring company all or some assets of the failed institution, including all kinds of loan assets. However, losses to the acquiring institution may occur, since a defaulted institution often has substantial amounts of low quality loans. Thus, the CDIC, by providing certain capital and income loss guarantees, can make such a transaction safer to the acquiring institution. This is the procedure of the deficiency coverage agreement. In the absence of the specific legal basis for a deficiency coverage agreement, such authority of the CDIC is presumably derived from Section 39.2 of the *CDIC Act*. It provides that the CDIC carry out, as follows:

> a) a transaction...that involves the sale of all or part of the shares or subordinated debt of the federal member institution,
> b) a transaction...that involves the amalgamation of the federal member institution,
> c) a transaction...that involves the sale or other disposition by the federal member institution of all or part of its assets or the assumption of all or part of its liabilities or both; or,
> d) any other transactions or series of transactions the purpose of which is to restructure a substantial part of the business of the federal member institution.

(b) Liquidation:

If the transaction under the restructuring plan is not substantially completed within sixty days, the CDIC will have to apply for liquidation of the institution under the *Winding Up and Restructuring Act*.[364] This is the last stage of the regulators' intervention, where the OSFI will take control of all business affairs of the institution for a short time. OSFI's role is regarded as a curator's role with the purpose of protecting rights of depositors and the creditors of an insolvent

[363] "Annual Report 97," *supra* note 361 at 24. In the event of failure of the Central Guarantee Trust, the CDIC entered into an arrangement with Toronto Dominion Bank that the CDIC would guarantee income losses to be incurred for the TD bank, to dispose of certain loans of the Central Guarantee Trust up to $ 2.49 billion.

bank.[365] Thus, taking the control itself does not terminate corporate legal existence; only a winding up order, which will be issued by a court upon the request of the OSFI, will completely terminate the corporate existence.

Section 538 of the *Bank Act* provides the legal grounds for the OSFI to take control of the bank, as follows:

> a) the bank has failed to pay its liabilities or, in the opinion of the Superintendent, will not be able to pay its liabilities as they become due and payable;
> b) in the opinion of the Superintendent, a practice or state of affairs exists in respect of the bank that may be materially prejudicial to the interests of the bank's depositors or creditors
> c) the assets of the bank are not, in the opinion of the Superintendent, sufficient to give adequate protection to the bank's depositors and creditors;
> d) any asset appearing on the books or records of the bank or held under its administration is not, in the opinion of the Superintendent, satisfactorily accounted for;
> e) the regulatory capital of the bank has, in the opinion of the Superintendent, reached a level or is eroding in a manner that may detrimentally affect its depositors or creditors;
> f) the bank has failed to comply with an order of the Superintendent...; or [the]
> g) bank's deposit insurance has been terminated by the Canada Deposit Insurance Corporation.

The duration of the OSFI's administration is limited to sixteen days. During the intervention period, the OSFI is authorised to control and administer the assets of the bank. Banks are also prohibited from engaging in securities and cash transactions, and from having access to such properties without permission of the OSFI.[366] Again, the powers, functions, rights, and privileges of the directors and officers and their responsibility for its management are suspended. Instead, the OSFI performs all the duties and functions, and exercises any powers, rights, and privileges

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[364] *CDIC Act*, s. 39.22.
[365] Ogilvie (1998), *supra* note 98 at 254. The office of curator originated in 1990, when there is legal facilitation to deal with the affairs of a troubled bank, and it used to be appointed by the president of the Canadian Bankers Association. Since the legislative revision in 1987, the curator's role has been exclusively undertaken by the OSFI.
[366] *Bank Act*, s. 538.

belonging to the officers and director prior to OSFI control.[367] After the control period is over, the bank will be dissolved under the *Winding Up and Restructuring Act*, unless the OSFI decides to relinquish control.[368] Liquidating the insolvent bank is subject to the procedure articulated in the *Winding Up and Restructuring Act*, which is applicable, to all financial institutions. The liquidation process is undertaken by a court-appointed liquidator under court supervision.

4. Issues Regarding the Discretion of Regulators

During the period of OSFI control over a failed bank, the OSFI is generally assigned to conserve the assets for later distribution as a conservator or curator. Suffice it to say that at the point of OSFI control, the seized institution still exists as a legal entity; thus, liquidation is not included in the curator's authority. However, when it comes to the mandatory tasks associated with controls, statutory provisions fail to give specific definitions.[369] Thus, OSFI's intervention might raise legal issues about the legitimacy of OSFI actions. For example, in its role as curator, the OSFI tends not to discharge obligations which a bank might have with customers. However, OSFI's failure to discharge obligations for a specific period might not only result in losses to customers, but also force the bank into actual "insolvency," which warrants a court to order immediate liquidation. That was the case in *Canada (Attorney General)* v. *Cardinal Insurance Co.* in 1982.[370]

Although this case was about insurance companies, it will be applicable to insolvent banks, now that all financial institutions come under the same OSFI jurisdiction. The Cardinal Insurance Co. came under the control of the OSFI after it failed to meet licensing requirements. During the intervention period, the OSFI was authorised to make the decision of discharging obligations,

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[367] *Ibid.*, s. 542.
[368] *Ibid.*, s. 543, s. 543.1.
[369] Ogilvie (1998), *supra* note 192 at 257.

including paying outstanding claims to policyholders. The evidence was that the refusal of the OSFI to pay claims to policy holders directly caused the insolvency of the company.[371] In this case, it was argued that the OSFI fulfilled the duties and obligations expected within their curator's capacity when it took control of the insolvent institution; the Ministry of Finance possessed the authority to provide the OSFI with such a power. The court ruling was in favour of the Ministry. In the judgement of White J., the power of the Ministry to direct the Superintendent's acts was valid, even if, as a result of the acts, the company became insolvent. The court's reasoning was based on the fundamental policy of giving priority to the protection of policyholders and the general public, over the interests of the shareholders of the corporation.

However, this ruling and justification might risk giving excessive power to regulators in the future. Thus, it might be more just and equitable to take a more modified stand, as follows.

> ...[T]he fact that the Superintendent is clothed with the same authority as the directors suggests that actual management of the bank's business is now required and that the Superintendent should be liable to those who suffer loss in the event that the Superintendent acts otherwise, even with the same degree of caution once expected of the curator.[372]

The legal issue arising from the above regulator's discretion illustrates a controversial problem residing in administrative powers. As noted, the defendant's ground for defeating the claims against it was based on the fundamental policy of protecting public interest. However, it has overridden the interest of shareholders in a private corporation or the rights of the corporation itself. This aspect is more obvious in the U.S. where discretionary powers of bank regulators are

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[370] *Canada (Attorney General)* v. *Cardinal Insurance Co.* [1982] 39 O.R. (2d) 204 (H.C.).

[371] Sanderson, *supra* note 337 at 11. During the taking of control, the OSFI was authorised to decide which cheques issued by Cardinal Insurance to policyholders should be signed by the OSFI. While various cheques were not issued by the OSFI at their discretion, it resulted in intensifying a court to declare that the Act says Cardinal Insurance was insolvent, pursuant to Section 161(1) of the *Winding Up and Restructuring Act*. It says that a company shall be deemed to be insolvent "if it has failed to pay any undisputed claim arising under any policy of the company."

more dominant. As a notable example,[373] a "cross-guarantee"[374] power of the FDIC had been questioned about legitimacy in several times, being criticized that it even "constitutes a compensable taking under the Fifth Amendment."[375] In other words, legal issues regarding a "cross-guarantee" provision suggests the following cautions: the overwhelming powers of the FDIC against the affiliated parties of insolvent banks, would threaten the right of private corporations, protected under the *Bill of Rights*.[376] It says that "private property may not be taken for public use, without payment of just compensation."

Comparison of the above issues between Canada and the U.S. presents a common dilemma in legislative policy, which arises from the development of bank insolvency legislation: how to balance the rights of private corporations against those of the general public, in relation to bank insolvency and accompanying governmental interventions?

5. CDIC' s Cost Recovery from Officers and Directors of Failed Banks

(a) Introduction:

The Canadian legal regime for bank directors and officers' liability has become a more significant matter in recent years: the CDIC, as part of the cost recovery method, has started to focus on initiating lawsuits against directors, officers, auditors, and other related parties of insolvent institutions.[377] Thus, certain acts and behaviours of bank directors and officers will more likely be prosecuted by the CDIC; it will file lawsuits against any institutions if "(i) CDIC has suffered a financial loss and (ii) there is a reasonable legal case supporting a charge of

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[372] Ogilvie (1998), *supra* note 192 at 257.
[373] 12 U.S.C. s. 1821(k)(1994).
[374] Further discussion of this case will be found at 110, below.
[375] For detail, see 112, below.
[376] U.S. Const., Amendment V.
[377] "Annual Report 95," *supra* note 343 at 3.

negligence, willful misconduct or wrongdoing."[378] However, despite such an aggressive attitude in CDIC litigation against bank officers and directors, the liability regime for bank officers and directors in Canada is much softer than those in the U.S. In other words, there is no special regime in Canada which requires bank directors and officers to be subject to higher standards of duty of care. As an illustration, the duty of care required of bank officers and directors expressed in the *Bank Act* is almost identical to the duty of care in the *Canada Business Corporation Act*, applicable to ordinary business corporations incorporated federally. On the other hand, in the U.S. even prior to codification of 12 U.S.C. Section 1821(k), U.S. laws clearly set higher standards of duty of care for directors and officers of banks than those of ordinary corporations. It is reflected in the regulators' recognition of the extraordinary duty, skill and diligence ("duty of care") expected from directors and officers responsible for guarding public funds.[379]

The following is a brief description of the liability regime for bank directors and officers in Canada.

(b) Duty of Canadian Bank Directors and Officers:

Section 157 of the *Bank Act* provides the specific duties required of bank directors and officers:

a) establish an audit committee...;
b) establish a conduct review committee...;
c) establish procedures to resolve conflicts of interest, including techniques for the identification of potential conflict situations and for restricting the use of confidential information;
d) designate a committee of the board of directors to monitor the procedures refereed to paragraph (c);
e) establish procedures to provide disclosure of information to customers of the bank that is required to be disclosed by this Act and for dealing with complaints...;

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[378] *Ibid.*
[379] Steven A. Ramirez, "The Chaos of 12 U.S.C. Section 1821(k): Congressional Subsidizing of Negligent Bank Directors and Officers" (1996) 65 *Fordham Law Review* 625 at 644.

f) designate a committee of the board of directors to monitor the procedures referred to in paragraph (e) and satisfy itself that they are being adhere to by the bank; and
g) establish investment and lending policies, standards and procedures....

To summarise, the Canadian *Bank Act* focuses on three main areas in terms of specific duties for directors and officers: preventing conflicts of interest, ensuring information disclosures to depositors, and supervising prudent investment and lending.

Besides such specific requirements for bank directors and officers, they remain subject to other statutes and regulations, as well as to "common law principles." The common law principles consist of a duty of loyalty and a duty of care. The *Bank Act* has incorporated these principles over the years and it now stipulates them under Section 158, as follows:

(a) act honestly and in good faith with a view to the best interest of the bank; and
(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

However, these legal principles for bank directors and officers are almost identical to that for ordinary corporations. As for duty of loyalty, bank directors are required to act in the best interest of their corporation, not in personal interest. While the wording of the statutory provision is not specific, courts have interpreted such fiduciary duties as follows: "to exercise power honestly and in good faith, to exercise power for a proper purpose, loyalty and to avoid conflicts of interest; to disclose interests in corporate transactions, to avoid appropriation of corporate opportunities and to account in takeovers."[380]

Likewise, the judicial interpretations of the duty of care required of bank directors and officers does not present any difference from those in ordinary corporations. This is reflected by Romer J.'s finding that:

> ... a director (a) must act honestly, and (b) must exercise such degree of skill and diligence as would amount to the reasonable care which an ordinary man might be expected to take, in the circumstances, on his own behalf. But, (c) he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience; in other words, he is not liable for mere errors of judgment: (d) he is not bound to give continuous attention to the affairs of his company.[381]

In *Re: City Equitable Fire Insurance Co.*,[382] a leading case on this subject of the duty of care, the directors of the corporation were sued for breach of a duty of care, when they failed to detect and prevent the fraudulent behaviour of a fellow director. The court ruling was in favour of the directors, who were defendants.[383] It was based on the above reasoning about the standard of a "duty of care" expected from bank directors and officers. In addition, it assumed that the standard of care required of directors and officers is to be exercised like "a reasonably prudent director." This means bank directors and officers can exercise their skills at a level even lower than the professional standards for doctors and lawyers.[384] Consequently, in Canada, there have been only two major categories in case law where bank directors and officers have been found liable for breach of duty of care. These have been for mismanagement of corporate affairs and for misstatements in relation to an issue of a prospectus. These two categories embody the standards of duty of care for bank directors and officers in Canada. As for mismanagement, recent cases indicate that bank directors or officers will be "vicariously liable for the misdeeds of

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[380] Ogilvie (1998) *supra* note 192 at 67.
[381] *Re: City Equitable Fire Insurance Co.* [1925] 1 Ch. 407.
[382] *Ibid.*
[383] Their act would be considered to have breached their duty of are in this case, but were absorbed from liability due to the exemption clause under the same provision (*i.e.*, according to this clause, directors were not liable for their act unless thieir act are considered a "willful misconduct").
[384] Ogilvie (1998), *supra* note 192 at 67. The author stated that "...the relatively low standards of care required by statute, while higher than the pre-existing common law standards, may well serve to ensure that bank directors are subject in law to lower standards of care than those required of any other professional or businessperson [*sic*] today." In other words, the legal standard set for a "prudent director' in corporations has been subjective, which is based on individual experience and background, not some hypothetical average director. On the other hand, for the professional people such as doctors, lawyers, etc., the standard for "prudency" is purely objective.

others [employee] under their general supervision."[385] As for the latter case of misstatement, directors have been found liable for the negligent misstatement made by themselves and by others regarding the issue of prospectuses. Reflected by the increase in liability for negligent misstatement, after *Hedley Byrne & Co. Ltd v. Heller Partners*,[386] this type of misconduct will, in the future, more likely be considered as the breach of duty of care.[387]

Nevertheless, this liability regime is structured to limit the liabilities of bank directors and officers. Thus, it might not provide sufficient legal ground which the CDIC would need for claiming damages against bank officers and directors in relation to insolvency issues. Hence, this liability regime could be reconsidered as "a line of older English and Canadian decisions [which] may not longer be good laws,"[388] where bank directors and officers might only be liable for mismanagement and misstatement as their breach of duty of care.

E. Japan

1. Introduction

As noted, Japan has not had a large number of bank failures for more than a half century. There was little need to establish a legal framework to deal with insolvent banks under its codified provisions. However, in the absence of legitimate procedures to deal with troubled banks, the Japanese bureaucracy successfully bailed out insolvent banks either by direct financial assistance or by merger arrangements.[389] In other words, unlike the U.S. and Canada, the stability of their financial system in Japan was not based on strict supervision, or on a deposit insurance system. Rather, it was based on the unique corporate culture and the relationship between government

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[385] *Ibid.* at 70.
[386] *Hedley Byrne & Co. Ltd* v. *Heller & Partners*, [1964] A.C. 465 (H.L.).
[387] Ogilvie (1998), *supra* note 192 at 70.
[388] *Ibid.*
[389] Dale, *supra* note 66 at 33.

and corporations, with banks at the center of this system. This made the banking industry immune to insolvency risks, and its stability has never been doubted by the general public, because of the 100% governmental guarantee in an "unwritten" code. The legitimate contract between insured depositors and a deposit insurance corporation was not the primary way to prevent bank runs or to maintain public confidence in the stability of the financial system.

Then came the banking crisis of the 1990s, which exposed the myth of bank solvency and revealed to the public that their financial security was threatened. Serial failures in the banking industry seemed to lead to dysfunction in the whole financial system in Japan. The government, being inexperienced in this scale of bank failures, still has not been successful in promptly adopting any effective procedures for salvaging such situations.[390] One reason is that legislative reform of essential areas of law has not been initiated; *e.g.*, adoption of western accounting standards, requirement of public disclosure, and improvement in a supervisory system independent of the Ministry of Finance. Most governmental procedures for the solution of a banking crisis remain on a case-by-case approach, although there is some improvement and development of law in this area, *i.e.*, (i) the establishment of the Financial Supervisory Agency[391] in 1998, and (ii) the introduction of the prompt corrective action remedy in 1998.[392]

Establishment of a new regulatory body, independent of the Ministry of Finance, enhances the supervisory system not only for deposit-taking institutions but also for all other financial

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[390] Cargill, Hutchison & Ito, *supra* note 4 at 124-32.

[391] *Kinyu Saisei Iinkai Secchi Ho* [Law Concerning Establishment of the Financial Supervisory Agency], Law No.130 of 1997. All legislative provisions under the Emergency Measures Law and the Deposit Insurance Law written in this chapter are not from official English translations of the statutes, but are translations by the author.

[392] "BL Administrative Ordinance," Art. 21.

institutions.[393] The FSA was established under the Law Concerning Establishment of the Financial Supervisory Agency and became effective from June 1998. A number of core functions which used to belong to the Ministry of Finance were transferred to the Financial Supervisory Agency (hereinafter "the FSA"). The FSA is responsible for supervising financial institutions in order to ensure their appropriate operation and prudent business management.[394] For pursuing such a goal, FSA's authority includes: (i) conducting examinations and inspections of all institutions;[395] (ii) imposing remedial measures on troubled banks;[396] (iii) issuing cease-and-desist orders or withdrawal of licenses for institutions, through consultation with the Ministry of Finance;[397] and, (iv) approval of any JDIC decision to provide financial assistance to troubled institutions.[398] However, for such tasks as planning and designing the financial system, these remain firmly within the jurisdiction of the Ministry of Finance. The FSA is only required to provide information and opinions and to assist the Ministry of Finance in the development of the financial system.[399] The legal status of the FSA is somewhat similar to that of the OSFI in Canada. The OSFI carries out supervisory operations under the auspices of the Ministry of Finance and is also responsible for supervising almost all types of financial institutions, except securities firms.[400]

The FSA's supervision is also similar to U.S. regulators, in the sense that both can enforce prompt corrective action as a procedure for early intervention in troubled banks. Japan's version of prompt corrective action is almost identical to U.S. laws in a number of ways, such as; (i) it

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[393] The FSA has three major divisions: Supervisory Department, Inspection Department, Securities and Exchange Surveillance Commission. Thus, it supervises not only deposit-taking institutions, such as banks, credit cooperatives, and trust banks, but also insurance companies, securities companies, and holding companies: Law Concerning Establishment of the Financial Supervisory Agency, Art.4.
[394] Law Concerning Establishment of the Financial Supervisory Agency, *ibid.*, Art. 3.
[395] Banking Law, Art. 24.
[396] *Ibid.*, Art. 26.
[397] *Ibid.*
[398] Deposit Insurance Law, Art. 29(1).
[399] Law Concerning Establishment of the Financial Supervisory Agency, Art. 6.

provides definitions for classifying institutions, and such classification is based on the Basle Accord for Capital Adequacy; and, (ii) affirmative actions which will be imposed on institutions vary in each category.[401] However, as examined in Chapter Two, accounting standards for capital calculation in Japanese banks is problematic, in that it ostensibly helps banks to increase their capital ratios. Thus, it is obvious that the Japanese approach is softer than in the U.S.

On the other hand, the development of legislative and administrative measures for disposing of insolvent banks is far behind any western counterparts. In fact, there are many flaws in governmental maneuvers for assisting mergers or for liquidating the assets of defaulted banks. Such provisions, although in existence, are only temporary, being effective until 2001.[402] The reason is that, in the absence of a self-financing deposit insurance system in Japan, any bailout schemes would only place a heavier burden on the public; the public opposition against such governmental manoeuvres is obvious. Nevertheless, Japan is heading toward a market-oriented banking economy in the future, which will require continuous law reform.

2. Pre-insolvency

The purpose of this section is to describe the current supervisory system by which banking regulators deal with troubled banks, and how the regulator copes with defaulted banks in ways that minimise economic and social damage. In the first part of this section, prompt corrective action will be examined. The following sections will focus on bailout measures for insolvent banks.[403] Such bailout schemes are mainly comprised of three methods; the receivership control,

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[400] *OSFI Act*, s. 2.
[401] "BL Administrative Ordinance," Art. 21.
[402] Emergency Measures Law, Art. 8, 27, and 52.
[403] "Japan: the Comprehensive Plan for Financial Revitalization," *Financial Regulation Report* (September 1998) at 5-8. The rescue scheme for the whole banking industry is provided by new legislation and can be classified into three categories. One deals with insolvent banks by placing them under government control while seeking merger and consolidation with compensation to the acquiring banks. A second offers

the bridge bank scheme, and the nationalisation of failed banks. Each procedure will be examined from a comparative perspective with Canadian and U.S. laws.

(a) Prompt Corrective Action:

As noted, the Japanese version of prompt corrective action is identical to that in U.S. law, codified in Section 1831. It classifies banks into three categories based on their capital level, and it orders each category of banks to take appropriate remedial action.[404] First of all, a bank will be categorised as Class One, once the risk-weighted capital ratio of the bank is below eight percent, which is the minimum requirement under the BIS standard.[405] If a bank is categorised as Class One, it must submit restructuring plans which should be practical enough to maintain prudent management. Basically, the plan should include enhancing capital adequacy levels. Second, when the BIS capital ratios of the bank come below four percent, the bank will be categorised as Class Two. The remedial plans to be imposed on the bank here are: (i) submitting a restructuring plan which should be practical to enhance capital level; (ii) restricting or suspending payments of dividends to shareholders, and of bonuses to officers and directors; (iii) restricting the asset growth, or reducing asset holdings; (iv) refraining from accepting any deposits or savings deposits, because it requires higher payments of interest; (v) restricting certain business activities, such as the ancillary business stipulated in Article 10 of the Banking Law; (vi) reducing the number of branch offices; and, (vii) taking any actions which are deemed to be

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financial assistance to banks which are in sound and safe conditions, but which have a possibility that their solvency will be at risk if they take over an insolvent institution. The direct financial assistance will be available by the JDIC to such depositories in the form of the JDIC subscription of preferred shares and subordinate bonds. The third offers financial assistance to banks which need financial assistance because of an excessive erosion of their capital as a result of writing off substandard loans. Such a measure will also take the form of the JDIC purchasing preferred shares and subordinate bonds, in exchange for the institution's submission of a restructuring plan which must be acceptable to the JDIC.

[404] "BL Administrative Ordinance," Art. 21.

[405] See, Chapter 2, above, for more details.

necessary in the opinion of the FSA. Finally, when the capital ratio of the bank is negative, all or part of the business operations will be suspended by a cease-and-desist order.[406]

3. Post-Insolvency

(a) Overview:

In post-insolvency, governmental measures in Canada and Japan present significant differences. As recognised in the Canadian study in the previous section, solutions to the disposal of insolvent banks are by merger or liquidation. There are no provisions in Canadian laws which give an insolvent bank with substantial capital the opportunity to restructure its business; Canadian laws do not help insolvent banks continue the operation in the name of "public interest." Obviously, Canadian laws restrict governmental expenditures more carefully for bailing out private institutions in order to protect insurance funds.

In contrast, governmental policy in Japan emphasises protecting the interests of all economic sectors and encouraging them to recover their business viability if it was lowered by a banking crisis. This attitude in the Japanese government remains unchanged throughout this century; governmental policy has always given a priority to protecting interests of the industries over those of the general public, and this is clearly expressed in new bank insolvency legislation. Furthermore, as part of the JDIC's cost recovery method, regulators do not prosecute bank directors and officers as aggressively as U.S. and Canadian counterparts; any notable legislative changes have been seen to impose stricter liability on bank directors and officers for negligence in duty of care. The stricter liability regime for bank officers and directors, as well as a restitution system, will be an essential element for creating a self-financing deposit insurance

[406] Above all details are prescribed in "BL Administrative Ordinance," Art. 21.

system in Japan. Also, it will provide preventive measures for bank insolvency. Thus, this area of law should also be restructured in the course of developing the deposit insurance system.

(b) Receivership Control:

Article 8 of the Emergency Measures Law authorises the FSA to force a troubled bank into the administration of a FSA-appointed receiver. The criteria for the FSA to decide to commence receivership are: (i) a bank becomes unable to meet withdrawal demands from its depositors, or such a risk is imminent in consideration of the asset value or the management prudence of the institution,[407] (ii) in such a circumstance, the management of the bank is critically undesirable, and (iii) without merging with another bank, liquidating the bank would result in blocking customers' access to financial resources. Upon commencement of receivership control, as in Canada, all corporation rights related to representation, management and disposition of assets and the execution of business, will be vested in a receiver under Article 11 of the Emergency Measures Law.

This receivership regime has unique structures, in terms of the numerous functions of a receivership, which is only a portion of the legal framework of its bankruptcy law.[408] First of all, the receiver has a duty to report to the FSA, with regard to: (i) the cause of insolvency, (ii) the financial viability, and (iii) the feasibility of a transferring operation from the failed bank.[409] Second, it is also the receiver's task to set a plan to carry out business operations and manage assets under its control. Such a plan includes establishing a temporary lending policy and

[407] Emergency Measures Law, Art. 8.
[408] *Ibid.*, Art. 11(6) provides that Article 97, 98, and 285 of the *Kaisha Kousei Hou* [Corporate Reorganization Law] Law No.172 of 1952; will be applied to a receiver and that Article 44(1) of the Civil Code, 1896, Law No. 89 will be applied to insolvent banks.
[409] Emergency Measures Law, Art. 13.

arranging a merger for the failed bank.[410] Third, the receiver is given the right to investigate those parties knowledgeable of the business operations and financial affairs at the time when the financial condition deteriorated.[411] The receiver is also responsible for initiating civil actions against those officers and directors who may have breached a duty of care.[412] Fourth, the court will allow the receiver to make decisions on such matters as: (i) transfer of all or part of business operation to another institution, (ii) imposition of capital reduction measures, or (iii) liquidation.[413] These provisions under the Emergency Measures Law override other provisions under the Civil Code and the Commercial Code, in relation to special resolutions at shareholder meetings,[414] as well as to procedures for the protection of creditors for capital reduction.[415]

The duration of the temporary operation of defaulted institutions under receivership control is limited to one year. If, within one year, a receiver cannot find any acquirer of the defaulted institution, the receivership control of the bank will be terminated and the bank will be taken over by a bridge bank.[416]

(c) Bridge Bank Operations:

When the business operation of the bank under receivership control cannot be transferred to another bank, the bridge bank will be organised as a subsidiary of the JDIC. Its purpose is to take over the business affairs of the bank and provide normal banking services to customers'.[417] While the title of this provision originated from "Bridge Bank" in U.S. laws, the details of

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[410] *Ibid.*, Art. 14.
[411] *Ibid.*, Art. 16.
[412] *Ibid.*, Art. 18.
[413] *Ibid.*, Art. 22.
[414] Commercial Code 1899, Art. 245. Under this section, to transfer all or part of the business operations of the institution requires 2/3rds of shareholder votes. However, this does not applied to insolvent banks.
[415] *Ibid.*, Art. 376, provides the necessary procedure and methods, including dealing with creditor rights, when a corporation decides to reduce its capital. Such creditor protection is not applicable to insolvent banks.
[416] Emergency Measures Law, Art. 24.

procedures are also close to the P&A transaction. This is because the Japanese bridge bank scheme aims at transferring business from an insolvent bank to a healthier one. However, such an operation will take longer and need substantial financial support from the JDIC.

The FSA will decide to incorporate a bridge bank on the same grounds stipulated in Article 8 of the Emergency Measures Law. The reason for incorporating a bridge bank is that, where a bank is in default or at a risk of default, the liquidation of such a bank would be detrimental to the public interest. The JDIC's function in relation to operating a bridge bank is : (i) taking over business affairs, including the assumption of liabilities and the transfer of certain assets of the bank which was under receiver control,[418] (ii) conducting the evaluation of the quality of each asset in order to decide which assets should be taken over by the bridge bank,[419] (iii) providing necessary financial assistance to the bridge bank,[420] (iv) giving advice for management of the bridge bank, or hiring qualified employees in the field of law, finance, and accounting,[421] and (v) drafting an internal policy for a lending procedure in accordance with sound and safe business practices.[422] The legal status of the bridge bank will be terminated with (i) completion of a merger of the bridge bank to a healthy institution, (ii) transfer of all business operations of the bridge bank to a healthy institution, (iii) transferring shares of the bridge bank to a healthy institution, and (iv) dissolution of the bridge bank upon the decision of the shareholders' meeting.

In short, the Japanese version of a "bridge bank" is a legal scheme where: (i) the FSA will replace former management of an insolvent bank with government-appointed management; (ii)

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[417] *Ibid.*, Art. 27.
[418] *Ibid.*, Art. 27.
[419] *Ibid.*, Art. 28.
[420] *Ibid.*, Art. 29.
[421] *Ibid.*, Art. 30.

the JDIC provides necessary financial assistance to carry out a normal business operation; (iii) the JDIC will also select higher quality assets acceptable to be transferred to the bridge bank, in order to keep the bridge bank in a sound and safe condition; and (iv) a prudent lending policy will be emphasised. The operation of a bridge bank is limited to one year.

Additionally, any acquiring bank, which takes over the assets and liabilities of the failed bank is eligible to apply for JDIC assistance.[423] Such assistance takes the form of JDIC's direct financial assistance or guaranteeing the loan and the loss to be accrued by the acquisition.[424]

(d) Nationalisation of a Defaulted Bank:

The passage of the bill which legitimised a nationalisation scheme was primarily aimed at accommodating the bailout program for the Long-Term Credit Bank, after its merger plan with Sumitomo Trust Corporation aborted in October 1998. The same scheme was also utilised for bailing out the Nippon Credit Bank in December 1998.[425]

Article 36 of the Emergency Measures Law stipulates that a bank has to come under public administration when (i) it cannot meet all liabilities with its own assets, and (ii) it is likely to cease meeting withdrawal demands in light of its financial condition and operational viability.[426] The criteria for the FSA decision of whether to place the bank under this nationalisation scheme is as follows: when liquidating the bank would result in, (i) spreading a contagious insolvency to other financial institutions, a consequence of which will affect detrimentally the whole financial system, (ii) causing a critical dysfunction of business activities in a certain industry or

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[422] *Ibid.*, Art. 30.
[423] *Ibid.*, Art. 30.
[424] *Ibid.*, Art. 35, and 36.
[425] See the JDIC Report, online source <http://www.junkankikou.co.jp>.
[426] Emergency Measures Law, Art. 36.

community because of a heavy concentration of lending to that industry or community,[427] and (iii) causing detrimental effects to international financial markets.[428] The essential part of the nationalisation scheme is that: (i) it re-capitalises failed banks with 100% direct assistance from the JDIC, (ii) funding is given by the JDIC for purchasing the preferred shares of the institution, and (iii) the bank has to accept absolute governmental administration and control.[429] The shares to be purchased by the JDIC will be priced according to the net asset value of the bank. The FSA sets up calculation standards for the evaluation of assets.[430] In addition, Article 45 authorises the JDIC to appoint or remove officers and directors upon the recommendation of the FSA. The other functions to be carried out by the JDIC are similar to receivership under Article 8 of the Emergency Measures Law. These functions are: (i) reporting to the FSA matters such as the cause of insolvency and of financial viability in the institution,[431] (ii) drafting a plan for carrying out business performance, including planning a temporary lending policy and the managing of assets under receivership control,[432] and (iii) initiating civil actions against officers and directors of the institution who may be in any breach of duty of care.[433] Management of the insolvent bank under the nationalisation scheme will be terminated by 2001. However, there is not yet any blueprint for the legal framework describing how insolvent banks will be dealt with after 2001.

F. The U. S

1. Introduction

The Federal Deposit Insurance Corporation's legal power over troubled banks is extraordinary and independent. Both in pre-and post-insolvency, the FDIC plays an active role in the bank

[427] *Ibid.*, Art. 37(1).
[428] *Ibid.*, Art. 37.
[429] *Ibid.*, Art. 38.
[430] *Ibid.*, Art. 40.
[431] *Ibid.*, Art. 46.
[432] *Ibid.*, Art. 47.
[433] *Ibid.*, Art. 50.

insolvency regime in the U.S. Its legal and administrative powers, along with those of the Office of the Comptroller of the Currency and the Federal Reserve Board, have often been controversial, making it a superpower for banks.[434] Still, in the U.S. where bank failures have not been unusual in this century, extraordinary powers vested in the FDIC have been justifiable and indispensable for depositors to feel secured and for the U.S. banking system to maintain its stability.

2. Pre-Insolvency

(a) Cease-and-Desist Orders:

The U.S. banking regulators adopt a most strict approach to troubled banks, whether in pre-insolvency or post-insolvency. A typical provision is the cease-and-desist order under Section 1818 of the Bank Act. This authorises regulators to instruct banks to prevent further deterioration of viability and to restructure problematic management. Section 1818 allows primary regulators to require officers and directors to cease unsound and unsafe practices and to remedy any situation which violates laws and regulations.[435] It also authorises regulators to remove those who allegedly conducted any activities in violation of laws and regulations.[436] Moreover, if directors and officers fail to remedy the situation, regulators will charge them with a civil money penalty under Section 1818(i).

The legal ground for regulators to issue the cease-and-desist order is provided in Section 1818(b); the order will be issued to a bank which engages in unsafe and unsound practices, or violates laws and regulations. In the absence of definitive standards for what are unsafe and unsound business practices, it has been a crucial matter to judge what kind of behaviour and acts

[434] Swire, *supra* note 2.
[435] 12 U.S.C.A. s. 1818(b).
[436] *Ibid.*, s. 1818(e).

will constitute unsafe and unsound business practices. The courts have vaguely defined these by stating the following to supplement the statutory silence:

> ...generally viewed as a conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholders...;[437] or
> ...practices which threaten bank solvency by improperly dissipating its assets, thereby weakening its financial stability and undermining interests and confidences of depositors."[438]

Based on these standards, the definition of "unsafe and unsound business practices" has been more firmly established by numerous court rulings. In summary, a bank will be considered to be unsound and unsafe if it operates in the following ways: (i) inadequacy of capital and reserves, (ii) poor quality loans, (iii) inadequate loan valuation reserves, (iv) inadequate provision for liquidity, (v) inadequate routine and policy controls, (vi) operating losses or low earnings, (vii) hazardous lending and collection practices, or (viii) any violation of laws and regulations.[439] In addition, typical violations of laws are those of insider lending restrictions and affiliated transaction restrictions.[440] These also warrant regulators to issue a cease-and-desist order.

Affirmative action stipulated under cease-and-desist orders will vary in each case and be decided through negotiation and agreement between regulators and the bank.[441] Failing that, the FDIC decides, based on proposals by a party or on recommendation by an administrative law judge.[442] Such an order is aimed at improving a specific area of practice and thus contains several clauses variously tailored to each situation.

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[437] *Greene County Bank* v. *FDIC*, C.A. 8, 1996, 92 F.3d 633. The same definition was used by the OCC in the case of *First National Bank of Eden* v. *Department of the Treasury*. 568 F.2d. 610 (8th Cir. 1978). Also, Carol Galbraith & Joseph Seidel, "The FDIC vs. Imprudent Banking Officials: The Enforcement Apparatus" (1987) 104 *Banking Law Journal* 92 at 29.
[438] *Simpson* v. *Office of Thrift Supervision*, C.A. 9, 1994, 29 F.3d 1418, 130 L.Ed.2d 1064.
[439] Galbraith & Seidel, *supra* note 437 at 7.
[440] *Federal Reserve Act*, 12 U.S.C.A. s. 23 (A), (B)(1987); *Federal Deposit Insurance Act*, 12 U.S.C.A. s. 1813(j)(1989).

Typical remedial actions are: (1) the *Capital* clause for improving capital adequacy through stock sales, cash contributions, the collection of written-off assets, or the reduction of classified items;[443] (2) the *Disclosure* clause for selling new securities and disclosing its securities sales condition, (3) the *Cash-Dividend* clause for suspending payment of cash dividends; (4) the *Additional Credit* clause for temporarily refraining from granting additional credits; (5) the *Lending Policies* clause for establishing a written lending policy; (6) the *Loan Loss* clause for establishing loan loss reserves; (7) the *Expense / Profitability* clause for implementing a plan to control overhead and expenses; (8) the Violation of Law clause for correcting all violations of state or federal laws; and (9) the *Liquidity and Funds Management* clause for establishing its policy regarding liquidity and funds management.[444]

The cease-and-desist order can also demand a bank to meet such requirements within a specific time period. If directors and officers fail to fulfill such a requirement and agreement, civil penalties can be assessed on them in their individual capacities under Section 1818(i).[445]

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[441] Galbraith & Seidel, *supra* note 437 at 7.

[442] *Ibid.*

[443] Besides this capital clause by a cease and desist order, or prompt corrective action, the primary regulators are authorised to issue a Capital Directive under 12 U.S.C.A. s. 3907. It states that:

> the appropriate Federal banking agency may issue a directive to a banking institution that fails to maintain capital at or above its required level.

[444] Galbraith & Seidel, *supra* note 437 at 8-9. The author continued this list as follows; *Diclosure* clause, *Progress Report* clause, *Routine and Control* clause, *Call Report* clause, *Management or Consultant Fee* clause.

[445] *Ibid.* at 6. Also, 12 U.S.C.A. s. 1818(i). According to this provision, there are three categories for assessing a civil penalty for violation of law or regulation or final order. As summarised, a First Tier penalty is applicable to any institution and affiliated party which (a) violates law and regulation, (b) violates any final order, (c) violates any required condition and written agreements between banking agencies and the institution. The fine for a First Tier penalty is $5,000. A Second Tier penalty will be imposed against an institution and affiliated parties which (a) recklessly engaged in unsafe and unsound practices in conducting the affairs of the institution, or (b) breached any fiduciary duty. A Second Tier category fine is $25,000. Any institution and affiliated parties which knowingly committed above mentioned misconduct, classified in First Tier and Second Tier penalties, will receive a Third Tier penalty. The fine of the Third Tier category is not more than $1,000,000., for each day.

(b) Prompt Corrective Action:

There is a similar but equally significant provision granting regulators another remedial action. That is the so-called prompt corrective action, under Section 1831o ("the PCA").[446] The significance of the PCA's framework is that the insolvency criteria for banks entirely depends on the capital condition of each bank. Based on their capital category, regulators will take early and decisive action against troubled banks. However, unlike a cease-and-desist order, various remedial actions and restrictions under the PCA are only aimed at improving capital levels, not at improving other solvency issues. Furthermore, restrictive intensity will be increased as a bank moves to lower capital categories. In this sense, the procedures under Section 1831o are similar in function to those in the *Guide to Intervention for Federal Financial Institutions*, which are used as an early intervention system in Canada. Compared to the *Guide*, the remedial orders and procedures under the PCA are more specific and clearly articulated in the written provisions in U.S. laws. The following is a summary of the procedures and remedial actions under the PCA.

Under the PCA framework, each bank is classified into one of five capital categories: well capitalised, adequately capitalised, undercapitalised, significantly undercapitalised, and critically undercapitalised.[447] Different remedial orders and restrictions are applied to each category and the restrictive intensity will be increased as banks move from undercapitalised to the critically undercapitalised category.[448]

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[446] Lawrence G. Baxter, "Administrative and Judicial Review of Prompt Corrective Action Decision by the Federal Banking Regulations" (1994) 7 *Administrative Law Journal* 505 at 4. The Prompt Corrective Action was introduced as part of the package in the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Responding to the chaotic situation caused by S&L failures in the 1980s, Congress authorised the regulators to hold and exercise extraordinary enforcement powers.

[447] 12 U.S.C.A. s. 1831o(b)(1) provides the definition of a capital category. For example, a bank will be classified as "well capitalized" if it significantly exceeds the required minimum level for each relevant capital measure, and if a bank meets the required minimum level, the bank will be classified as adequately capitalized.

A bank will be identified as undercapitalized, if it "fails to meet the required minimum level" of capital adequacy. In such a case, the bank will be required to take actions: (i) accepting close monitoring by the federal banking agency;[449] (ii) submitting a capital restoration plan;[450] (iii) restricting assets growth;[451] (iv) obtaining prior approval for acquisition, branching, and new lines of business;[452] and (v) having discretionary safeguards.[453]

A bank will be classified as significantly undercapitalized, when its capital level is "significantly below the required minimum level" of capital adequacy. A bank in this capital category will be required to take more drastic remedial actions such as: (i) selling shares, including voting shares, or sales of obligations held by the institution;[454] (ii) being acquired by another institution;[455] (iii) restricting transactions with affiliates;[456] (iv) restricting interest rate payments;[457] (v) restructuring asset growth;[458] (vi) restricting certain business activities;[459] and, (vii) improving management.[460]

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[448] Baxster, *supra* note 446 at 8. Also, 12 U.S.C.A. s. 1831o (d), (e), (f), (g), (h) specify such remedial actions for each of these different capital categories.
[449] 12 U.S.C.A. s. 1831o(e)(1).
[450] *Ibid.* s. 1831o(e)(2) provides detailed rules about how to draft and implement a plan. For example, a 1831o(e)(2)(C) requires that: (i) a plan should be based on realistic assumptions and likely to succeed in restoring the institution's capital; (ii) a plan should not increase credit risk, interest rate risk, and other types of risk to which the institution is exposed; and, (iii) each company having control of the institution should guarantee the institution's compliance with a plan and provide assurances of performance.
[451] *Ibid.*, s. 1831o(e)(3).
[452] *Ibid.*, s. 1831o(e)(4).
[453] *Ibid.*, s. 1831o(e)(5). This provision grants the federal banking agency to take actions if it is necessary for the purpose of prompt corrective action.
[454] *Ibid.*, s. 1831o(f)(2)(A)(i).
[455] *Ibid.*, s. 1831o(f)(2)(A)(ii).
[456] *Ibid.*, s. 1831o(f)(2)(B).
[457] *Ibid.*, s. 1831o(f)(2)(C).
[458] *Ibid.*, s. 1831o(f)(2)(D).
[459] *Ibid.*, s. 1831o(f)(2)(E).
[460] *Ibid.*, s. 1831o(f)(2)(F) requires a bank to take one or more following actions; (i) new election of directors; (ii) dismissal of directors or senior executive officers; and, (iii) employment of qualified senior executive officers.

Once a bank capital is identified as critically low, which is below two percent to risk-weighted asset value, regulators can declare that bank insolvent and appoint a receiver within ninety days.[461]

The capital adequacy level has increasingly become a most dependable indicator, revealing how viable and healthy an institution should be. It serves as a distinctive criterion which tells regulators when troubled banks should suspend operations. Thus, such measures represents the current latitude which banking regulators possess to aggressively wind up the affairs of troubled banks in their early stages.

3. Regulator's Discretion and Legal Grounds for Insolvency Declaration

As seen in the previous section, the declaration of insolvency will be warranted by the regulators as an unsuccessful result of a cease-and-desist order or the PCA. Besides these provisions, the statute provides specific criteria for regulators to decide when a bank is insolvent and when receivership control should begin. For example, Section 1821(b)(5) articulates the grounds for appointing a receiver:

> (A) Insolvency in that the assets of the institution are less than the institution's obligations to its creditors and others including members of the institutions.
> (B) Substantial dissipation of asset or earnings to due to (i) any violation of any law or regulation; or (ii) any unsafe or unsound practice
> (C) An unsafe or unsound condition to transact business, including substantially insufficient capital or otherwise.
> (D) Any willful violation of a cease-and-desist order which has become final.
> (E) Any concealment of books, papers, records or assets of the institution or any refusal to submit books, papers, records, or affairs of the institution for inspection to any examiner....
> (F) The likelihood that the institution will not be able to meet the demands of its depositors or pay its obligations in the normal course of business.
> (G) The incurrence or likely incurrence of losses by the institution that will deplete all or substantially all of its capital with no reasonable prospect for replenishment of the capital of the institution with federal assistance.

[461] *Ibid.* s. 1831o(h)(3).

> (H) Any violation of any law or regulation, or an unsafe or unsound practice or condition which is likely to cause insolvency or substantial dissipation of assets or earnings, or is likely to weaken the condition of the institution or otherwise seriously prejudice the interest of its depositors.

Still these statutory criteria leave room for regulators to make the ultimate decision: is the bank insolvent?

Thus, numerous case laws indicate that while statutory provisions are "liberally constructed," it is just and equitable for regulators to exercise discretionary power to make a final judgment on institution solvency.[462] For example, in the case of *U.S. Savings. Bank v. Morgenthau,*[463] regarding the issue of when a bank should be deemed solvent or insolvent, a court stated that it is a "matter of judgment and discretion as regards [the] right of the Comptroller of Currency."[464] Likewise, in *Re: Conservatorship of Wellsville,*[465] the court ruled,

> ... "insolvency" within the meaning of Section 191 of this title encompasses both inability of bank to meet its obligations as they mature and closing of its doors; status of insolvency is not determined by theoretical state of balance sheet which may include assets whose actual value is far less at which they are carried on its books; a bank to be "solvent" must own assets in an amount at lease equal to its liabilities.

Case law further states that such discretionary powers delegated to the regulators is intended to protect depositor and creditor rights by "promot[ing] speedy winding up of affairs of the bank."[466]

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[462] *Grindley* v. *First Nat. Bank-Detroit,* D.CA. Mich. 1937, 87 F.2d 110. Also, *Cadle* v. *Banker*, Ala. 1874, 20 Wall. 650, 22 L.Ed. 448. In this case, the court concluded "the power vested in the comptroller to appoint receiver is discretionary, and his action in making an appointment is final and not subject to attack by debtors of the bank."

[463] *U.S. Sav. Bank* v. *Morgenthau*, 1936, 85 F.2d 811, 66.

[464] Furthermore, the "theoretical state of [a] balance sheet" has been denied by several courts. Rather, insolvency in Section 191 and Section 192 "encompasses inability to met its obligations as they mature and closing its doors." See, "*Smith," supra* note 328.

[465] *Re: Conservatorship of Wellsville,* Pa., C.A.Pa.1969 407 F.2d 223.

[466] *Davidson* v. *Whitfield*, 1940 99 P. 2d 156, 186 Okl. 536.

This permissive attitude in the judicial authority toward the administrative discretion of regulators might be less clearly perceived in Canada. However, this is becoming more common in Canada. For while it could hardly be practical to set up numerical standards for solvency nowadays, regulators will be more likely to deal with insolvent banks at earlier stages. Thus, many cases might warrant regulators to exercise greater discretionary power over insolvency issues under the justification of protecting the public interest.

4. Post-Insolvency

(a) Introduction:

There are numerous differences in legislative structures between Canada and the U.S. when it comes the to post-insolvency stage. For example, unlike its Canadian counterpart, in the U.S. the FDIC exclusively undertakes all administrative and legal procedures, whether in receivership or dissolution. Moreover, FDIC powers as a receiver, conservator, and liquidator are not subject to any other governmental authority. In fact, in the U.S., once a bank is declared insolvent officially, the FDIC will be appointed as a sole receiver for commencing restructuring plans or undertaking liquidation. Restructuring plans include the P&A transaction, the open bank scheme, or the bridge bank operation. It is a significant difference that such extraordinary legal powers are concentrated solely in the FDIC in the U.S.; in Canada, those numerous tasks are divided among three entities-the OSFI, the CDIC, and the courts.

On the other hand, FDIC receivership is very similar to its Canadian counterpart. That is to say, it is the primary purpose of FDIC receiverships to preserve the assets and properties of the insolvent bank. In order to fulfill this purpose, the FDIC will carry out numerous tasks,

including: succeeding to all rights, powers, and privileges, and assets of the institution;[467] performing all the powers of shareholders, the directors, and officers, by limiting their functions to the extent provided by the FDIC;[468] collecting all obligations and monies due the institution;[469] and paying valid obligations within certain limitations.[470]

(b) P&A Transaction:[471]

While Section 1823 (c)(4)(A) requires the FDIC to choose the least expensive solution to disposing of banks in each situation, in most cases the P&A transaction is a more desirable solution than liquidation. As in Canada, the FDIC will provide financial assistance to an acquiring bank for equalising the value of assets and liabilities in the P&A transaction.[472] FDIC's financial assistance for the P&A transaction is separated from its receivership capacity, at least at the theoretical level. This is the so-called corporate capacity of the FDIC.[473]

The FDIC's authority for providing financial assistance for amalgamation and merger is provided in Section 1821(d)(3)(G) and Section 1823(c). First, Section 1821 provides that the FDIC will merge an insolvent institution with a healthy institution by transferring all liabilities and all or part of the assets. Second, Section 1823 (c)(2)(A) states that, in order to facilitate such

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[467] *Ibid.*, s. 1821 (d)(3)(A).
[468] *Ibid.*, s. 1821(d)(3)(B), and (C).
[469] *Ibid.*, s. 1821(d)(3)(B)(iii).
[470] *Ibid.*, s. 1821(d)(3)(H).
[471] There is another similar method, that is the so-called modified P & A transaction. See, Rosenberg & Ronald, *supra* note 338 at 8-9. As mentioned above, the P&A transaction gave almost a 100% deposit insurance guarantee to all depositors and creditors in the past. Thus, such an excessively protective environment became a target of criticism in recent years: it damages the function of the market mechanism since depositor and creditor will not have any incentive to monitor the institution because of the 100% guaranteed deposit; such guarantees, supported by the FDIC fund, will burden FDIC finance. Thus, under the modified P &A transaction, the liabilities of the uninsured depositors and of all creditors will not be transferred to the acquiring banks.
[472] Rosenberg & Given, *supra* note 338 at 21.

amalgamation or transfer of assets and liabilities, the FDIC will offer financial assistance to the acquiring banks. Such assistance will take the form of (i) purchasing any assets, or assuming any liabilities, (ii) making loans or contributions, and depositing or purchasing securities of an acquiring bank, or, (iii) guaranteeing the acquiring institution against losses by reason of mergers or consolidation.[474] Thus, it is common in all three countries that the compensation to an acquiring bank takes the form of purchasing its assets, making loans or making contributions.

(c)Open Bank Assistance:

The FDIC is also authorised to conduct open bank assistance under Section 1823(c).[475] Open bank assistance is a measure by which the FDIC, along with other healthy financial institutions and private investors, provide financial assistance to failed banks. Under open bank assistance, a failed bank will not come under receivership control, unlike the P&A transaction. Instead, it will be allowed to continue its business with recapitalisation assistance from the FDIC and others, until it is amalgamated into another institution.[476] Thus, the FDIC will not be responsible for transferring assets or liabilities to another bank, for disposing low quality assets, or compensating an acquiring bank for its loss.

In order to recapitalise a failed bank, both the FDIC and private investors will subscribe for the stock issued by the failed bank. The shares subscribed by the FDIC and others will also be merged into those of the acquiring bank when the bank is merged into the acquiring bank. Thus, with this merger, FDIC's recovery for its capital contribution will be guaranteed by the acquiring bank. In addition, the FDIC will be able to recover its costs by exchanging or selling those

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[473] Peter G. Weinstocks, "Directors and Officers of Failing Banks: Pitfalls and Precautions"(1989) 106 *Banking Law Journal* 434 at 7-8.
[474] 12 U.S.C.A. s. 1823(c)(2)(A).
[475] Rosenberg & Given, *supra* note 338 at 9.

shares to outside parties.[477] Furthermore, there are other merits for granting the open bank assistance: (i) it provides a less expensive alternative to the P&A transaction; (ii) it divides the financial burden for rescuing a bank between the FDIC and private investors, and (iii) private banks assume the costly functions, such as asset management and disposition of non-performing loans.[478] This method was adopted in the case of the Bank of Oklahoma in 1986, and the Continental Illinois National Bank and Trust Company of Chicago in 1985.[479]

Governmental funding for insolvent banks, in the form of open bank assistance, may be an exceptional method in legislative policy for bank insolvency; in most cases, it emphasises that any insolvent bank should suspend its operations or even should be terminated at an earlier time. Canadian legislation, strictly adhering to this basic policy, does not allow any methods similar to open bank assistance. Furthermore, open bank assistance needs substantial capital contributions from private investors, including other banks. For this reason, this method might not be a practical solution for Japanese banks. Evidently, there is no provision in Japanese law equivalent to the open bank assistance.

The P&A transaction and open bank assistance strategy both necessitate FDIC expenditure. The law limits certain circumstances under which the FDIC is authorised to provide such financial assistance. Section 1823(c) states that such assistance should (i) prevent an institution's default, (ii) restore a closed insured bank to normal operations, or (iii) reduce the risk to the FDIC, otherwise severe financial conditions would threaten the stability of other institutions which

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[476] Steven A.Weiss & Kenneth E. Kraus, "D'Oench Protection for Private Institutions Assisting the FDIC: a Necessary Component of the Thrift and Bank Bailout"(1991) 108 *Banking Law Journal* 256 at 16.
[477] Rosenberg & Given, *supra* note 338 at 12.
[478] Weiss & Kraus, *supra* note 476 at 2.
[479] Rosenberg & Given, *supra* note 338 at 12.

possess significant financial resources. Furthermore, as a factor to be considered for the assistance, Section 1823(c)(4)(A) provides that the cost for either the P&A transaction or open bank assistance should not exceed the cost of liquidation. However, such a limitation is not applicable when "the continued operation of the institution is essential to provide adequate depository services in its community."[480]

(d) Bridge Bank Scheme:

A bridge bank operation is an emergency, alternative measure to liquidation, the P&A transaction, and open bank assistance. It is organised as a government-run national bank when a bank is in default or in danger of default.[481] Suffice it to say that this is the origin of the "bridge bank" scheme in Japanese legislation. Thus, the similarity between Japanese and U.S. laws can be found in almost every aspect in this bridge bank scheme. First, the legal ground for the OCC to charter a bridge bank are articulated in 12 U.S.C. s.1821 (n)(2)(A) as follows: (i) operating national banks will save the cost of liquidation, including paying insured accounts; (ii) the continued operation is essential to provide adequate banking services to the community; or, (iii) the continued operation by a bridge bank is in the best interests of the depositors of the institution.[482]

Furthermore, as specifically articulated, the purpose of the bridge bank is to provide continuous banking services to the community, especially for "credit-worthy farmers, [owners of] small business, and households."[483]

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[480] 12 U.S.C.A. s. 1823 (C)(4)(A).
[481] 12 U.S.C.A. s. 1821(n).
[482] *Ibid.*, s 1821(n)(2)(A).

The bridge bank operates in the following manner. Upon incorporation, the bridge bank will assume the bank's liabilities, including deposit liabilities and other liabilities associated with any trust business.[484] It also purchases the assets of the defaulted bank [485] and performs temporary functions.[486] While carrying out contingent operations, the FDIC attempts to (i) find the acquiring banks,[487] or (ii) re-privatise it through issuing new stocks for sales.[488] The operation of a bridge bank is limited to two years. Within these two years, the status of the bridge bank will be terminated, and the FDIC will commence necessary procedure, for liquidating the bridge bank.

4. FDIC Cost Recovery

(a) D'Oench Doctrine, Cross Guarantee Provision:

The FDIC is a self-financing corporation, with annual assessment fees as its main source of funds.[489] However, FDIC expenditure is also enormous; it has to pay off all depositors and secured creditors by liquidation, as well as compensate losses for acquiring banks under any assisted merger scheme. Worse, recovery from liquidation does not often cover all costs for paying off all liabilities; normally a failed bank carries poor quality assets, including substandard or non-performing loans, or securities backed by illiquid or devalued real estate. Thus, for precluding any depletion of FDIC funds, it is significantly important that the FDIC is provided with lawful cost recovery methods. Otherwise, the FDIC would not be able to maximise realisation of any failed bank's assets.

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[483] *Ibid.*, s 1821(n)(3)(B).
[484] *Ibid.*, s 1821(n)(1)(B)(ii).
[485] *Ibid.*, s 1821(n)(1)(B)(iii).
[486] *Ibid.* s.1821(n)(1)(B)(iv).
[487] *Ibid.* s. 1821(n)(7) and (10).
[488] *Ibid.* s.1821(n)(5).
[489] Estey Report, *supra* note 19 at 387.

One typical provision contributing to FDIC fund maximisation can be found in Section 1823(e), the so- called D'Oench doctrine.[490] This gives legal enforcement powers to the FDIC in order to pass recovery costs onto any affiliated parties or borrower of a failed bank. To be more specific, under the regime of the D'Oench doctrine, any secret or unrecorded agreement between borrowers and the bank will be void.[491] Thus, the FDIC will be able to realise such value on assets as is close to book value at liquidation. Also, the FDIC will be able to estimate the value of assets of the failed bank more accurately when they conduct the P&A transaction. Furthermore, the D'Oench doctrine does more than protect FDIC funds; it is also significantly important to facilitate the P&A transaction for a failed bank.[492] For example, in order to implement the P&A transaction, it is necessary for the FDIC to attract a candidate bank for purchasing the assets of the bank. In other words, the FDIC has to convince private institutions involved in the assistance that such a transaction with the FDIC is safe, with no risk of loss. For this reason, the value of the assets of the failed bank, which will be priced on estimation of the balance sheet, should be accurate. To put it another way, the validity of the estimated asset value will be suspicious if there are any secret or oral, unrecorded agreements. Then, the book value of the loan assets will not be accountable at all.[493] The amount of losses to be incurred to an accruing bank, through realisation on loans, will be unpredictable, and thus will make the transaction less attractive to an

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[490] Kevin A. Palmer, "The D'Oench Doctrine: a Proposal for Reform" (1991) 108, *Banking Law Journal* 565 at 1.

[491] Weiss and Kraus, *supra* note 476 at 1-2. The name of the doctrine originated with the case of D'Oench Dhume & Co. v. FDIC in 1941(315 U.S. 447, 62 S.Ct. 676, L.Ed.956, 1942). D'Oench, Dhume & Co. was a securities firm which sold bonds to the Belleville Bank and Trust Co. When the bond was defaulted, the D'Oench firm and the bank made an agreement: in order to cover the loss of the defaulted bond, the firm executed a note payable to the bank, but the note would be enforced by the same bank. When the FDIC acquired this note as a receiver for the insolvent Belleville bank, the D' Oench firm attempted to defeat the claim of the FDIC on the note. Their defence was based on a secret agreement between the bank and the D'Oench firm, which was not shown in any records. The U.S. Supreme Court affirmed FDIC immunity from any defense based on any secret agreement and established this as the D'Oench Doctrine. The passage of the Federal Deposit Insurance Act of 1950s codified this doctrine in 12 U.S.C.A., s. 1821 (e).

[492] *Ibid.* at 10-13.

[493] *Ibid.*

acquirer. Thus, it has been essential for the FDIC to accurately estimate the value of failed banks by collecting all eligible obligations payable to the bank under D'Oench protection.

By the cross-guarantee provision in Section 1815(e), the FDIC will be allowed to assess any affiliated company of a failed bank, if disposing of the failed bank accrues any loss to the FDIC.[494] However, as noted, this assessment could result in causing another bank failure. As a matter of fact, in the past an institution affiliated with a failed bank became insolvent immediately after payment of the assessment fee.[495] Thus, sometimes the reform or modification of this provision has been discussed.[496]

The above two legal frameworks of the D'Oench doctrine and the cross-guarantee provision are structured in favour of the FDIC and satisfactorily justified in the name of protection of depositors and FDIC funds. However, in the context of Japan and Canada, this would be regarded as too strict and even unjust to borrowers and affiliated banks. Given that it would even threaten the fundamental rights of private corporations, it remains unthinkable for Japan and Canada to adopt similar legal measures as cost recovery methods.

(b) Liability of Directors and Officers:

The other technique which is indispensable for maximisation of FDIC cost recovery is the strict liability regime of bank directors and officers. Namely, the "civil money penalty" in Section 1818(i) will be imposed on them in their individual capacity; and the FDIC will bring civil

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[494] William F. Sheehan and Celestine R. Mcconvile, "FIRREA's Cross Guarantee Provisions, Solvent Banks and the Fifth Amendment"(1995) 112 *Banking Law Journal* 574 at 1. The passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 introduced the cross-guarantee provision of s.1815(e). This provision authorises the FDIC to charge one bank which is affiliated to a failed bank in the case of any losses when the FDIC acquires the bank. At a time of unceasing series of bank failure in the 1980s, the regulators "sought to rope in entities affiliated with the failed (or ailing) bank either to avert a failure or to spread its cost."

[495] *Ibid.* at 1-3. For example, Main National Bank was declared insolvent by the OCC immediately after the assessment by the FDIC. It was mostly because Main National Bank was forced to compensate for the loss to the FDIC incurred by disposing of the failed Bank of New England, a sister bank of Main National Bank.

actions against them for negligence from breach of their duty of care. In other words, in pre-insolvency, bank officers and directors in the United States will be forced to pay civil money penalties on the ground that an institution violates laws and regulations, and the final cease-and-desist order. Furthermore, after the bank is declared insolvent, the FDIC will be authorised to resort to civil action in order to recover monetary damages from the officials of a failed bank.[497] The FDIC, as a plaintiff, has a right to bring lawsuits against former officers and directors of the failed bank. A most typical claim alleged by the FDIC is common law negligence. The FDIC will allege that directors and officers of the failed bank are liable for their negligence in management and supervision, especially in its lending practice.[498] Since there is no specific definition of negligence of "duty of care" in the statutes, it depends on the agency's interpretation of the statutes, regulations and cases.[499] However, the non-statutory definition of "duty of care" is significantly different between the U.S. and Canada. As noted, Canadian case laws interpret a director's duty of care in a much narrower context, limiting liability of directors and officers. In stark contrast, in the U.S., the definition of duty of care is more broadly interpreted.[500] Thus, any actions and behaviours which might be relevant to the cause of insolvency will fall under "negligence of management." Thus, such a strict liability structure on bank directors and officers makes them vulnerable to civil actions brought by the FDIC. The following is a list of causes of action, which is likely to be alleged by the FDIC.

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[496] *Ibid.*

[497] Galbraith, *supra* note 437 at 18-19. The FDIC has enormous resources in terms of investigation, as well as litigation budgets for civil law suits against bank officers and directors. The author describes such considerable litigation power as follows:

> ...[t]he FDIC hires highly paid lawyers from private law firms to litigate suits involving closed banks...[and] the threat of expensive litigation of immense claims ranging from half a million to hundreds of millions of dollars in damages can be formidable, regardless of whether defendants think that they have any liability or any liability insurance.

[498] *Ibid.*

[499] *Ibid.*

1) failure to adhere to applicable laws and regulations,
2) failure to heed warnings of bank supervisory authorities,
3) failure on the part of directors to exercise adequate supervision over the bank's officers and employees,
4) failure to heed warnings of substantial and continuing overdrafts,
5) failure to properly supervise operating expenses,
6) failure to properly perfect all security interests,
7) failure to properly supervise loan disbursals,
8) failure to scrutinize insider transactions,
9) failure to adequately supervise the purchase of leases,
10) extensions of credit in violation of the bank's own written loan policy,
11) failure to utilize acceptable accounting methods,
12) failure to establish adequate debtor repayment programs,
13) failure to establish or follow adequate real estate appraisal procedures in violation of law,
14) failure to establish or follow adequate collection procedures,
15) permitting conflicts of interest to the detriment of the bank,
16) failure to properly manage bank liquidity,
17) providing more than 100 % financing for speculative ventures,
18) extensions of credit in excess of the bank's legal lending limit,
19) permitting unsafe and unsound concentration in energy related lending,
20) extension of credit to borrowers who were not creditworthy or were known to be in financial difficulty,
21) extension of credit based on inadequate or inaccurate information concerning the financial condition of prospective borrowers,
22) extensions of credit supported by inadequate or wrongly valued collateral security,
23) extension of credit without required internal approvals,
24) extension of credit outside the normal trade area of bank,
25) permitting unsafe and unsound concentration of credit,
26) misstatements of financial reports and statements of condition,
27) payment of imprudent cash bonuses or dividends,
28) failure to regularly attend board meetings, and
29) failure to supervise, manage, conduct, and direct the business and affairs of the bank to insure compliance with the law, the bylaws of the bank, and safe, sound, prudent principle of banking.[501]

The numerous civil suits against former bank officers and directors that are initiated by the U.S. regulators have no counterpart in bank insolvency laws in Canada and Japan.

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[500] Ramirez, *supra* note 379 at 643. The author stated that the U.S. law courts differentiated duties of bank directors and duties of directors of ordinary corporations, since the banking business involves custody of public funds. Thus, courts has long set higher standards for duty of care for directors of banks.
[501] Galbraith, *supra* note 437 at 18-19.

Conclusion

This thesis has aimed at identifying problems in the Japanese banking system, and highlighting problematic aspects of the bank regulatory regime, which have made the Japanese banking system inefficient and unproductive, compared to its Canadian counterpart. The inquiry started with a question: What is the primary purpose of banking regulations common to the two countries? One commonality found was to ensure the stability of its banking system because the banking business is especially susceptible to insolvency risks. However, the interpretation of "stability" turns out to be significantly different in both countries, and this affects the direction of the development of bank legislation in both countries. In Canada, financial stability gives exclusive priority to ensuring the security of depositor funds over the rights of corporations.

On the other hand, "financial stability" in the Japanese context is more focused on stable growth in profit earnings in corporate sectors, which successfully contributes to growth of the national economy. Thus, most competitive factors and market mechanisms were eliminated and fund allocation was strictly controlled by laws and administrative orders. To stabilise the Japanese financial system, relationships between the Ministry of Finance and the banks, and between banks and corporations, have been increasingly interdependent, creating a unique mechanism for the government to preserve its controlling power over corporate sectors and for corporate sectors to secure their interests. The negative consequences of this system are: (i) banks have increased excessive dependency on their stock holdings for their profit earnings and for keeping the requirement of capital adequacy; (ii) financial products offered by banks are less diversified, because the introduction of innovative financial instruments for corporate lending and for individual assets management were not encouraged, because this would cause an excessive competition among financial sectors and thus risk financial stability; and, (iii) for the same

reason, strict governmental control by legal or administrative rules prevented reorganisation in financial sectors, through mergers and consolidations which were necessary to respond to the changing marketplace. This resulted in failure to consider the right of depositors, or the right of the general public to benefit from higher quality financial services and products. In other words, the personal sector in Japan has never been valued as much as the business sectors, but only regarded as a "savings sector," whose resources of funds were utilised to finance governmental fiscal and corporate activities.[502]

This aspect of Japanese banking system is in stark contrast with its Canadian counterpart. As noted, this century in Canada has witnessed a drastic evolution of the regulatory regime governing financial institutions, which was responsive to more diversified and sophisticated consumer demands. In the course of such developments in the financial system, the policy-makers have been most concerned with increasing competition among financial sectors in order to make the financial system efficient and to ensure its solvency; the ultimate purpose has been to provide the highest quality of financial products and services to domestic users, as well as to make Canadian financial sectors more competitive in global markets. Consequently, such governmental initiatives and sophisticated consumer demands have successfully transformed Canadian financial industries into a most desirable model in the world nowadays. The Canadian banking system is acclaimed as "one of the true success stories in Canadian history,"[503] and has obtained the reputation as "the strongest banking system among G7 nations."[504]

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[502] The post office in Japan is also a national savings institution run by the government, as in Great Britain. It is considered to be one of the largest depositories in terms of asset size in the world, 1/3 of which based in the personal sectors. The primary purpose of the institution is somewhat similar to credit cooperatives in Canada or Thrifts in the U.S.: that is, encouraging savings in the personal sector, especially for workers and to social welfare. However, the postal savings system also plays a key role in financing government fiscal activities through the Trust Fund Bureau and for operating the Postal Life Insurance Annuity and Postal Annuity System. Suzuki, *supra* note 41 at 288.

[503] Christopher Guly, "Jim Peterson: Banking is one of the true success story, but..." *Canadian Banker* 105:2 (March 1998) 27 at 29.

[504] See, text-accompanying note 30 at 8.

Now, how are banking systems and bank regulatory regimes in the two countries expected to evolve in the next decade?

Epilogue: Future of Banking System in Japan and Canada:

There is no perfect model for a financial system that is applicable to all countries, since each country has its unique characteristics of development. As the Task Forces on the Future of Canadian Financial Services Sector states:

> ...[n]o single regulatory model has emerged as the ideal approach. This is partly due to the fact that the evolution of the financial services has taken place in quite different ways from country to country. Government must adopt the regulatory model that best serves their country."[505]

Nevertheless, several aspects can be identified as common to both countries, in terms of their fundamental policies in seeking a most desirable regulatory regime which is suitable for the country's setting.

First of all, a primary concern of regulatory reform is that it should enhance public interest; in other words, both corporate customers and individual users should benefit from the highest possible quality of financial services and products.[506] In order for financial institutions to be motivated to offer such highly-valued products, in terms of price and quality, a regulatory regime

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[505] Canada, Department of Finance, *Change Challenge Opportunity: Competition, Competitiveness and the Public Interest* (Ottawa: Task Force on the Future of Canadian Financial Services Sector, 1998) at 67 [hereinafter "Competition"].

[506] "Minister of Finance Announces a New Policy Framework for Canada's Financial Services Sector"(June 1999), Online: Department of Finance Canada Homepage <http://www.fin.gc.ca/ newse99/99-059e.html> (data accessed: 30 September 1999). Also, "Summary of the Interim Report of the First Committee of the Financial System Council" (July 1999), Online: Ministry of Finance Homepage <http:wwww.mof.jp/english /system/fs001a.htm> (data accessed: 6 October 1999) [hereinafter "Interim Report"].

should be structured to increase competition among domestic financial sectors.[507] This implies that legal restrictions on business activities of financial institutions, especially those impeding innovation in financial products and services, should be removed. As a matter of fact, in order for institutions to survive the severe competition, they have to design and distribute financial products and services in a way that will cater to all types of customer demands.

Second, under heightened pressures of severe competition, a trend for strategic alliances, mergers, and consolidated "in-pillar"[508] and "cross-pillar"[509] will also be increased. In addition, aggressive entries of foreign financial institutions become a more significant factor for enhancing competition and catering to consumer demands, which have become more diversified and sophisticated. Besides being a competitive force in domestic markets, foreign financial institutions often bring advanced technology and skills, which domestic institutions may lack, and thus foreign institutions will contribute to development and innovation in domestic markets.[510] Again, as foreign institutions have increasingly strengthened their dominant status in certain areas of financial services, it is inevitable that domestic financial sectors will be consolidated and will strengthen their competitive advantages in order for them to remain competitive against foreign institutions.

All the above-mentioned aspects are common to the two countries' regulatory policy for the future, but a closer look shows significant differences in details. This is understandable, given

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[507] *Ibid.* "Interim Report," at para. 1. Also, "Competition," *supra* note 505 at 95.
[508] "Competition," *supra* note 505 at 30.
[509] *Ibid.*
[510] *Ibid.* at 27 and 55. For sources of information about activities of foreign financial institutions in Japan, see, Masahiko Ishizuka, "Brave New World" *Asian Business* 162:24 (January 1998); R. Taggart Murphy, "Japan's Big Bang" *Fortune* 136:12 (December 1997); Yoko Shibata, "Taking the Shackles Off Japanese Companies' Finance Departments" *Global Finance* 11:6 (June 1997); Margaret Price "Japan Welcoming Foreign Managers," *Pension and Investments* 25:13 (June 1997); Anthony Rowley, "Preparing for the Big Bang" *The Banker* 147:855 (May 1997); and, Sam Jameson, "Scandal Hurts Big Bang Reform" *Asian Business* 33:9 (September 1997).

that the two financial systems have different courses of evolution, and each system can be identified at a different stage of development. Thus, the following section will synthesise each country's regulatory policy in order to highlight differences in how both seek better financial systems for the future.

Japan

Japanese financial institutions fall far behind their Canadian counterparts in terms of developing innovative financial products and services which would more efficiently meet customer demands. As has been stated, this is due to strict legal and administrative restrictions which for a long time have prohibited financial institutions from diversifying their products and services. For example, in the U.S. and Canada, disintermediation in financial markets resulted in providing a variety of choices in financial services to corporate customers and individual users. In other words, corporate dependency on bank borrowing has been reduced since corporate sectors turned more to money and stock markets and asset-securitization for their fundraising; as well, individual users started to prefer pooled funds, such as mutual funds and pension funds for their wealth management.[511] However, in Japan, such changes, where corporate and individual customers would have to turn away from their main banks, until recently have rarely occurred.[512] Nevertheless, market development for asset-backed securities are finally encouraged by governmental initiatives, because this gives a more flexible and less expensive method for corporate finance.[513] In addition, in response to the increasingly aging population in Japan, it is imperative that individual users be given more efficient methods for wealth management, without depending only on bank savings and social welfare programs.[514] This is not only because these

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[511] *Ibid.*, Jameson at 33.
[512] *Ibid.*
[513] "Interim Report," *supra* note 506 at para. 5.
[514] *Ibid.* at para. 1.

methods will give higher returns on investment than bank savings, but also because they will reduce the governmental burden of providing social welfare programs.[515]

In the 1990s in Japan, a series of institutional failures in the financial industry made it an urgent matter to re-organise a whole sector by mergers and strategic alliances, in order to prevent further dysfunction in the financial system. In order to achieve a desirable reorganisation, an artificial separation between long-term and short-term banking needs to be eliminated, and new regulatory rules must give financial sectors more flexibility for ownership and investments.[516] One method for such elimination is, for example, to allow both types of banks, commercial banks and long term banks, to utilise various methods for fund raising; for example, ordinary banks should be allowed to issue bank debentures and encouraged to securitize their various assets to enhance capital adequacy.[517] Additionally, lines between banks, trusts, securities and the insurance business will be further blurred, as each type of institution starts to offer overlapped products and services; for example, banks have started to sell various types of investment trusts similar to mutual funds[518] and to offer general securities accounts directly;[519] and they will also be allowed to sell insurance policies in branch offices by the year 2000.[520] On the other hand, insurance companies have been allowed to engage in the banking business since October 1999,[521] and business powers for bank affiliated trust and securities subsidiaries will be expanded.[522] Competitive forces in the markets will also necessitate more closures of weaker financial institutions, and strategic alliances and mergers of financial institutions, "in-pillar" and "cross-

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[515] *Ibid.*
[516] "Financial System Reform: Toward the Early Achievement of Reform" (June 1997), Online: Ministry of Finance Homepage <htttp:www.mof.go.jp/english/big-bang/ebb32.htm>; and "Schedule for Financial System Reform" (June 1999), Online: Ministry of Finance Homepage <http//www.mof.go.jp.english/if/if004.htm> (data accessed: 6 October 1999) [hereinafter "Schedule"].
[517] *Ibid.* "Schedule" at para. 3.
[518] *Ibid.* at para. 1.
[519] *Ibid.*
[520] *Ibid.* at para. 3.
[521] *Ibid.*

pillar" will be more common. This will reduce the number of domestic banks in response to overcapacity and will grant stronger domestic institutions with greater economies of scale. As an illustration, the two largest city banks and one long-term bank announced their merger plan in August 1999.[523] This trend is expected to be followed by other institutions.[524]

Foreign financial institutions have consistently expanded their market shares in Japan by taking advantage of their advanced technology and skills in specific areas of financial business. Unlike their Canadian counterparts, an increasingly permissive regulatory regime for foreign entries into the domestic market aims at merging insolvent financial institutions with solvent ones; as well as it is expected that foreign entries will become competitive forces and will enhance innovations in the financial services and products to be offered to domestic users.[525] In other words, because neither the government nor domestic institutions can afford to rescue insolvent institutions, this has enabled foreign competitors, in many cases, to take over failed financial institutions.[526] One example is the Merrill Lynch acquisition of the failed securities corporation, Yamaichi Securities Co.[527] Foreign entries have become more of a threat to domestic competitors even in retail markets; *e.g.*, Citibank, one of the biggest commercial banks in the U.S., has planned to triple the number of private banking clients in three years.[528] In addition, there are many alliances of domestic insurance companies with, which particularly aim at taking advantage of foreign firms' advanced skills in asset and pension management.[529]

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[522] "Interim Report," *supra* note 506 at para. 3.
[523] They are Dai-Ichi Kangyo Bank Ltd., Fuji Bank Ltd., and Industrial Bank of Japan Ltd. See, Bill Spindle and Peter Landers, "Japan's Latest Megamerger Sparks Rumor Tempest" *The Globe and Mail* (23 August 1999) B7.
[524] *Ibid.*
[525] Rowley, *supra* note 510 at 63.
[526] *Ibid.*
[527] Anthony Rowley, "Merrill Thunders Into Japan" *The Banker* 148:865 (March 1998) 6 at 6.
[528] *Ibid.*
[529] Japanese insurance companies' strategic alliances with foreign institutions have been remarkably increased since deregulation in Japan's corporate pension industry. See, Margaret Price, "Pension Deregulation Gathers Stream in Japan" *Pension & Investment* 25:5 (March 1997) at 14.

Canada

Canadians have been served by their financial institutions with the highest possible quality services and products according to global standards.[530] Compared to Japanese users, both corporate and individual customers have become more sophisticated in terms of their choice of products and services; products such as asset-backed securities are common methods for corporate finance, and most individual savings go to pooled funds, such as mutual funds and pension funds, seeking higher returns on their assets than from bank deposits.[531]

Legislative policies for reforming the financial system in Canada have sought a balance between enhancing efficiency and ensuring solvency. It is recognised that the regulatory regime for financial sectors has been responsive to the changing marketplace and has catered to increasingly diversified and sophisticated customer demands.[532] As a result, restrictive rules on financial institutions, in terms of business powers and ownership, have been gradually removed over the years.[533] As noted, comprehensive legislative changes in the financial sector in 1992 have allowed banks to offer almost all financial services and products directly or through subsidiaries, with two notable exceptions. Banks are still prohibited from sales and distribution of insurance products and car leasing.[534] Mergers and acquisitions of the majority of securities and trust companies by chartered banks have almost been completed over the last fifteen years.[535]

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[530] *Ibid.* at 68.
[531] *Ibid.* at 47.
[532] "Competition," *supra* note 505 at 96.
[533] *Ibid.*
[534] *Ibid.*
[535] *Ibid.* at 30, 31.

Furthermore, the business activities of domestic insurance companies, which are significantly competitive with banks, have become more similar to those of securities firms and banks; for example, insurance firms are developing the so-called "universal life insurance," which gives a return to investors at the market rate, and also segregated funds, which are very similar to mutual funds. In addition, insurance companies have captured more individual savings by offering mutual funds.[536] Through their bank subsidiaries, insurance companies also offer deposit account, chequing services, and personal loans.[537]

In addition, the existence and further entries of foreign firms in the Canadian market cannot be ignored. As a matter of fact, whereas Canada has stricter restrictions on entry and business activities of foreign banks than most other countries,[538] foreign financial institutions, which are not categorized as "banks," have become increasingly dominant in the Canadian market. Not only are they expected to bring more advanced technology and skills to the Canadian market, but also they have increasingly become a threat to domestic firms in particular areas of financial business; even the large chartered banks gave up their business growth in such areas as securities custody and payroll business, and some of their divisions have already been sold to foreign financial institutions.[539] All of the financial institutions which have come into the Canadian market in such a fashion are "international giants,"[540] such as State Street and Northern Trust Company for securities custody; Newcourt Credit Group and GE Capital for asset-backed financing; Automated Data Processing Inc. and Ceridian for payroll processing; Countrywide Credit Industries for mortgage origination; and MBMA and Capital One Financial for credit card

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[536] *Ibid.* at 52.
[537] Canada, Ministry of Finance, *Change Challenge Opportunity: Improving the Regulatory Frameworks* (Task Force on the Future of the Canadian Financial Services Sector, 1998) at 45.
[538] *Ibid.*
[539] *Ibid.* at 26-31.
[540] *Ibid.* at 26.

business.[541] Furthermore, International Netherland Groups (ING) or Citizens Bank have started electronic banking services without a physical presence in Canada.[542]

It is expected that within a few years, it will hardly be possible to define the business of "banking" by the traditional concept of "banking." Corporate activities in the financial field will be further diversified and complicated by continuous innovation and development of products and services. On the other hand, it will be a significant challenge for regulators in any nation to adopt the rules that are most desirable for its financial industry, in order to accommodate industrial growth and, at the same time, to ensure the benefit and safety of consumers.

[541] *Ibid.*

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[542] *Ibid.*

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